Monetary Policy for 2019

December 2018

THE BANK OF KOREA

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The ‘Monetary Policy for 2019’ is published in accordance with the provisions of Article 6 of the Bank of Korea Act, and upon resolution by the Monetary Policy Board.

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Governor
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<The Bank of Korea Act>

Article 6 (Setting of the Operational Direction for Monetary and Credit Policies)

(1) The Bank of Korea shall set a price stability target in consultation with the Government.
(2) The Bank of Korea shall set and publish the operational direction for monetary and credit policies every year.
(3) The Bank of Korea shall do its best to achieve the price stability target as provided for in Paragraph (1).

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1. Inflation Target

The inflation target has been set at 2.0%, as measured by the year-on-year rate of change in the Consumer Price Index (CPI).

The Bank has set its inflation target for 2019 and onward at 2.0%, as measured by the year-on-year change in the Consumer Price Index (CPI). After comprehensive consideration of relevant issues such as the appropriate medium- to long-term inflation level and the cases of major advanced economies, the Bank has decided to maintain the target at its previous level of 2.0%. Starting from 2019 the Bank will seek to enhance the stability of its inflation target operations by not specifying the period of target application.*

* Between 2004 and 2018 it had explicitly stated that the inflation target would be reset before the end of each three-year application period.

To enhance the general public's understanding of inflation developments, the Bank will strengthen its communications. The Bank will publish bi-annual reports reviewing the status of its inflation target operations, with contents including an assessment of inflation developments, the inflation forecast and the related risks, as well as the future monetary policy for achieving the target. The Bank will also hold Governor's press conferences.

2. Economic Growth

Domestic economic growth is expected to sustain a rate that does not diverge significantly from its potential level.

It is forecast that the global economy will grow more moderately in 2019 than it has during 2018. Advanced economies are foreseen continuing their trends of sound growth, albeit at slower paces. The U.S. is expected to maintain its trend of solid growth, thanks to rising consumption in line with its strong labor market conditions, although the rate of growth will fall due to factors including the monetary policy normalization by the Federal Reserve and a reduction in the effects of fiscal policy. There are possibilities of financial unrest in some emerging market economies, but Asian EMEs such as India and the ASEAN-5 countries are likely to maintain momentums of growth at levels similar to those in 2018. Economic growth in China is expected to slow, however, as the pace of increase in exports eases due to the US-China trade dispute, amid the ongoing implementation of restructuring policies to promote domestic demand-driven growth. Looking ahead, the global economy faces potential uncertainties including the possibility of a worsening of the global trade disputes, concerns about slowing growth in China, and the political risks in the euro area.

It is forecast that inflation in advanced economies will fall in line with the drop in global oil prices, while emerging economies will see slightly rising inflation due to increased import prices in consequence of depreciations of their currencies.

Domestic economic growth is expected to sustain a rate that does not diverge significantly from its potential level. It is anticipated that Korean economic growth will continue, driven by exports and private consumption thanks to the sustained growth of the global economy and to the active fiscal spending by the government. While facilities investment is expected to reverse to an increase, led mainly by the IT sector, it is forecast that construction investment will remain sluggish on the effects for example of a decline in the volume of new housing starts.

However, there are both upside and downside risks to the future growth path. Among the upside risks are those due to the expansionary fiscal policies of the government and the increased investment expenditures planned by major conglomerates, while the downside risks include escalations of the global trade disputes, a slowdown in growth in China, and a delayed improvement in employment conditions.

3. Inflation

While consumer prices are foreseen rising at a rate similar to that in 2018, the rate of core inflation is expected to pick up gradually.

Consumer price inflation is forecast to be in the mid- to upper 1% range. Amid not so significant demand-side inflationary pressures, it is anticipated that supply-side factors such as agricultural product and global oil prices will have smaller impacts on prices than they had this year, but that the continued wage increases and the hikes in public service fees* will put upward pressures on prices. Core inflation (with food and energy product prices excluded from the CPI) is expected to accelerate from the lower-1% level this year to the mid-1% range in 2019, driven by the continuing wage increases. Considering the government's stance of strengthening its welfare policies,** the acceleration is expected to be moderate. The downside risks to the future price path have increased somewhat recently, due to factors including the drop in global oil prices.

* Hikes in taxi fares and gas fees are both planned.

** Through expanding the provision of free education, increasing the medical insurance coverage, etc.

4. Financial and Foreign Exchange Markets

Volatilities in the financial and foreign exchange markets could frequently increase.

As the uncertainties about the external risks are by no means small, volatilities in the financial and foreign exchange markets could frequently increase, depending on how these risks unfold. Potential factors that would cause market instability include the monetary policy normalization by the US Federal Reserve, the US-China trade dispute, the heightened volatility in the Chinese financial markets, and the political uncertainties in the euro area. Should two or more of these external risks materialize simultaneously, global investors' sentiments could weaken dramatically and cause heightened volatilities of major price variables and capital flows.

Domestic banks' foreign currency liquidity is expected to remain favorable in general, thanks mainly to the continued current account surplus. However, it is possible that the preferences for safe assets of investors in the global financial markets, and a contraction in global liquidity, could negatively affect Korea's external borrowing conditions.

5. Financial Stability

It is forecast that the financial system will remain generally stable, but that the accumulated household debt and the increased debt service burdens due to higher lending rates could work as risk factors.

The pace of growth in the supply of credit, and particularly that of household credit by the banking sector, is expected to slow. The amount of increase in banks' household lending is expected to lessen compared to that this year, owing primarily to the government's measures related to the housing markets and its introduction of the DSR regulation. Corporate lending is forecast to continue growing at a pace similar to that recorded this year, despite the new regulation on loans to sole proprietors, as banks will likely expand their operations of funds for corporate lending.* Household lending by non-bank financial institutions is on the other hand expected to grow at a level similar to that seen this year, due mainly to increased supplies of household loans in some sectors** and despite the new regulations on lending and the sluggishness of housing markets outside of Seoul and its surrounding areas.

* Banks are likely to prepare for the introduction of differences between household loans and corporate loans in the risk weights applied in calculating the loan-to-deposit ratio from January 2020.

** Household lending by credit-specialized financial companies could increase, driven in part by their active supplying of loans with medium-level interest rates in efforts to overcome their dwindling profitability.

Given the accumulated household debt, and the high proportion of variable-rate loans, it is forecast that households' interest payment burdens will increase if lending rates rise. Debt servicing difficulties will likely worsen particularly for vulnerable borrowers holding relatively many unsecured loans and loans from non-bank financial institutions, among which high proportions have floating interest rates. However, given the amount of households' financial assets,* the interest payment burdens of the household sector as a whole are unlikely to be substantial.

* The amount of households' financial assets is about 2.2 times that of their financial liabilities (flow of funds statistics, Q2 2018),
The amount of financial assets of household borrowers is about 1.1 times that of their financial liabilities (2017 Survey of Household Finances and Living Conditions).

Housing prices are forecast to remain generally stable, thanks mainly to the weaker financing capacities of multiple-home owners and rental business operators, the strengthened real estate-related taxation, and an increase in the number of newly occupied apartments.

Although the uncertainties surrounding global and domestic conditions could constrain the soundness of financial institutions, it is expected to remain relatively stable in view of their improvements in profitability and their solid asset quality and resilience.

Ⅱ Monetary Policy for 2019

The Bank will maintain its accommodative monetary policy stance, while considering macro-economic conditions such as the domestic economic and inflation trends, and financial stability conditions including the accumulation of household debt.

It will strengthen its explanation of prices in its Monetary Policy Report, so as to reinforce its policy communication, and will promote more efficient operation of its lending system as well.

The Bank will also enhance its monitoring of the possibility of expanded volatility in the financial and foreign exchange markets, and of financial system stability, and respond actively as needed in times of unrest.

1. Base Rate

(Maintaining accommodative monetary policy stance)

The Bank will operate the Base Rate so as to ensure that the economic recovery continues and consumer price inflation can be stabilized at the newly set inflation target over a medium-term horizon. As it is forecast that the domestic economy will continue to grow at a rate that does not diverge significantly from its potential level, and that the demand-side inflationary pressures will not be large, the Bank will maintain its accommodative monetary policy stance. It will closely monitor the effects on growth and inflation of changes in external uncertainties related for example to the monetary policy normalizations of major economies and the US-China trade dispute, and determine whether any further adjustment in the degree of accommodation is called for. Moreover, the Bank will make use of a variety of indicators* to closely examine whether the underlying inflation trend will converge to the inflation target.

* Core inflation and auxiliary price indices, expected inflation, global inflation, global oil prices, GDP gap, slack in employment and manufacturing, etc.

(Paying attention to financial stability)

The Bank will pay close attention to the possibility of a buildup in financial imbalances in line with the increase in household debt, and also to the possibility of expansions in financial and foreign exchange market volatility in consequence of changes in external risk factors. The pace of increase in household debt is slowing, but considering the fact that it is still faster than the rate of income growth, and could constrain consumption and growth, the Bank will continue to examine the trends of household debt and the various conditions that can influence them. It will also continually check for any considerable levels of fund inflows to specific asset entities. The increase in global risk aversion in the process of the monetary policy normalization by the US Federal Reserve, and the expanding concerns about the Chinese economy, could lead the volatility of capital flows and price variables to grow, and the Bank will thus strengthen its monitoring of financial markets in Korea and abroad.

(Keeping General Principles of Monetary Policy Operation unchanged)

After a review of whether any revision or improvement of its 「General Principles of Monetary Policy Operation」 (announced in 2016) is needed,* the Bank has decided to leave the Principles unchanged.

* In consideration of the relationships between its policy objectives and the various factors that the Bank considers in operating its policy, of the necessity for any changes in its basic principles for achieving its objectives, etc. (<Ref.> 「General Principles of Monetary Policy Operation」).

2. Improving the Effectiveness of Monetary Policy

(Enhancing policy communication)

The Bank will strengthen its monetary policy communication, by improving the effectiveness of its monetary policy. It will offer more explanations of price movements in its Monetary Policy Report, in order to help economic entities to better understand the inflation target and the inflation situation. It will expand its explanations of any changes in major determinants of prices such as aggregate demand and cost factors, and their effects, and of the resulting future inflation path. The Bank will continue its efforts to achieve efficient policy communication by improving its monetary policy decision statement, so that in this uncertain policy environment market participants' expectations of monetary policy can form in accord with the Bank's policy intentions.

(Improving efficiency of open market operations)

The Bank will work to improve its open market operations system in ways that boost the incentives for eligible institutions to participate in the competitive bidding for Monetary Stabilization Bonds.

(Flexible responses to changes in policy conditions)

The Bank will respond effectively to changes in financial and economic conditions at home and abroad. It will consider, in a timely manner, changes in global financial and economic conditions related for example to the possibilities of a slowdown in global economic growth and of a change in the pace of monetary policy normalization by the US Federal Reserve, and reflect them in its conduct of monetary policy. It will also work to enhance its monetary policy effectiveness by analysing how structural changes in finance and the real economy, including the shifting relationship between growth and inflation, the dual labour market, and the deepening of financial imbalances, influence the monetary policy transmission effects.

3. Effective Management and Continuous Rationalization of Lending Facilities

(Enhancing effectiveness of Bank Intermediated Lending Support Facility)

The Bank will continue to improve the Bank Intermediated Lending Support Facility, so as to enhance the effectiveness of its monetary policy and maximize the effects of its funding support for SMEs. It will examine the operating conditions of its Program for Stabilization of SME Lending, and also review the ceilings of the different individual programs and whether their ways of operation are appropriate. The Bank will continue to examine the effects of the Bank Intermediated Lending Facility in reducing lending rates, in an intensified effort to ensure that its funding support leads to cuts in the lending rates charged to SMEs. To enhance the effectiveness of its SME financial support it will improve its SME lending ratio system, and also maintain its focus on securing the appropriateness of its funding support through follow-up management and joint examinations of the loans extended under this system.

(Continued rationalization of lending facilities)

To ensure the efficient management of its lending facilities, the Bank will consider establishing principles for the operation of its lending collateral system. It will examine the standards for eligibility of marketable securities as collateral, so as to ensure the reliable and adequate provision of liquidity in response to changes in financial and economic conditions.

4. Promoting Financial and Foreign Exchange Market Stability

(Preparing for possibilities of expanded volatility)

The Bank will prepare for the possibilities of heightened volatility in the financial and foreign exchange markets, and deal actively with any market unrest as necessary. It will closely monitor the developments of international and domestic risk factors and the movements of price variables and domestic portfolio investment by foreigners, and continually check and supplement its Contingency Plans to reflect changes in conditions related to the various risk factors. In any events of financial market unrest the Bank will promptly convene meetings of its 「Monetary and Financial Task Force」 and its 「Financial and Economic Conditions Review Meeting」 for example, and by actively expressing its commitment to market stabilization as necessary prevent the spread of market anxieties. The Bank will leave interest and exchange rates to be determined basically by market supply and demand, and in cases of worsening instability, such as excessive herding behavior in specific directions, adopt step-by-step measures in response in a timely manner so as to ensure market stability.

(Strengthening global policy·financial cooperation)

The Bank will work to enhance its capacities for responding to external shocks, by means such as expanding its roles in international organizations and cooperative bodies and working to enhance the regional and global financial safety nets. By participating actively and playing a leading role in discussions led by international organizations and cooperative bodies,* and delivering accurate information on Korea's economic conditions and outlook, the Bank will contribute to enhancing Korea's external credibility. The Bank will participate actively in the discussions of the IMF 15th General Quota Review,** and in the ASEAN+3 on enhancing the functions of CMIM, while deepening its financial cooperation with central banks in major countries.

* The Bank will expand its role in international organizations by newly assuming membership on the BIS Board of Directors from January 1, 2019.

** The quotas are the amounts of contributions that member countries make to the IMF. In accordance with Section 2, Article 3 of the IMF's Articles of Agreement, a general quota review, which looks into the overall quota policies, including whether to increase the quotas and how they are allocated among the individual members, shall be conducted at intervals of not more than five years.

5. Maintaining Financial System Stability

(Strengthening examinations of financial system stability)

The Bank will closely monitor financial system stability in responding to any changes in domestic or international financial and economic conditions, and preemptively identify potential risk factors and recommend appropriate measures for responding. The Bank will assess the vulnerabilities and resilience of the financial system through its 「Financial Stability Meetings」, and warn against any risk factors at an early stage through its 「Financial Stability Report」 for example. The Bank will analyze the impacts on financial stability of factors causing uncertainty internationally, and of changes in housing market conditions domestically for example. By heightening the sophistication of its methods of risk measurement and assessment,* the Bank will work to enhance its accuracy in analyzing conditions related to financial stability. It will also work to identify at an early stage any factors triggering systemic risks, through the monitoring and targeted examination of individual financial institutions. In its conduct of joint banking examinations the Bank will place its focus on household and corporate borrowers that have weak debt servicing capacities, and on analyzing the effects of regulations. It will also actively discuss this in its 「Financial Stability Report」. The Bank will bolster its research on the impacts of digital innovation including the spread of FinTech, and seek policy options in this area related to financial stability.

* Through revision of the Financial Stability Index (FSI) so as to enhance its function as a leading indicator of crises, and by making active use of the FI-Net (financial stability information collection and sharing system)

(Strengthening cooperation with domestic and international institutions involved in promoting financial stability)

The Bank will cooperate closely with domestic and international institutions involved in promoting financial stability, and draw up measures to cope effectively with financial stability risks. The Bank will share with the government and the supervisory authorities its views on major current issues related to financial stability, and discuss measures in response to them, and will also participate continually in the discussions on global financial stability and regulations led by international organizations including the FSB, the BCBS and the CPMI.

(Expanding and improving payment and settlement infrastructure)

The Bank will constantly strive to expand and improve the financial and settlement infrastructure, including BOK-Wire+. It will carry out the project of constructing the next generation BOK-Wire+ (to be launched in 2020) on schedule, so as to enhance the convenience of funds transfers for financial institutions and promote system stability. The Bank will continue its research at the technical level (e.g. through simulation tests) on the applicability of innovative digital technologies such as distributed ledger technology to the payment and settlement infrastructure, while also seeking to facilitate a variety of mobile payment services so as to enhance financial consumer convenience and reduce settlement fees.

(Evaluating safety and encouraging improvements of payment and settlement infrastructures)

The Bank will assess the safety of the important payment and settlement infrastructures in accord with the strengthened international standards, and encourage improvements in them as necessary. It will rearrange its net settlement risk management system, by raising the collateral-to-net debit cap ratio to help financial institutions strengthen their credit risk management, and by expanding the range of assets eligible as collateral in consideration of the increased burdens of financial institutions in putting up collateral. The Bank will cope proactively with international organizations' examinations* of the progress made in implementation of the global financial regulations related to payment and settlement. It will also closely analyze risk factors resulting from the spread of payment service provision by non-financial companies, and draw up effective monitoring measures as necessary.

* An assessment of Korea's major payment and settlement infrastructures is scheduled as part of the "IMF/WB Financial Sector Assessment Program (FSAP)" in 2019.

<Reference>

General Principles of Monetary Policy Operation

The Bank of Korea Act stipulates the goal of monetary policy as follows: "The Bank shall contribute to the sound development of the national economy through ensuring price stability, while giving due consideration to financial stability in carrying out its monetary policy." In order to enhance transparency, predictability and effectiveness of monetary policy, the Bank will carry out its task by setting specific targets and objectives in accordance with this goal.

□ **(Inflation targeting)** The Bank of Korea maintains a flexible inflation targeting system to effectively achieve price stability, which is the primary objective of monetary policy. The inflation target is currently set at 2.0% in terms of consumer price inflation (year-on-year).

- o **(Medium-term horizon)** The inflation target is meant to be achieved over a medium-term horizon, since consumer price inflation is affected not only by monetary policy but also by various other factors at home and abroad, which entail transitory and irregular impacts and the lag in monetary policy transmission.

- o **(Forward-looking operation)** The Bank conducts its monetary policy in a forward-looking manner, while considering symmetrically the risks of inflation remaining persistently above or below the target. The path of convergence of inflation toward the target is assessed on overall inflation and growth outlooks as well as their uncertainties and risks, and on financial stability conditions.

- o **(Flexible operation)** The Bank conducts its monetary policy to support real economic growth to the extent that this does not hinder attaining the inflation target over the medium-term.

□ **(Consideration of financial stability)** In ensuring price stability over the medium-term, the Bank pays careful attention to the impact of monetary policy on financial stability.

- o **(Relationship with inflation targeting)** As persistent financial imbalance could undermine macroeconomic stability, paying due attention to financial stability in conducting monetary policy is consistent with the rationale behind flexible inflation targeting.

- o **(Examination of financial stability)** The Bank examines, assesses and announces financial stability conditions on a regular basis, to prevent excessive buildup of financial imbalances that may be brought about by monetary policy implementation.

- o **(Harmonization with macroprudential policy)** Since there are limits to maintaining financial stability solely by monetary policy that indiscretely affects the whole economy, monetary policy needs to be complemented by macroprudential policies to prevent accumulation of financial imbalance.