

Monetary Policy for 2020

December 2019

BANK OF KOREA

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‘Monetary Policy for 2020’ 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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<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).

1. Economic Growth

Domestic economic growth is projected to be in the lower 2% range, slightly higher than that of the previous year.

Although global growth is expected to improve at a moderate pace, there still remain uncertainties regarding the persistence of trade protectionism and geopolitical risks. Advanced economies in general are forecast to maintain growth rates similar to 2019 levels, although they may differ from country to country. It is forecast that the US growth rate will achieve its potential level on the back of consumption, and the euro area will maintain a modest growth rate with the easing of the sluggishness in the manufacturing sector. However, Japan's economic growth is likely to slow, affected by the consumption tax hike. EMEs are expected to witness a recovery in their growth momentum, thanks to the easing of the global trade contraction and to expansionary macroeconomic policy. However, a moderate slowdown in economic growth is likely to continue in China, owing to uncertainty concerning the US-China trade dispute and to the Chinese government's continuing economic rebalancing efforts. With regard to the future growth path of the global economy, there are potential uncertainties such as continuing trade protectionism and geopolitical risks. Meanwhile, global inflation will be higher than that of the previous year due to the improvement in growth momentum, but its increase will be constrained by factors such as the fall in international oil prices.

Domestic economic growth is projected to be in the lower 2% range, slightly higher than that of the previous year. Supported by eased sluggishness in global trade, recovery of the semiconductor industry, and the government's expansionary fiscal policy, facilities investment and exports will improve and private consumption is expected to recover gradually after the second half of next year. With the growth rate staying below its potential level, however, the negative output gap is expected to widen modestly. There is a high level of uncertainty surrounding the future growth path. Downside risks include continuing global trade disputes, heightened geopolitical risks, and delayed recovery of the semiconductor industry. Among the upside risks are a trade agreement between the US and China and stronger domestic demand in line with the government's active countercyclical policy.

2. Inflation

While consumer price inflation is expected to be higher than that of the previous year, it is set to remain below the target.¹⁾

Consumer prices are forecast to increase by around 1.0%. Inflation is projected to be higher than that of the previous year as supply-side downward pressures on prices ease, but tepid demand-side inflationary pressures and the government's stance of strengthening support for education and healthcare are likely to continue. Core inflation (CPI excluding food and energy prices) is expected to be in the upper 0% range, similar to that of the previous year.

While upside risks to the future inflation path include stronger improvement in domestic and global economic activity and the possibility of hikes in some public service fees, there still remain downside risks, such as the government's expanding of its welfare policies and weaker demand-side inflation pressures due to a delayed recovery in domestic demand.

3. Financial and Foreign Exchange Markets

Volatility in the financial and foreign exchange markets might frequently increase.

Volatility in the financial and foreign exchange markets might frequently increase, depending on how external risk factors unfold. Expectations of improvement in growth momentum, both domestic and global, as well as the accommodative monetary policy stance will have a positive impact on investor sentiment. However, there remain some destabilizing factors, such as uncertainties over follow-up trade negotiations between the US and China, and over the global economy, as well as geopolitical risks. Should these external risks materialize, risk aversion could intensify and thus cause heightened volatility of major price variables and flows of foreign portfolio investment.

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 Korea's external borrowing conditions could be negatively affected by future developments in the global financial market.

1) When setting its 「Inflation target for 2019 onwards」 at 2.0% in Dec. 2018, the Bank of Korea decided not to specify the period of target application, in order to enhance the stability and credibility of its inflation targeting framework.

4. Financial Stability

It is forecast that financial institutions' supply of credit will be fair and their financial soundness will remain stable. Risk factors, however, include the possibility of increased inflows into real estate and high-risk assets as well as weakening debt servicing capacities of vulnerable borrowers.

The supply of credit by financial institutions, especially to the corporate sector, is expected to be fair in general. It is projected that the pace of growth in household lending will continue to slow gradually, owing to the government's tightening of macroprudential policies. Corporate lending is forecast to sustain a relatively high rate of growth, led by SME lending.

The soundness of financial institutions is projected to remain stable in general, based on their solid asset quality and resilience. However, possible risk factors include expanded fund inflows to real estate and high-risk assets in line with the low-for-long rates, and the possibility of weakening debt servicing capacities of vulnerable households and marginal firms due to continued low growth.

The Bank will maintain its accommodative monetary policy stance, while judging whether to adjust the degree of monetary policy accommodation in overall consideration of developments of macroeconomic and financial stability conditions.

It will enhance the effectiveness of monetary policy and come up with efficient operational measures of policy instruments.

The Bank will strengthen its monitoring of the financial and foreign exchange markets and its review 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 in an accommodative manner so as to ensure that the economic recovery continues and consumer price inflation can be stabilized at the inflation target (2.0%) over a medium-term horizon. The Bank is taking into account that domestic economic growth is expected to remain below the potential growth rate and that demand-side inflationary pressures will be weak. When determining whether any further adjustment in the degree of accommodation is called for, the Bank will consider the developments of major risk factors including the US-China trade dispute and global economic activity, as well as the changes in domestic macroeconomic trends and financial stability conditions. In the process, the Bank will closely monitor the underlying inflation trend using various indicators.²⁾

(Paying attention to financial stability)

The Bank will pay attention to the risk of a buildup of financial imbalances in line with the continued accommodative financial stance, and also to the possibility of heightened volatility in capital flows and in financial markets in consequence of changes in external risk factors. The Bank will closely examine the pace of growth in private credit including household and corporate loans, and any considerable levels of fund inflows to specific asset markets. It will carefully monitor how the developments in external uncertainty factors affect, for example, risk appetites and global liquidity flows.

2) Core inflation and auxiliary price indices (such as core inflation excluding administered prices), expected inflation, GDP gap, etc.

(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,³⁾ the Bank has decided to leave the Principles unchanged.

2. Improving the Effectiveness of Monetary Policy

(Enhancing policy communication)

The Bank will improve the effectiveness of its monetary policy by strengthening its monetary policy communication. The Bank will provide more explanation of the background behind policy decisions, by continuously improving its monetary policy decision statement and by further disclosing the monetary policy meeting materials. By reviewing the status of its inflation target operations (twice a year), the Bank will faithfully explain inflation conditions and forecasts, related risks, and the monetary policy direction.

(Enhancing research and analysis in response to changes in economic conditions)

Taking into consideration the changes in global and domestic economic conditions, the Bank will strengthen its research and analysis in areas such as operations of the inflation targeting framework, transmission effects of monetary policy, and monetary policy instruments other than interest rates, and subsequently seek relevant countermeasures. It will review provisions required for improving the operation of the inflation targeting framework.⁴⁾ It will enhance the analysis of factors that cause medium- to long-term changes in inflation, such as changes in inflation dynamics. Furthermore, based on this analysis, the Bank will seek measures to effectively operate its inflation targeting framework. The Bank will examine and analyze the effects and channels of monetary policy transmission, in view of structural changes both at home and abroad. In preparation against a reduction of the interest rate policy space, the Bank will strengthen its research into the application of non-interest rate monetary policy instruments that are appropriate for domestic financial and economic conditions over the medium- and long-term horizon.

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

4) According to the 「Inflation target for 2019 onwards」 (set on Dec. 26, 2018), the Bank of Korea reviews whether any improvements are required on a bi-annual basis and after consultation with the government, the Bank discloses and explains the results to the public.

3. Effective Management of Lending Facilities

(Enhancing Bank Intermediated Lending Support Facility's support for economic growth)

The Bank will support the recovery of the Korean economy through the Bank Intermediated Lending Support Facility. The Bank will carry out an analysis of the operational performance of the facility reform (Oct. 2019) to review its effects and identify measures for improvement. In reflection of changes in the credit environment and funding conditions facing SMEs, the Bank will flexibly adjust individual program ceilings and operation methods. It will intensify efforts to ensure that its funding support leads to reductions in the lending rates charged to SMEs.

(Reform of lending collateral system)

In consideration of financial institutions' available collateral and financial market conditions, the Bank will consider expanding the scope of securities eligible as collateral. If the scope is expanded, the Bank will review and strengthen the management of collateral risks such as adjusting haircut ratios.

4. Promoting Financial and Foreign Exchange Market Stability

(Continuing efforts for financial and foreign exchange market stability)

The Bank will closely examine the possibility of unrest in financial and foreign exchange markets, and conduct market stabilization measures in a timely manner if needed. It will examine and supplement its contingency plans on a regular basis, and if market unrest occurs, the Bank will immediately initiate said plans, such as convening the 「Monetary and Financial Task Force」. 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.

(Improving the foundation for liquidity adjustment)

To respond flexibly to changes in market conditions, the Bank will review liquidity provision channels and expand the size of Treasury bond holdings. It will conduct outright purchases of Treasury bonds to expand its holdings for RP sales. In preparation against the possibility of heightened money market volatility, the Bank will conduct RP purchase tests on non-banks.⁵⁾ In consideration of changes in market

conditions, the Bank will improve the standards for selecting institutions subject to open market operations and the related bidding system.

(Strengthening efforts to supplement the benchmark rate)

The Bank will strengthen efforts to enhance the credibility of the existing benchmark rate and to develop a new risk-free benchmark rate. In consideration of major countries' cases, and in keeping with global trends, the Bank will, together with relevant authorities, select a new risk-free benchmark rate and pursue tasks related to disclosure.

(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 strengthening regional and global financial safety nets. The Bank will participate actively in discussions on major global issues led by international organizations and cooperative bodies, while continuing to deepen its financial cooperation with central banks in major countries.

5. Maintaining Financial System Stability

(Strengthening early warning activities)

Considering the high level of uncertainty in domestic and external conditions, the Bank will strengthen early warning activities to prevent unexpected shocks from spreading into financial systemic risks. The Bank will analyze and review the risk of a buildup of financial imbalances amid low interest rates, the possibility of an increase in household and corporate credit risks, and their impacts on financial institutions' soundness in a multi-faceted way through the 「Financial Stability Report」. The Bank will detect systemic risk factors at an early stage, by improving the accuracy of its analyses of financial stability conditions,⁶⁾ and enhancing the monitoring and sectoral inspections of individual financial institutions.

5) Non-bank financial institutions are currently selected as institutions subject to RP transactions. However, as there is no history of RP transactions with non-bank financial institutions, the Bank will purchase RPs from them to enhance its response capacities in emergencies.

6) Through the revision of the Financial Stability Index (FSI), the Bank will enhance its early warning function and continuously supplement the existing risk assessment models.

(Improving payment and settlement infrastructure)

The Bank will continue to improve payment and settlement services by reinforcing relevant infrastructure. For example, the Bank plans to complete the installation of the next-generation BOK-Wire+ by the second half of 2020. The Bank will also promote a mobile debit payment service,⁷⁾ which has been jointly developed with the banking sector. In line with rapid innovation in fintech, the Bank will draw up access criteria in a direction that increases the openness of the payment and settlement systems while ensuring security of these systems.

(Facilitating payment and settlement innovation and strengthening the oversight framework)

The Bank will continue to build on the research into new innovations such as distributed ledger technology, crypto assets, and CBDC, and play an active role as overseer to enhance security of the settlement systems. The Bank will organize a task force dedicated to CBDC research and recruit additional experts. At the same time, it will actively engage in discussions with the BIS and other international organizations, keeping an eye on CBDC development at other central banks. Based on the 「Principles for Financial Market Infrastructures」, the Bank will enact assessment principles, reflecting domestic conditions, to improve the effectiveness of its oversight of the payment and settlement systems.

7) This service enables easy payments, the use of ATMs, deposits of change to bank accounts, and withdrawals at member stores.

<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).
 - **(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.
 - **(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.
 - **(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.
 - **(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.
 - **(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.
 - **(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.