

■ Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad from October 2016 through April 2017 reveals the following. In the global economy, signs of a somewhat accelerating pace of recovery appeared. The United States sustained its trend of robust growth, with consumption increasing consistently thanks for example to favorable employment conditions. The euro area and Japan meanwhile maintained modest trends of improvement, and China continued its stable growth.

Economic growth in major economies¹⁾

	2014		2015		2016						
	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	
US	2.4	2.6	1.6	0.8	1.4	3.5	2.1				
Euro area	1.2	2.0	1.8	2.2	1.3	1.7	1.9				
Japan	0.3	1.2	1.0	1.9	2.2	1.2	1.2				
China	7.3	6.9	6.7	6.7	6.7	6.7	6.8				

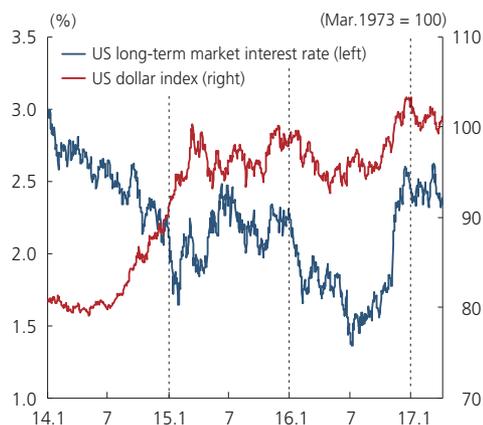
Note: 1) The quarterly rates of growth are annualized quarter-on-quarter rates for the US, Japan and the euro area, and year-on-year rates for China.

Sources: Individual countries' published statistics.

In the international financial markets, long-term market interest rates in major countries and the value of the US dollar rose greatly after the US presidential election in November 2016, but from mid-December then showed generally stable pictures, with their paces of increase slowing for example. Entering March 2017 long-term market rates and the value of the dollar rose again, on forecasts that the US Federal Reserve would hike rates at a pace

faster than had been previously expected, but after the FOMC meeting the markets regained stability as these concerns eased.

US long-term market interest¹⁾ rate and US dollar index²⁾

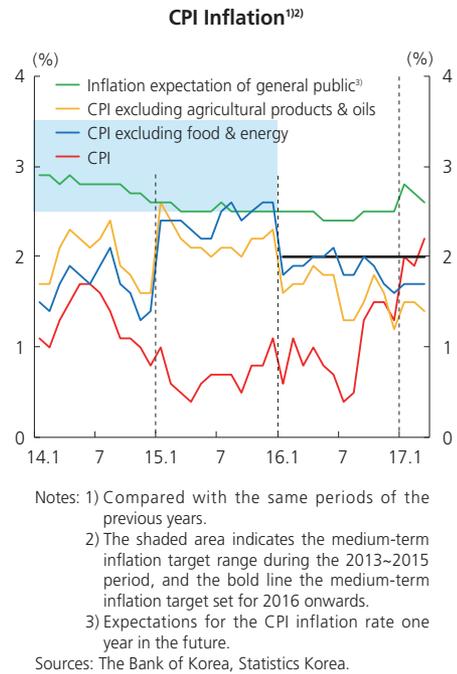
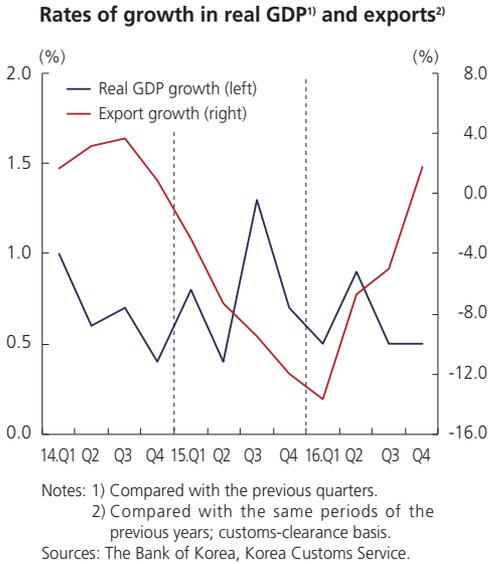


Notes: 1) Treasury bond (10-year) yields.

2) The measure of the value of the US dollar relative to a basket of foreign currencies (EUR, JPY, GBP, CAD, SEK, CHF).

Source: Bloomberg.

2 The domestic economy continued its trend of modest growth even despite sluggishness in private consumption, owing to improvements in exports and facilities investment. During the fourth quarter of 2016 the growth rate (quarter-on-quarter) was 0.5%, notwithstanding slumps in private consumption and exports, as facilities investment improved. It is judged that the pace of growth then picked up somewhat in the first quarter of 2017 – due to buoyancy in exports mainly of semiconductors and petroleum products, to significantly improved facilities investment, and to a continuing solid trend of growth in construction investment.



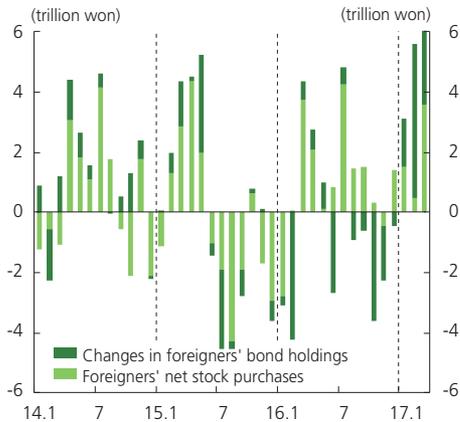
③ The rate of domestic consumer price inflation rose from the mid-1% range in the fourth quarter of 2016 to around 2% during the first quarter of 2017, as a result mainly of supply-side factors such as increases in the prices of oil, agricultural, livestock and marine products. The inflation expectations of the general public also climbed somewhat, but core inflation, which shows the underlying price movements, remained at the mid- to upper-1% level.

The pace of increase in housing sales prices meanwhile slowed greatly from November 2016, on factors such as the government’s housing market stabilization policies, including the 11/3 real estate measures, as well as the rise in domestic market interest rates after the December rate hike by the Federal Reserve. Entering 2017 they then showed steady movements. Leasehold deposit prices meanwhile sustained their trend of general stability.

④ In the domestic financial markets, major price variables including interest rates, stock prices and exchange rates showed relatively large fluctuations, influenced for example by changes in international financial market conditions. Long-term market interest rates rose greatly after the US presidential election in November 2016, together with interest rates in major countries, as inflation concerns emerged due for example to the expansionary fiscal policies of the Trump administration. They later stabilized as the Bank of Korea implemented market stabilization measures, including purchases of Treasury bonds and reductions in its Monetary Stabilization Bond issuance. The won/dollar exchange rate had also shown a rising trend after the US election, but then fell greatly entering 2017 in line for example with the new US government’s statements

cautioning against the trend of dollar strengthening, and its protectionist tendencies. Portfolio investment funds of foreigners meanwhile shifted to net inflows, as global financial market volatility eased after December 2016.

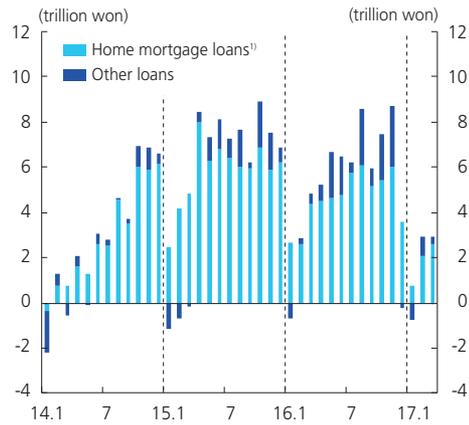
Changes in foreigners' domestic portfolio investment



Sources: Financial Supervisory Service, KOSCOM.

⑤ The pace of increase in household lending by banks slowed – for reasons such as a reduction in the housing transaction volume, the effects of the government's policies concerning household loans and real estate, and rising loan interest rates. Household lending by non-bank financial institutions on the other hand sustained a high rate of increase.

Changes in banks' household loans¹⁾



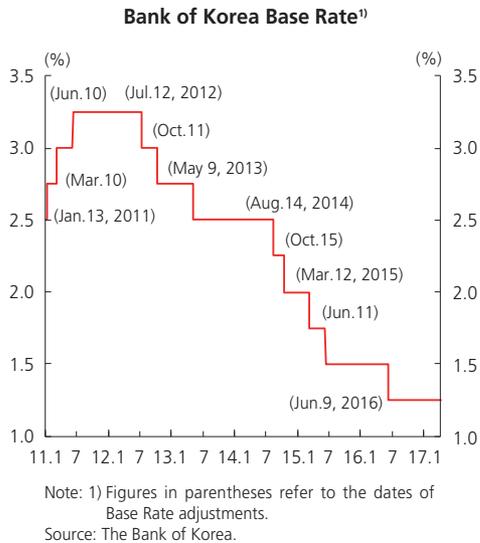
Notes: 1) Compared with the previous months.

2) Including mortgage transfers.

Source: The Bank of Korea.

[Conduct of Monetary Policy]

⑥ The Bank of Korea conducted its monetary policy accommodatively during the October 2016 to April 2017 period, to ensure that the recovery of economic growth continues and consumer price inflation approaches the target level over a medium-term horizon. In this process it devoted attention to financial stability as well, and closely monitored the uncertainties surrounding conditions in Korea and abroad, as well as their effects, the changes in monetary policies of major countries including the US, the trends of growth in household debt, and so on.



7 Under this policy stance the Bank of Korea held the Base Rate at a level of 1.25% per annum throughout this period. The factors considered most importantly at the times of the monetary policy decisions were as follows:

During the October to December 2016 period the Base Rate was maintained at 1.25% per annum. The decisions to do so were based on the Bank's judgment that, notwithstanding the increased downside risks to the economic growth path, in view of the high uncertainties about conditions at home and abroad, it was desirable to cautiously watch future changes in conditions and their effects on the domestic financial markets and economy. First, it was forecast that the domestic economy would continue its weak but moderate trend of growth during this period, due to the recovery of the global economy. However, as the trend of recovery in domestic demand had been limited, owing to factors such as a contraction in

sentiment, the downside risks to the growth path were judged to have risen somewhat. There was a need to consider as well the significantly increased uncertainties related to domestic and overseas conditions, including the results of the US presidential election and the new US government's policies, the normalization of monetary policy by the US Federal Reserve, and the domestic political situation. The rate of consumer price inflation had shown a level in the low- to mid-1% range, but was accelerating on the effects for example of rising international oil prices, and was forecast to gradually rise to approach the inflation target level. It was in addition judged necessary to be even more mindful of the risks on the financial stability side, as volatilities in the financial and foreign exchange markets at home and abroad were growing due to the uncertainties about domestic and foreign conditions and household loans were sustaining high paces of increase greatly above normal years' levels at both banks and non-bank financial institutions.

During the January to March 2017 period the Bank continued to maintain a Base Rate of 1.25% per annum as well. The decisions to hold it unchanged were made in view of the points that the domestic economy was expected to continue its moderate pace of growth and the rate of consumer price inflation was forecast to move close to the 2% target level, and that it was necessary to be continuously mindful of financial stability given the very high uncertainties surrounding domestic and external conditions. First of all, the domestic economy was expected to continue its moderate pace of growth as

exports and investment improved, even though consumption remained sluggish due to a contraction in sentiment. Another point considered was that demand-side inflation pressures were not great, as core inflation, which shows the underlying price movements, had maintained the mid- to upper-1% level even though consumer price inflation had reached the 2% inflation target level. On the financial stability side, meanwhile, there was a need for caution related to the rising possibility of an additional policy rate hike by the US Federal Reserve in line with the continuing recovery of the US economy, as well as to the political uncertainties in the euro area. Although household lending had risen at a slower pace, due mainly to a slowdown in lending by banks, the need to wait to observe whether these movements would become a long-term trend was taken into account.

The Bank of Korea held the Base Rate at 1.25% per annum in its April meeting as well. This was a result of comprehensive consideration of several points – that although the pace of domestic economic recovery had picked up somewhat recently, the uncertainties concerning the future growth path remained high, that it was being forecast that consumer price inflation would move at around the 2% inflation target level, and that it was necessary to continue focusing on risks to financial stability related for example to the expansion in household debt and to the hikes in interest rates by the US Federal Reserve. Specifically, the domestic economy was expected to record a GDP growth rate slightly exceeding the January forecast figure

(2.5%), thanks to improvements in exports and investment in line with the global economic recovery, but it was assessed that its growth could be hindered by trade conditions vis-à-vis major countries and by inadequate improvements in household real purchasing power. The point was also considered that consumer price inflation was forecast to show a level of 1.9% for the entire year, while upward pressures on consumer prices from the demand side were not high. Meanwhile, it was also judged necessary to bear in mind the possibility of expanding volatilities in the financial and foreign exchange markets, since the uncertainties about domestic and external conditions including monetary policy normalization by the US Federal Reserve and geopolitical risks remained high. In addition, it was considered necessary as well to devote continuing care to the risks to financial stability given the increasing household debt resulting from the high pace of increase in household lending by non-bank financial institutions, although the increase in household lending by banks had contracted.

⑧ The Bank of Korea continued its policy efforts for achieving financial and foreign exchange market stability. While on the one hand closely monitoring the movements of major price variables including interest and exchange rates, the in- and outflows of foreigners' investment funds, etc., it also responded actively to emergent destabilizing factors at home and abroad by activating its emergency response system, strengthening its communication, and implementing market stabilization measures, and promoted market stability thereby. At the times of announce-

ment of the US presidential election result (November 2016), the National Assembly's passage of the presidential impeachment bill (December) and the Constitutional Court's decision to impeach the president (March 2017), it convened its 「Emergency Financial and Economic Conditions Review Meeting」 and 「Emergency Executive Meeting」, and closely examined financial and economic conditions in Korea and abroad, while at the same time heightening its communication with the markets to ensure that anxieties in sentiment did not spread. In particular, during the period 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 including purchases of Treasury bonds and a reduction in Monetary Stabilization Bond issuance.

The Bank also devoted efforts to presenting early warnings and suggesting directions for response through identification of potential risks in advance in the financial system. In December 2016 it reformed the analysis framework used in its 「Financial Stability Report」, and closely assessed the vulnerabilities in financial conditions in the household and other sectors while checking on resilience for withstanding domestic and external shocks. In March 2017 it held a regular Monetary Policy Board meeting for the examination of financial conditions, and analyzed in depth financial stability conditions in various sectors such as the credit markets, the asset markets, financial institu-

tions, etc., and examined financial system resilience. Moreover, it also released the main contents of this meeting's discussions to the public on the day of the meeting, and thereby strengthened its communication with market participants.

[Future Monetary Policy Directions]

㉑ In the Bank's 「Economic Outlook Report」 released on April 13, 2017, it forecast that the domestic economy will continue its moderate pace of growth, thanks to improvements in exports and facilities investment in line with the global economic recovery, and record a growth rate of 2.6% in 2017. In 2018 the growth rate is expected to then rise to 2.9%, as the world economy's trend of recovery continues. Looking at the contributions to growth of the different expenditure sectors in 2017, the contribution of the export sector will maintain its level of last year, but the contribution of domestic demand seems likely to decrease slightly. Concerning the future growth path, there is a mix of both upside and downside risks. Among the former are an expansion in the external demand recovery due to strengthening trends of improvement in the global economy and in IT business conditions, a decline in the effects of China's measures to limit trade, and economic stimulus policies by the new Korean government. The downside risks meanwhile include those of weakening world trade growth due to strengthened protectionism, of expansions in the effects of China's measures to limit trade, and of increased financial market volatility stemming for example from an upsurge in geopolitical risks.

Economic growth outlook¹⁾

(%)

	2016			2017*			2018*
	Year	1st half	2nd half	Year	1st half	2nd half	Year
GDP	2.8	3.2	2.5	2.6	2.6	2.7	2.9
Private consumption	2.5	2.9	2.1	2.0	1.9	2.0	2.3
Facilities investment	-2.3	-3.7	-0.9	6.3	9.5	3.3	3.4
Intellectual property products investment	2.3	1.9	2.6	2.7	2.5	2.9	3.2
Construction investment	10.7	9.9	11.4	4.5	7.3	2.2	-0.1
Goods exports	2.2	1.3	3.0	3.3	4.0	2.6	3.5
Goods imports	3.6	2.7	4.5	4.0	6.2	1.8	3.4

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

Source: The Bank of Korea.

It is forecast that consumer prices will rise by 1.9% during 2017, and they are expected to show a pace of increase at the same level in 2018 as well. The upside and downside risks to the future path of inflation are also assessed as mixed, with the overall risk neutral. The major upside risks include those of a rise in international oil prices after an extension in the production cuts agreed on by OPEC oil-producing countries, of an acceleration of the domestic economic recovery owing for example to improvements in the global economy, and of worsening weather conditions. Among the potential downside risks to prices are an increase in US shale oil production and a dulling of demand-side price pressures owing for example to increased economic uncertainties in Korea and overseas.

Inflation outlook¹⁾

(%)

	2016			2017*			2018*	
	Year	1st half	2nd half	Year	1st half	2nd half	Year	
CPI inflation	1.0	0.9	1.1	1.9	2.0	1.8	1.9	
Core Inflation:	CPI excluding food & energy	1.9	1.9	1.8	1.7	1.6	1.7	1.9
	CPI excluding agricultural products & oils	1.6	1.7	1.5	1.5	1.4	1.6	1.9

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

Sources: The Bank of Korea, Statistics Korea.

⑩ Among the major issues that will have to be considered in the future operation of monetary policy, we have looked closely at the effects of monetary policy normalization by the US Federal Reserve, at whether the high extent of growth in household lending will continue, and at global inflation conditions.

The US Federal Reserve's monetary policy normalization will work as a factor heightening capital outflow pressures. However, after comprehensive consideration of past cases of capital outflows, and of current economic conditions at home and abroad, we appraise the possibility of large-scale outflows to be limited. However, in any case where financial markets in some EMEs with relatively high external vulnerabilities become unstable as global risk factors materialize, a possibility also exists of capital outflow pressures growing in Korea due to contagion, and there is as a result a need for close review of developments related to the various risk factors.

Entering 2017 the pace of increase in household lending slowed. This slowdown, occurring primarily in lending by banks,

seems a consequence mainly of a reduction in housing transactions, of the effects of the government's household lending and real estate-related policies, and of increases in loan interest rates. In the future as well the pace of lending growth is expected to slow compared to 2016, on the effects of the government's household loan-related policies and of hikes in lending rates. However, if the housing economy improves after the spring moving season, there is a possibility that the extent of slowdown in household lending growth will not be large, and it is hence necessary to sustain close monitoring of household lending trends.

The trend of increase in global inflation will put upward pressures on domestic prices, but it is judged unlikely that the domestic inflation trend will accelerate to a large extent due to this. However, given the point for example that the effects of global inflation on domestic prices have become stronger compared to the past, it is necessary to continue to check for any changes in global inflation and their effects.

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 Bank of Korea plans to maintain its accommodative monetary policy stance, as the upward price pressures on the demand side are not expected to be significant for

the time being given the moderate economic growth. In this process it will closely examine developments related to domestic and external risk factors, along with any resulting changes in financial and economic conditions, and analyze in depth their effects on the future paths of growth and inflation. Besides consumer price inflation, the Bank will moreover also closely watch the movements of indicators including core inflation, expected inflation, international oil price trends, various auxiliary price indices, the GDP gap, and idle production capacities in employment and in the manufacturing industry.

In view of the fact that the domestic and external uncertainties surrounding the Korean economy recently are higher than ever before, efforts will be made in addition to ensure that financial market stability is firmly maintained. The Bank will strengthen its examinations related to potential risk factors that could heighten financial market volatilities at home and abroad, such as Korea's trading conditions vis-à-vis major countries, geopolitical risks, the trends of monetary policy normalization by the US Federal Reserve, the developments of the new US government's policies, etc., while closely monitoring capital in- and outflows as well. And since it also remains uncertain whether the slowdown in the pace of increase in household debt has become a trend, the Bank will thoroughly monitor household debt to ensure that it does not hinder financial stability.

The Bank will strengthen its policy

communication to ensure the greater transparency and predictability of monetary policy. Efforts will be continued to improve the methods of description and the contents of the monetary policy statement, in ways that maintain consistency with the 「General Principles of Monetary Policy Operation」 announced at the end of 2016 and heighten the statement's coherence with the Bank's economic forecasts. Moreover, while faithfully disclosing the contents of its monetary policy-setting meetings, through its 「Monetary Policy Report」 and press releases for example, the Bank also plans to continue revitalizing its communication with the financial markets, academia, the media, and so on.