

■ Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between April and October of 2017 shows the following. The global economy displayed signs of an expanding pace of recovery. The United States economy continued its stable growth as factors such as improved employment conditions and favorable economic sentiments buoyed domestic demand. In the euro area and Japan the trends of improvement continued, based mainly on consumption, while China sustained its trend of solid growth.

Economic growth in major economies¹⁾

	2014	2015	2016		2017		
			Year	Q3	Q4	Q1	Q2
US	2.6	2.9	1.5	2.8	1.8	1.2	3.1
Euro area	1.3	2.0	1.8	1.9	2.5	2.2	2.6
Japan	0.3	1.1	1.0	0.9	1.6	1.2	2.5
China	7.3	6.9	6.7	6.7	6.8	6.9	6.9

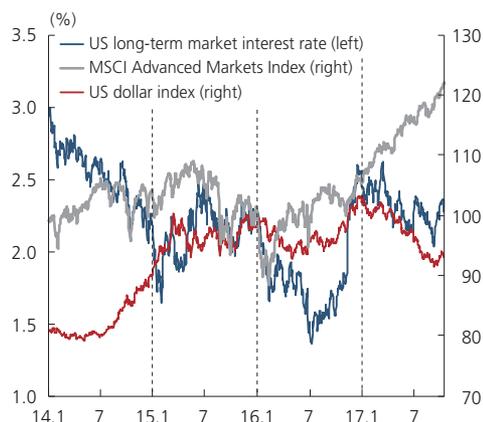
Note: 1) The quarterly rates of growth are annualized quarter-on-quarter rates for the US, Japan and the euro area, and year-on-year rates for China.

Sources: Individual countries' published statistics.

In the international financial markets, long-term market interest rates in major countries including the US fluctuated within narrow ranges in accord with variations in economic conditions. Stock prices sustained rising trends in both advanced and emerging countries, owing for example to improved corporate performances in major countries and to the global economic recovery. The US dollar meanwhile showed a trend of

weakening, on concerns about political uncertainties in the US and the highlighting of possible reductions in their monetary policy accommodativeness by the ECB and other central banks.

US long-term market interest rate¹⁾, stock prices²⁾ in advanced countries and US dollar index³⁾



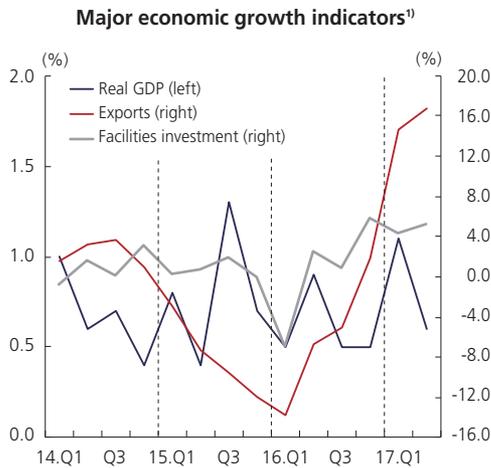
Notes: 1) Treasury bond (10-year) yields.

2) January 1, 2014=100

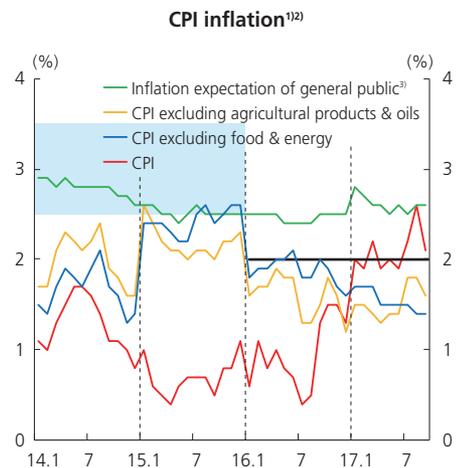
3) The measure of the value of the US dollar relative to a basket of foreign currencies (EUR, JPY, GBP, CAD, SEK, CHF); March 1973=100.

Source: Bloomberg.

2 The domestic economy maintained its upward trend, led by exports and facilities investment. Although the pace of increase in construction investment slowed in the second quarter, the domestic economy recorded a quarter-on-quarter growth rate of 0.6% based on robustness in exports and facilities investment. In the third quarter the growth rate rose, as exports sustained their high rate of increase, driven by semiconductors and petroleum products for example, and as consumption maintained its gradual pace of recovery as well.



Notes: 1) Rates of growth quarter-on-quarter for real GDP and facilities investment; year-on-year for exports (customs clearance basis).
Sources: The Bank of Korea, Korea Customs Service.



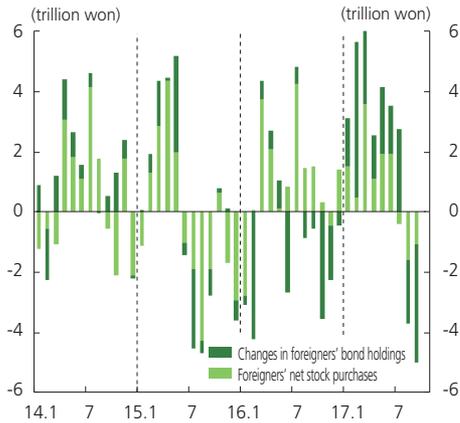
Notes: 1) Compared with the same periods of the previous years.
2) The shaded area indicates the medium-term inflation target range during the 2013-2015 period, and the bold line the medium-term inflation target set for 2016 onwards.
3) Expectations for the CPI inflation rate one year in the future.
Sources: The Bank of Korea, Statistics Korea.

③ Domestic consumer price inflation was in the mid-2⁰% range in the second quarter, but entering the third quarter it then accelerated, on the effects for example of increasing agricultural product prices. The inflation expectations of the general public were in the mid-2⁰% range generally, and core inflation, indicative of the underlying price movements, remained at the mid-1⁰% level.

Housing sales prices meanwhile showed a high rate of increase from May, based on rising sales prices especially in Seoul and its surrounding areas. This was in line for example with investment demand related to the reconstruction and redevelopment businesses. However, the pace of housing sales price growth slowed somewhat following the government's announcement of housing market stabilization measures (the 8.2 Measures hereafter). Leasehold deposit prices meanwhile sustained trends of stability generally.

④ In the domestic financial markets, long-term market interest rates rose gradually from the middle of June, as the possibility of major countries changing their monetary policy stances emerged. Entering August their extents of increase widened with the weakening of investment sentiment due to an increase in North Korea-related geopolitical risk for example. The won/dollar exchange rate fluctuated in line with developments related mainly to monetary policy normalization by the US Federal Reserve and to the North Korea risk. Foreigners' domestic portfolio investment meanwhile reversed to net sales from August, influenced by factors such as the increase in North Korea risk.

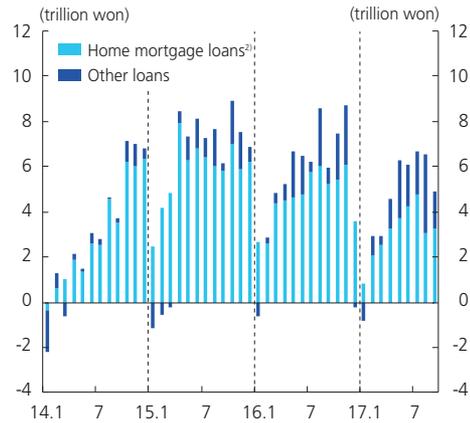
Changes in foreigners' domestic portfolio investment



Sources: Financial Supervisory Service, KOSCOM.

⑤ Looking at bank household lending, the extent of growth in banks' individual home mortgage loans slowed somewhat on the effects of the 8.2 Measures. In the third quarter bank household lending increased slightly more than it had in the second quarter, however, as the upward trend in group loans continued and as other lending expanded significantly due to factors such as the launch of Internet-only banks. Meanwhile, the amount of increase in non-bank financial institution household lending fell slightly, as the government's strengthened efforts to manage household lending continued.

Changes in banks' household loans¹⁾



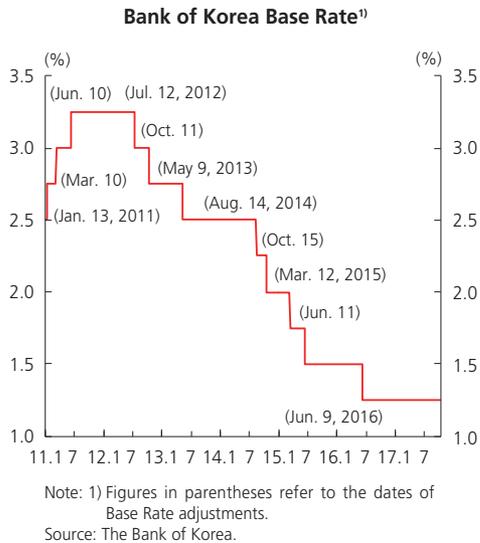
Notes: 1) Compared with the previous months.

2) Including mortgage transfers.

Source: The Bank of Korea.

[Conduct of Monetary Policy]

⑥ During the May to October 2017 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 can be 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 the monetary policies of major countries' central banks, conditions related to Korea's trade with major countries, the upward trend of household debt, geopolitical risks, etc.



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

In its May 2017 Monetary Policy Board meeting the Bank of Korea decided to hold the Base Rate at 1.25% per annum because, although the pace of domestic economic growth had accelerated a bit more than had been expected, it was judged necessary to observe future changes in conditions a little longer given the fact that the uncertainties concerning the path of growth were still high. Although the pace of consumption growth had remained unsatisfactory in the period leading up to the meeting, the GDP growth rate for the year was expected to pick up and slightly exceed its April forecast (2.6%) as exports and investment improved. However, there was a possibility that the speed of the economy's improvement could

be restrained by changes in Korea's trading conditions vis-a-vis major countries and by uncertainties related to the normalization of its monetary policy by the US Federal Reserve. The rate of consumer price inflation had meanwhile sustained the inflation target level of 2%, in line for example with increases in the prices of petroleum and agricultural, livestock and marine products, and was expected to fluctuate at the 2% level for some time. Meanwhile, it was judged necessary to keep in mind risks from the financial stability perspective, given that foreign exchange market volatility had expanded, due to the uncertainties related to domestic and external conditions, and that the amount of increase in household lending was still higher than in normal years even though it had contracted slightly year-on-year.

The Bank continued to hold the Base Rate at an annual level of 1.25% in the July and August Monetary Policy Board meetings as well. The decisions to do so were made in consideration of the fact that, although the domestic economy was forecast to grow at a solid pace, the inflationary pressures from the demand side were not large while the uncertainties as to domestic and external conditions were very high. It was thus deemed necessary to cautiously watch any future changes in these conditions, and the effects that they would have on the domestic economy. The domestic economy was judged likely to continue its solid growth, as exports and investment were improving and consumption was also recovering gradually. The consumer price inflation rate had risen to the lower 2% level, owing for example to

increases in the prices of agricultural, live-stock and marine products and to the base effect following the reduction in electricity fees of the previous year, and it was forecast that it would not diverge greatly from the July forecast (1.9%) for the year as a whole. Core inflation, showing the underlying price movements, was however maintaining a rate in the mid- to upper-1% range, and the demand-side inflationary pressures did not seem to be great. Meanwhile, it was deemed necessary to devote attention to the possibility of increased risks to financial stability, as the volatility of financial market price variables had grown, with stock prices, exchange rates and long-term interest rates fluctuating to significant extents since July on factors such as the rise in North Korea risk. In addition, while household lending had continued to grow at a rate above normal years' levels, due mainly to lending by banks, the pace of housing price increase had slowed since the government's announcement of its housing market stabilization measures. It was, however, also considered necessary to observe whether this situation would become a long-term trend going forward.

In the October meeting as well the Bank maintained the Base Rate at 1.25% per annum. This was decided on after a comprehensive consideration of the point that, although the domestic economy would likely continue its solid growth, there were potential uncertainties related to Korea's geopolitical risks, to changes in its trading conditions vis-a-vis major countries, etc., and it was thus desirable to watch these trends and their future influences a bit more, together with the forecast that demand-side inflation-

ary pressures would not be great for the time being. Specifically, it was judged that the domestic economy would continue its solid growth, as exports and facilities investment continued to show high rates of increase and consumption also expanded gradually. In line with this the GDP growth rate for this year was expected to exceed the July forecast figure (2.8%), and to also come out at its potential level next year. The consumer price inflation rate had remained at the 2% level, but was forecast to show the upper-1% level for some time going forward, due for example to the subsiding of the base effect from the previous year's electricity fee cuts, and then gradually approach the 2% inflation target level. Demand-side inflationary pressures were expected to be not large, with the core inflation rate continuing in the mid-1% range for the time being. With regard to housing prices, the points were also considered that housing prices were rebounding slightly in some parts of Seoul and its surrounding areas, albeit at slower paces, and that the amount of household lending growth was still sustaining a higher level than in normal years even though it had contracted.

⑧ The Bank of Korea, in accordance with the basic directions revealed in its 「2017 Monetary Policy Operational Directions」 of December last year, reformed its Bank Intermediated Lending Support Facility with effect from September.

First, the Bank expanded and reorganized its Support Program for High-tech and Other Start-up SMEs, renaming it as the Support Program for New Growth Engine

Development and Job Creation, and thereby strengthened its support for SMEs that contribute to the discovery of new engines of growth and the creation of jobs. Moreover, in order to reinforce the support for regional SMEs, which are experiencing difficulties in business management and in maintaining employment due to the effects for example of the restructurings of large enterprises and the weak consumption recovery, the Bank raised the total ceiling of its Support Program for Regional Enterprises by resuming operation of its special ceiling. In addition the Bank introduced a Program for Stabilization of SME Lending, in order to boost the effectiveness of its conduct of monetary policy by easing the volatility in SME lending and by ensuring the smooth operation of credit channels besides the interest rate channel. Meanwhile, the Bank normalized operation of the 5 trillion won that it had temporarily added to the Intermediate Lending Support Facility ceiling in March of last year, to thus maintain the total Bank Intermediated Lending Support Facility ceiling at 25 trillion won.

⑨ The Bank of Korea also continued its policy efforts for financial and foreign exchange market stability. When the US Federal Reserve announced its rate hikes and implementation of its balance sheet normalization program, and when North Korea continued its provocations, the Bank convened meetings of its 「Monetary and Financial Task Force」 to monitor the international financial market fluctuations in the CDS premium or the exchange rate, along with market participants' reactions, and to discuss any measures needed in

response. In September, notably, when geopolitical risks became greatly elevated due to North Korea's sixth nuclear test, the Bank activated its emergency system in collaboration with its overseas representative offices, and strengthened its monitoring. During the long Chuseok holidays in October as well it examined international financial market conditions daily.

The Bank also devoted steady efforts to the preemptive identification of potential risk factors and the presentation of early warnings. Through the June issue of its 「Financial Stability Report」, and its 「Financial Stability Meeting」 held in September, it closely assessed vulnerabilities in financial stability conditions by sector, and examined resilience against domestic and external shocks to the financial system. In preparation for the possibility of increased risk stemming from the buildup in household debt, it closely monitored trends of household lending, through meetings of its 「Household Debt Task Force」 for example, while also attending the meetings of the 「Consultative Group for Managing Household Debt」 and the 「Microeconomic and Financial Meeting」 to share with the government and the supervisory authorities understandings related to the household debt problem and state its views as to the appropriate responses.

[Future Monetary Policy Directions]

⑩ In the Bank's 「Economic Outlook Report」 released on October 19, it forecast that the domestic economy will continue its trend of improvement, as the buoyancy of

goods exports and facilities investment persists, thanks to the global economic recovery, and private consumption also shows a gradual trend of recovery, and record a rate of growth during this year of 3.0%. In 2018 the Korean economy is expected to show a growth rate of 2.9%, in line with a pickup in the pace of private consumption growth under the influence of the government policies, amid a continuing trend of world economic recovery. Looking at the contributions to growth of the different expenditure sectors, it is forecast that during next year the contribution of exports will rise and that of domestic demand activities will fall.

Concerning the future path of growth there is a mix of both upside and downside risks. The former include risks of strengthening trends of improvement in exports and facilities investment in line with an acceleration of the world economic recovery, of an improvement in Korea's trade conditions vis-a-vis China stemming from an easing of the THAAD tensions, and of an expansion of the consumption recovery due to the government's household income boosting policies. Among the downside risks meanwhile are those of worsening trade conditions with major countries such as the US, of expanded financial market volatility in line with major countries' normalizations of their monetary policies, and of a contraction in economic sentiment as a result of heightened North Korea risks.

Economic growth outlook¹⁾

(%)

	2016		2017		2018 ^s		
	Year	Year ^e	1st half	2nd half ^e	Year	1st half	2nd half
GDP	2.8	3.0	2.8	3.2	2.9	2.9	3.0
Private consumption	2.5	2.3	2.1	2.5	2.6	2.7	2.6
Facilities investment	-2.3	14.0	15.9	12.1	2.8	2.3	3.4
Intellectual property products investment	2.3	2.9	2.6	3.1	3.0	3.2	2.9
Construction investment	10.7	6.9	9.4	4.9	0.2	0.3	0.1
Goods exports	2.2	3.7	4.2	3.3	3.5	2.4	4.6
Goods imports	3.6	7.1	9.3	5.0	3.4	2.1	4.8

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

Source: The Bank of Korea

It is forecast that consumer prices will rise by 2.0% during this year, and their pace of increase is expected to then slow slightly in 2018. The upside and downside risks to the future path of inflation are also assessed as mixed, with the overall risk being neutral. As the major upside risks, there are those of a strengthening of the domestic economic recovery due to the improved global economic conditions, of a rise in the won/dollar exchange rate in reaction to North Korea risk and to the monetary policy normalization by the US Federal Reserve, and of a pickup in the degree of wage increases in line with improving employment conditions. The downside risks meanwhile include a drop in international oil prices in consequence of increased US shale oil production, and the possibility of the private consumption recovery proceeding more slowly than expected.

Inflation outlook¹⁾

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

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of October 2017.
Source: The Bank of Korea, Statistics Korea.

11 Among the major issues that will have to be considered in the future operation of monetary policy, we have looked closely at the changes in the relationship between growth and prices, and their causes, at the impacts on household lending of the government's measures related to housing and household debt, and at the effects of the North Korea risk on the financial and foreign exchange markets.

Since the global financial crisis the relationship between growth and prices has weakened, in major countries as well as in Korea. This appears to be a result of a combination of structural factors and cyclical factors. The former include structural changes in the labor market, the intensification of intra- and international competition, and the decline in inflation expectations, and the latter the diminution of the influence of growth on prices due to the persisting idle production capacity. The problems due to structural factors will be difficult to resolve within a short span of time, but if that of idle production capacity is resolved as the solid growth continues going forward, then it is judged that there is a possibility of

the cyclical factors that have constrained the upward trend of prices gradually easing. Going forward there is thus a need to continually examine and analyze whether growth is continuing in major countries and in Korea, as well as the speed at which idle production capacity decreases and the consequent changes in price flows.

The amount of growth in financial sector household lending diminished during the January-March period of this year, but since May it has risen again in line mainly with expectations of housing price increases. In response the government has promoted housing market stability and strengthened its management of the pace of household lending increase, through implementation of the 8.2 Measures for example. Notably, as the 8.2 Measures include additional designations of speculative districts and overheated speculative districts, stricter regulations on household financing, and stronger levies on transfer incomes of owners of multiple homes, the pace of price increase has slowed and the transaction volume declined in the housing market, and household lending growth has lessened somewhat. Going forward as well it is expected that the amount of growth in household loans will decrease, as the housing market stabilizes and as the amount of loans available declines on the effects of the government's measures related to housing and to household debt. However, given the possibility that household lending may not slow greatly in a short period of time, in consequence of increases in the supply of new housing and in newly occupied residences, of extensions of approved group loans, and of advance

demand for loans prior to the strengthening of loan regulations, there is a need to continue closely observing household lending trends.

The risks related to North Korea have risen recently but, similarly to in the past, the domestic financial and foreign exchange markets have generally shown temporary expansions in volatility and regained stability afterwards. This has been a result, together with the learning effect from the experience to this time, of the predominant view that sees occurrence of an extreme situation such as a war to be unlikely. However, with the level of tension on the Korean peninsula having become elevated due to North Korea's frequent provocations, cautions about the North Korea risk appear to have grown more than in the past, especially among foreign investors. And inasmuch as the possibility cannot be ruled out of financial market volatility expanding following future changes in circumstances, such as additional provocations by North Korea, there is a need to continue close monitoring of developments related to North Korea risk.

12 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 appears likely to continue its solid growth, but since it is forecast that the demand-side price inflationary

pressures will not be large, the Bank will maintain its accommodative policy stance while carefully checking future economic growth and inflation trends. In this process it will closely observe developments related to domestic and external risk factors, and any resulting changes in financial and economic conditions as well. Besides consumer price inflation the Bank will also closely monitor core inflation, expected inflation, 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 in addition take into account the high uncertainties as to the domestic and external conditions surrounding the Korean economy, and devote efforts to ensuring that financial market stability is firmly maintained. It will strengthen its examinations related to changes in domestic and external conditions that can heighten financial market volatility, such as geopolitical risks, the changes in monetary policies of major countries' central banks, etc., and closely monitor trends of capital in- and outflows. Together with this, given the ongoing trend of household lending growth the Bank will also continue devoting attention to any possible expansion in financial imbalances.

Meanwhile, it appears that conditions are gradually forming for adjustment in the degree of monetary policy accommodativeness, which has been expanded in response to the low-growth and low-inflation environment until this time. This view is grounded in the forecast that the domestic economy

will show a growth rate at around its potential level, and that inflation will also be at the target level. However, given the potential uncertainties related to geopolitical risks, to Korea's trade conditions vis-a-vis major countries, etc., the Bank will check whether the recent trends of improvement in the economy remain firm going forward as well, and whether they are sustainable.