■ Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions in Korea and abroad between July and October of 2018 finds the following. The global economy maintained sound growth. The United States continued its firm growth driven by expansionary fiscal policies. The pace of growth in the euro area weakened compared to last year, but remained above the potential growth rate level. Japan also emerged from a temporary slump to a recovery. China sustained a pace of growth in the mid- to upper-6% range, but the downside risks to growth increased due to the escalation of its trade dispute with the US.

Economic growth in major economies[1]

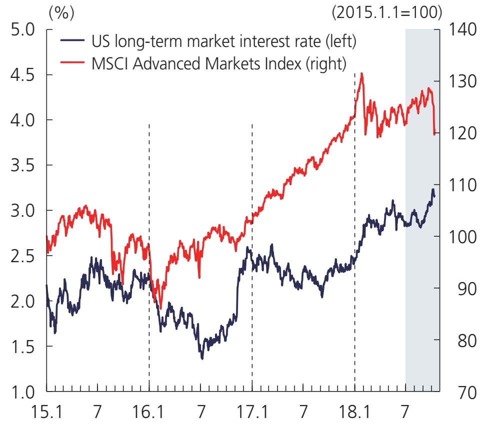
(%)

	2015	2016	2017			2018	
			Year	Q3	Q4	Q1	Q2
US	2.9	1.6	2.2	2.8	2.3	2.2	4.2
Euro area	2.1	1.9	2.4	2.7	2.7	1.6	1.8
Japan	1.4	1.0	1.7	2.3	0.9	-0.9	3.0
China	6.9	6.7	6.9	6.8	6.8	6.8	6.7

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

In the international financial markets, long-term interest rates in major countries showed upward trends in line with robust economic indicators and with strengthening expectations of policy rate hikes by the US Federal Reserve. Stock prices fell in both advanced and emerging market economies. Stock prices in advanced countries increased before then plunging in October, on the likelihood of worsening corporate profitability due to the increases in US interest rates and on the concerns about fiscal soundness in Italy. Stock prices in EMEs declined while showing high volatilities, affected by financial unrest in vulnerable EMEs. The US dollar appreciated as preferences for safe assets spread.

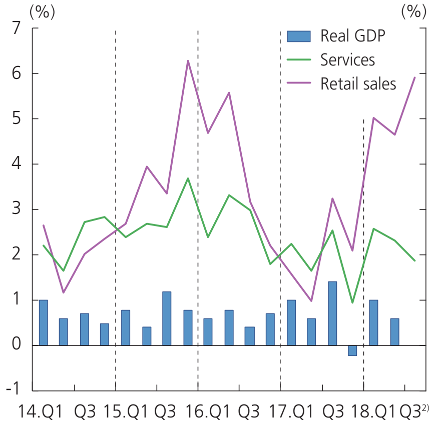
US long-term market interest rate[1] and stock prices in advanced countries



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

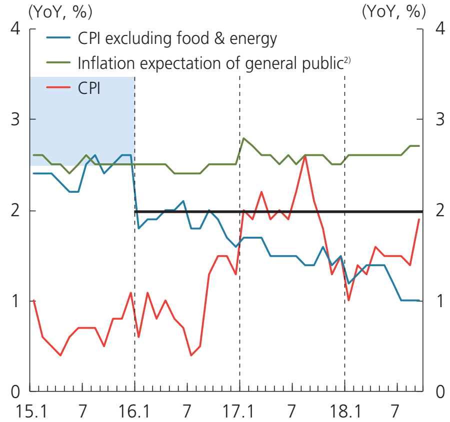
2 The domestic economy sustained a pace of growth at the level of its potential growth rate. The adjustments in facilities and construction investment persisted during the second quarter, but the economy grew by 0.6% quarter-on-quarter as exports continued to increase robustly led by buoyant exports of semiconductors and as consumption increased modestly. These trends then continued in the third quarter as well. Employment meanwhile was sluggish during the third quarter, with the extent of increase in the number of persons employed having lessened greatly.

Major economic growth indicators[1)]



Notes: 1) Rates of growth quarter-on-quarter for real GDP; year-on-year for retail sales and services.
2) Based on the average of July and August's values.
Sources: The Bank of Korea, Statistics Korea.

CPI inflation[1)]



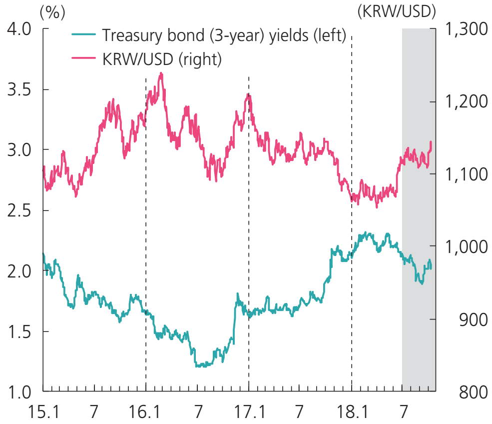
Notes: 1) The shaded area indicates the medium-term inflation target range during the 2013~2015 period, and the bold line the medium-term inflation target set for 2016 onwards.
2) Expectations for the CPI inflation rate one year in the future.
Sources: The Bank of Korea, Statistics Korea.

3 Consumer price inflation picked up slightly in the second quarter, as the prices of agricultural, livestock and marine products as well as petroleum products rose. The core inflation rate fell to the 1% level, influenced by the government's strengthening of its welfare policies and by a cut in the individual consumption tax on passenger automobile purchases. The inflation rate expected by the general public was in the mid- to upper-2% range.

The pace of increase in housing sales prices accelerated greatly in some parts of Seoul and its surrounding areas, on the effects of increased investment demand in line with expectations of rising prices. It then slowed following the government's announcement during September of housing market stabilization measures. Housing leasehold deposit prices continued to decline.

4 In the domestic financial markets, long-term market interest rates fell substantially until the middle of September, owing to the US-China trade dispute, to financial unrest in vulnerable EMEs, and to the sluggish domestic employment. They then rebounded in line mainly with rising US Treasury bond yields. The Korean won/US dollar exchange rate fluctuated within a certain range before then rising greatly in October on the effects of a sharp drop in US stock prices. Domestic portfolio investment by foreigners meanwhile reversed to a decline from September. Bond investment fell as a large volume of bonds reached maturity, and stock investment also fell as investor sentiment contracted owing to concerns about an escalation of the US-China trade dispute.

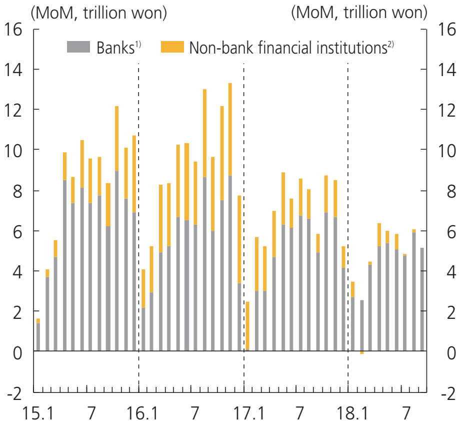
Korean Treasury bond yield and exchange rate (KRW/USD)



Sources: The Bank of Korea, KOFIA.

5 Household lending increased steadily led by banks, but its extent of increase was less than that during the same period the year before.

Changes in household loans

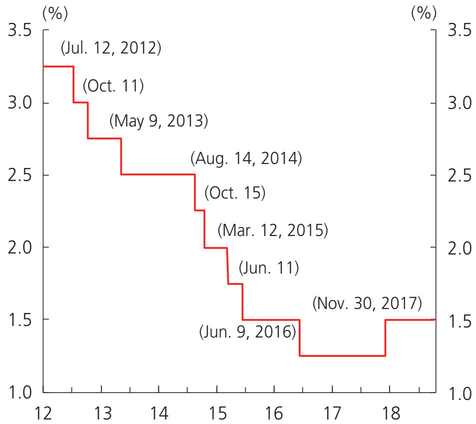


Notes: 1) Including mortgage transfers.
2) Data until Aug. 2018 available.
Source: The Bank of Korea.

[Monetary Policy Operating Conditions]

6 During the August through October 2018 period the Bank of Korea conducted its monetary policy in an accommodative manner, to ensure that the recovery of economic growth would continue and that consumer price inflation would be stabilized at the target level over a medium-term horizon. In this process it devoted attention to financial stability as well, and carefully examined domestic and overseas risk factors such as Korea's trading conditions vis-à-vis major countries, changes in the monetary policies of major countries' central banks, financial and economic conditions in EMEs, and the upward trend of household debt. Under this policy stance the Bank of Korea held the Base Rate at a level of 1.50% per annum throughout the period.

Bank of Korea Base Rate[1]



Note: 1) Figures in parentheses refer to the dates of Base Rate adjustments.
Source: The Bank of Korea.

7 A detailed look at the monetary policy decisions during this period, and the backgrounds behind them, follows:

First, at the August 2018 meeting of the Monetary Policy Board the Bank maintained the Base Rate at 1.50% per annum. This was a decision made in consideration of the facts that, although the Korean economy was continuing to grow at the level of its potential growth rate, the uncertainties as to the future growth path were high, and that the inflationary pressures on the demand side were still not strong. It was judged that the domestic economy had been growing at its potential growth rate driven by solid consumption and exports, even though the adjustments in facilities and construction investment had continued. Employment had however become more sluggish, with the extent of increase in the number of persons employed having contracted greatly. It was expected that, although investment would slow, the domestic economy would generally maintain a rate of growth at its potential level thereafter, coinciding with the path forecast in July, as consumption would increase steadily and exports would also sustain favorable flows thanks to the buoyancy of the world economy. Consumer price inflation was in the mid-1% range, as the pace of increase in petroleum product prices had picked up while the rises in service charges and agricultural product prices had slowed. It was forecast that the rate of consumer price inflation would show the mid-1% level for a while, before then accelerating to gradually approach the target level. The core inflation rate had fallen to the 1% level, but was expected to climb modestly afterward. The financial markets had meanwhile been generally stable. Long-term market interest rates had fallen, affected by the financial unrest in some EMEs and the slump in employment. Stock prices, after having fallen due to the US-China trade dispute, had rallied as the related concerns had eased somewhat, while the Korean won/US dollar exchange rate had fluctuated in line with the changes in the dollar's value. The paces of increase in housing prices in some regions in Seoul and its surrounding areas had picked up again, while the amount of increase in household lending had lessened somewhat. But from the financial stability perspective it was judged necessary to remain mindful of the fact that household lending was still sustaining a higher pace of growth than in normal years.

In the October meeting the Bank maintained the Base Rate at 1.50% per annum as well. This decision was made in view of the point that the Korean economy was projected to continue to grow at a pace that did not deviate much from its potential growth rate level while inflation would also fluctuate in the mid- to upper-1% range, but that it was necessary to observe further the effects that the recent higher uncertainties about external conditions would have on the forecast growth path. In the domestic economy the adjustments of facilities and construction investments were continuing, but it was judged that the economy had generally sustained its pace of growth at the potential growth rate level as exports were showing robustness and consumption was expanding modestly. The projected paths of GDP growth for this year and 2019 were 2.7% each, somewhat lower than the July projections (of 2.9% and 2.8% respectively), but it was forecast that growth would not diverge greatly from the potential growth rate level.

Employment remained sluggish, with the number of persons employed increasing only slightly. Consumer price inflation had risen to the upper-1% level, as the pace of increase in agricultural product prices had picked up and the temporary cut in electricity fees had come to an end, and was forecast to fluctuate in the mid- to upper-1% range for some time. The core inflation rate was also foreseen rising gradually. In the financial markets, price variables had fluctuated to large extents, with stock prices falling greatly and the won/dollar exchange rate rising considerably on factors such as the escalation of the US-China trade dispute and the plunge in global stock prices, while long-term market interest rates rose in reflection of interest rate movements in major countries. On the other hand, housing prices had increased rapidly, mainly in some parts of Seoul and its surrounding areas, before their upward trends had then slowed after the government's announcement of housing market stabilization measures. The amount of increase in household lending had declined somewhat, but household debt was still rising more rapidly than household income, and from the financial stability standpoint it was judged essential to bear this continually in mind.

8 The Bank of Korea decided to reform its Bank Intermediated Lending Support Facility so as to boost the effectiveness of its support for companies that create jobs, with effect from November. It expanded the scope of the job-creating companies eligible for support under its 「Support Program for New Growth Engine Development and Job Creation」, and strengthened its support for financial institutions lending to corporations under this program.

9 The Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions at home and abroad. During the Chuseok holiday in September it collaborated with its overseas representative offices in the 24-hour monitoring of developments related to overseas risks such as the US-China trade dispute and the financial unrest in EMEs, and subsequently convened a 「Financial and Economic Conditions Review Meeting」 in which it comprehensively examined international financial market conditions and the effects that they would have on the Korean economy. Immediately following the US Federal Reserve's policy rate hike in September, the Bank convened a meeting of its 「Monetary and Financial Task Force」, to examine international financial market trends and the effects that the rate hike would have on the domestic financial and foreign exchange markets. It also closely monitored the outbreaks of financial unrest in some EMEs, and their developments.

The Bank also continued its efforts for preemptive identification of potential risks within the financial system. During its September 「Financial Stability Meeting」 it closely assessed vulnerabilities in the household and corporate sectors, and examined the financial system's resilience to domestic and external shocks. The Bank also participated in the 「Macroeconomic Finance Meetings」, where it analyzed the effects of the Federal Reserve's policy rate hikes while seeking measures in response together with the government and the supervisory authorities. While closely assessing conditions of and risks related to household debt through meetings of its 「Household Debt Taskforce」, the Bank also preemptively identified systemic risks in the non-bank financial sector through participation in the 「Non-bank Financial Sector Macroprudential Soundness Task Force」 led by the Financial Services Commission.

[Future Monetary Policy Directions]

10 According to the Bank of Korea's 「Economic Outlook Report」 released on October 18, the domestic economy appears likely to show growth rates of 2.7% during both this year and the next. Although investment will slow, it is expected that a pace of growth that does not diverge greatly from the level of the economy's potential growth rate will be maintained, as consumption will continue to expand modestly and exports will also show buoyancy. It is forecast that the contribution of exports to growth will fall slightly next year, while that of domestic demand will rise slightly. With regard to the future growth path, there is a mix of both upside and downside risks. The upside risks include those of improved domestic demand conditions in line with the government's expansionary fiscal policies, and of expanded investment expenditures by major large enterprises, while among the downside risks are those of a slowdown in the pace of increase in exports due to an escalation of the US-China trade dispute, of expanded volatilities in the international financial markets owing to changes in monetary policies in major countries, and of a delayed improvement in employment conditions and a slowdown in consumer sentiment.

Economic growth outlook[1)]

(YoY, %)

	2017	2018			2019^e		
		Year^e	H1	H2^e	Year	H1	H2
GDP	3.1	2.7	2.8	2.6	2.7	2.7	2.6
Private consumption	2.6	2.7	3.2	2.3	2.7	2.4	2.9
Government consumption	3.4	4.8	5.3	4.3	4.5	4.3	4.7
Facilities investment	14.6	-0.3	1.9	-2.5	2.5	2.2	2.9
Intellectual property products investment	3.0	2.5	2.8	2.1	2.8	2.8	2.9
Construction investment	7.6	-2.3	-0.1	-4.3	-2.5	-3.5	-1.6
Goods exports	3.8	3.5	2.8	4.2	3.2	3.4	3.0
Goods imports	7.4	2.1	2.5	1.7	2.7	2.0	3.3

Note: 1) Figures are the forecasts as of Oct. 2018.
Source: The Bank of Korea.

The headline consumer price index is expected to rise by 1.6% during this year, and by 1.7% in 2019. The upside and downside risks to the future inflation path are mixed. Among the major upside risks are an increase in international oil prices in line with ongoing geopolitical risks in some oil-producing countries, and a continuing increase in agricultural and livestock product prices. The downside risks include those of increased downward pressures on inflation owing to the expansion in welfare expenditures related to education and medical services, and of weaker than expected improvements in business conditions in the non-IT and service sectors.

Inflation outlook[1]

(YoY, %)

		2017	2018			2019e		
			Year[e]	H1	H2[e]	Year	H1	H2
CPI inflation		1.9	1.6	1.4	1.7	1.7	1.7	1.6
Core Inflation	CPI excluding food & energy	1.5	1.2	1.3	1.0	1.6	1.3	1.8
	CPI excluding agricultural products & oils	1.5	1.2	1.3	1.2	1.7	1.5	1.9

Note: 1) Figures are the forecasts as of Oct. 2018.
Sources: The Bank of Korea, Statistics Korea.

11 Among the major items that will have to be considered in the operation of monetary policy going forward, we have examined the effects of the US-China trade dispute on the Korean economy, the core inflation, and the recent situation related to the financial imbalances.

During this year the trade tensions between the United States and China, Korea's two major trading partners, has been gradually intensifying. The US-China trade dispute is likely to negatively affect the Korean economy through the trade and the uncertainty channels. The impacts on Korean exports due to the measures taken until now have still been limited, but are expected to escalate next year as the US raises tariffs on imports from China. Further, if the trade dispute between the two countries leads to a global economic slowdown, it could cause not only a decline in exports through the trade channel, but also a contraction in investment sentiment through the uncertainty channel. Close observation of changes in global trade conditions is therefore necessary.

Although Korea's real economy has been growing at a rate close to its potential level, its core inflation has been slowing. An analysis of this slowdown in core inflation finds the following. First, a breakdown of the trends of core inflation by item reveals that the core inflation in private service charges has accelerated, while that in goods prices has slowed slightly and those in housing prices and public service charges have fallen substantially. Second, a Phillips curve analysis of the factors behind the changes in core inflation shows that the contributions of global and domestic factors have not changed significantly, but that those of other factors including government policies have pulled the core inflation rate down considerably. Third, a dynamic factor analysis of common and idiosyncratic components shows that recently the explanatory power of idiosyncratic components has relatively increased. In consideration of these analytical findings, it is assessed that the recent slowdown in Korean core inflation has been caused by downward pressures due to idiosyncratic components such as the government's strengthening of its welfare policies, amid demand-side inflationary pressures that are not high. It is therefore judged necessary to take into account the changes in idiosyncratic factors along with macroeconomic factors when assessing inflation conditions.

As concerns grow about the recent accumulation of financial imbalances, opinions are being raised that a response on the monetary policy side is necessary to mitigate them. There are mixed views on whether financial imbalances should be addressed through monetary policy, but there is a consensus that responding to them first through macroeconomic policies is appropriate, and that a monetary policy response could also be called for if the financial imbalances spread and there are concerns about them undermining the stability of the overall economy. Lately, the ratio of household debt to income has been increasing steadily as households' debts have been increasing more rapidly than that of incomes. This seems to be connected with the rise in housing prices in Seoul and its surrounding areas. Corporate loans related to real estate have grown substantially, led mainly by those to self-employed business owners. Under these circumstances, it is judged necessary to pay continuous attention to financial stability in the course of future monetary policy operations.

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.

As it is forecast that the inflationary pressures on the demand side will not be high for the time being, while the domestic economy sustains a rate of growth that does not diverge greatly from its potential level, the Bank plans to maintain its accommodative monetary policy stance. In this process it will closely examine changes in financial and economic conditions at home and abroad along with their effects on growth and prices, and will judge whether an adjustment in the degree of accommodation is called for. Besides consumer price inflation the Bank will also closely review various auxiliary price indices, inflation expectations, international oil prices, global inflation, the GDP gap, and the spare capacities in employment and the manufacturing sector.

The Bank will operate its monetary policy while devoting attention to financial stability as well. Given the high uncertainties related to the escalation of the US-China trade tensions, the acceleration of policy rate hikes by the US Fed, and the possibility of the financial unrest in EMEs spreading, the Bank will keep close watch on their developments and effects. Also, inasmuch as the accommodative financial conditions may have caused the financial imbalances including the household debt buildup to increase, it is judged necessary to devote efforts as well to alleviating these risks.