

Korea: Central bank starts easing cycle with 25bp rate cut

The Bank of Korea's rate cut today is a mere reversal of a 25 basis point hike in November 2018 rather than a real policy stimulus for the economy, which is close to or already in recession. We believe this is just the beginning of the easing cycle



Source: Shutterstock

1.50%

BoK policy rate

After 25bp cut today

Lower than expected

A surprise for the market, not for us

The Bank of Korea (BoK) surprised the market today by cutting its policy rate by 25 basis point to 1.50%. The consensus was still largely in denial of easing; 15 out of 25 participants in a Bloomberg survey expected no change, with many likely expecting the BoK to wait until after the Fed rate cut

later this month. We were in the minority forecasting a 25bp rate cut.

As it is expected that domestic economic growth will be moderate and it is forecast that inflationary pressures on the demand side will remain at a low level, the Board will maintain its accommodative monetary policy stance. - BoK policy statement

The [policy statement](#) pointed to a deepening slowdown in exports and construction and facilities investment, while inflation continued to be low and falling short of the central bank's projected path. The statement also signalled a downgrade of the central bank's growth and inflation forecasts for this year, while Governor Lee Ju-yeol formally announced new forecasts in his press conference subsequently.

Policy guidance of more easing ahead

The BoK governor's press conference typically steals all the market attention on these decision days. And the focus is especially more intense when the policy is actually changed, just as it is today. The key takeaways from his remarks are:

- **Weak economic outlook:** Downgrade of forecast GDP growth in 2019 to 2.2% and CPI inflation to 0.7%, from the previous forecasts 2.5% and 1.1%, respectively in April. This is BoK's fifth forecast downgrade over the last 12 months, putting growth at the lowest level since the 2008-09 global financial crisis.
- **Trade rift with Japan:** Given the scale of bilateral trade, Governor Lee warned about a significant impact on the Korean economy in the event that Japan's export restrictions against Korea become a reality and even broaden, though it's hard to gauge the actual impact.
- **Market volatility:** No clear direction on (KRW) exchange rates with changes in expectations about the Fed policy and uncertainty from the US-China trade war adding to FX market volatility. A rate cut could have a negative impact on financial stability.
- **Housing market risk:** A rate cut could fuel a further surge in housing prices, though that's probably more a concern for the government, which has a strong will to curb home prices.
- **Policy guidance:** Growth takes priority over financial market stability. Yet, undermining the impact of today's rate cut, Governor Lee sees monetary policy at a level that doesn't hurt the real economy, though the central bank could still take policy action to some degree as it has yet to reach its effective bottom for lowering rates.

Here's what we think

Today's policy rate cut is a mere reversal of a 25 basis point hike in November 2018 and doesn't represent a real policy stimulus for the economy, which is close to recession. Watch out for next week's release of preliminary GDP figures for 2Q19. GDP contracted by 0.4% in 1Q19 from the previous quarter. Another such (quarter-on-quarter, seasonally adjusted) contraction would confirm the (technical) recession.

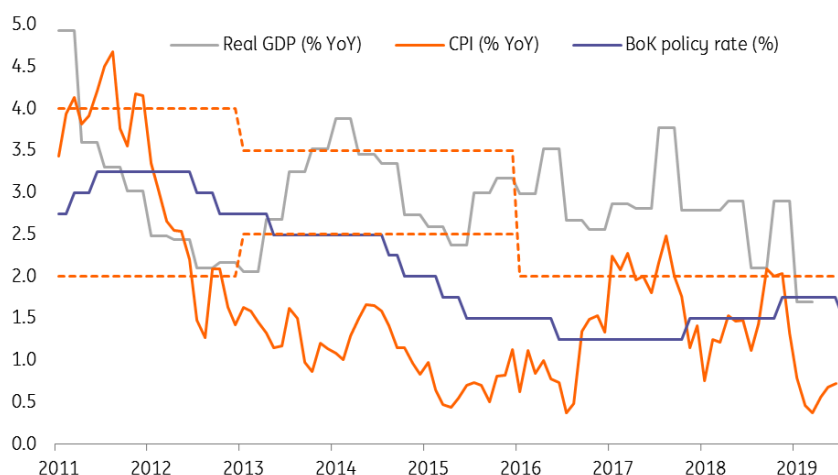
The Korean economy may actually be in a recession right now, we're simply waiting for the data to confirm it. - ING Asia Chief Economist, Rob Carnell

We believe this is just the beginning of an easing cycle and there is more to come. Just as the US-China trade friction, Korea's trade tensions with Japan could get worse before they get better. With the growth outlook likely turning gloomier in the rest of the year, the BoK will be forced into more policy easing. We consider our forecast of a 1.25% policy rate by year end subject to more downside than upside risk.

One could view the year-to-date KRW underperformance as the market appreciating the need for easier policy, and thus getting the central bank to deliver on it. If so, the worse of the KRW performance this year is probably over. We think the markets are already pricing in more BoK rate cuts ahead. And with the imminent Fed rate cut supporting the weak US dollar trend ahead, we don't see today's rate cut or future moves as having much of a detrimental impact on the Korean won (KRW). Our year end USD/KRW forecast remains at 1180 (spot 1177).

Is the South Korean economy headed for a recession?

Growth, inflation and Bank of Korea policy rate



Dotted lines are BoK's inflation target, shifted from a range to point target in 2016.

Source: Bloomberg, CEIC, ING