Korea in the lead of Asia's monetary tightening cycle

Although we don't believe Korea's central bank will tighten policy this year, we expect it to be one of the first in Asia in 2018

Source: istock

1.5% Consensus for policy rate

Will the tightening start this week?

The Bank of Korea Monetary Policy Committee may start its tightening cycle as early as this week, the first central bank in Asia to do so after a four-year long easing streak that ended in mid-2016. Though not a unanimous consensus, the consensus forecast is a 25bp rate hike to 1.50% this week. The BoK MPC meets on Thursday, November 30 and until the end of last week, the consensus was almost evenly split between a 25bp rate hike and no change. It has now skewed toward a rate hike call, leaving us among the minority who are forecasting no policy change this week.

Rising growth and inflation

Strong export-led recovery drove real GDP growth to a four-year high of 3.6% year-over-year in the third quarter of 2017. The export recovery has broadened to domestic demand mainly via a surge in investment spending that contributed to most of GDP growth in the first three quarters. The firmer domestic demand and higher food and fuel prices have pushed inflation above the BoK's 2% target. The year-to-date CPI inflation of 2.1% YoY through October was up from 0.9% a year ago.

A softer October activity data

Our scepticism on the BoK tightening this week rests on our view that sustaining steady acceleration in growth in the period ahead will require continued strength of exports. And here we have a sharp slowdown in export growth in October dampening that optimism. The positive base effect from 2016 export weakness has almost ended and slower exports are likely to weigh on GDP growth in the period ahead.

> *On inflation, we think it's still not out of control to warrant a rate hike as yet*

The acceleration this year mostly came from food and fuel prices, the consumer price component that are more prone to supply rather than demand shocks. And there is little that monetary policy could do about such supply-side factors. Moreover, we consider lower core CPI inflation this year, 1.5% year-to-date in October 2017 down from 1.6% a year ago, a sign of well-anchored inflation expectations.

A greater fiscal accommodation

Moreover, we don't believe the BoK will hike rates this year but we do believe they will be one of the first central banks in Asia to do so in 2018, with a 1Q18 hike. Even as the monetary policy moves to tightening, there is room for fiscal manoeuvring to support growth. President Moon has embarked on a stimulus plan that boosts public sector jobs, social benefits and minimum wages.

11% Year-to-date KRW appreciation vs. USD

A Korean won-friendly policy mix

Despite the 11% year-to-date appreciation of the Korea won (KRW) against the US dollar this year the won has been under bouts of weakening pressure for most of 2017 from political tensions stemming from North Korea's nuclear ambitions. It's impossible to say for certain that tensions will not flare up again, resulting in some additional risk premium on the KRW.

But assuming not, the positive policy mix of tightening monetary policy and loose fiscal policy will sustain the KRW among the outperforming Asian currencies in 2018.