Bank of Korea keeps policy rate on hold amid fresh uncertainty

As widely expected, the BoK unanimously decided to leave its policy rate unchanged at 3.50%, mainly due to growing upside risks for inflation and rising private sector debt. The hawkish pause will be extended into the second quarter of next year, but we'll also see different views emerge among board members on how to respond to the macroeconomic changes

3.5% BoK's base Rate

As expected

Economic recovery likely to continue despite increasing uncertainty

Uncertainty in the outlook for growth and CPI has grown due to elevated geopolitical tensions, but the current situation is extremely fluid. This should be a key reason for today's unanimous decision to hold, and the Bank of Korea will unlikely shift its policy stance until issues that have emerged recently begin to affect the economy.

The BoK assesses that the inflation slowdown pace is expected to be more gradual than forecasted in August with rising global oil prices. On top of that, the latest Israel-Hamas conflict certainly adds upside risks for inflation, and CPI may rise above the August forecast as a result. On the other hand, the BoK has acknowledged the heightened uncertainty but still believes that recovery will continue. Growth therefore remains on the BoK's August projection path of 1.4% year-on-year growth with an improved outcome for exports.

Household debt is a concern, but the onus shouldn't be on monetary policy to solve it

The excessive increase in household debt growth is another factor for the Bank of Korea to maintain its hawkish stance. The central bank's monetary restrictiveness has been challenged by rising private sector debt despite higher borrowing costs. Governor Rhee Chang-Yong points out that the tightness of monetary policy should be analysed with various measures, and the rise in private debt itself shouldn't be interpreted as a signal that monetary tightening is not restrictive enough. We believe that the housing market seems to react more sensitively to the government's macroprudential measures than the monetary policy, and the recent pick-up in household debt is also mainly triggered by loosening mortgage conditions and property purchase rules.

Governor Rhee reiterates that the Bank of Korea believes excessive household debt level compared to GDP is a risk factor in the medium-term growth perspective, but that government macroprudential measures should come first to tackle down this problem. Meanwhile, the Bank of Korea will keep an eye on how the property market and household debt develop in line with changes in policies, but monetary policy will necessarily not be sympathetic to boosting the property market or leveraging property investment.

GDP and CPI outlook

We think that third-quarter growth for this year is stronger than what we initially had expected. Monthly activity data suggested that construction rebounded temporarily and service consumption also improved, stimulated by government support. Resilient consumption in the US may also have supported export recovery in the third quarter. However, we continue to believe that investment has stayed weak, and the positive contribution from net exports diminished. We therefore expect third-quarter GDP to have decelerated to 0.4% quarter-on-quarter seasonally adjusted from the previous quarter's 0.6%. Fourth-quarter GDP will likely decelerate faster with downside risks rising. The annual GDP growth is expected to rise to 1.1% YoY for 2023 and 1.7% for 2024.

Meanwhile, inflation is expected to move up again until year-end with growing upside risks considerably. Despite government efforts to curb inflation, such as extending the fuel tax cut and providing subsidies for fresh food, October inflation will likely climb up faster to 3.9% YoY (vs 3.7%

in September). Public transportation fees in the metropolitan Seoul area hiked this month while gasoline prices continued to rise. We also see manufactured food and dairy prices hiking and, ahead of the kimchi-making season in November, cabbage and other vegetable prices surged already. We expect to see annual CPI to rise 3.7% YoY in 2023 and headline inflation to decelerate to the 2% level only from early 2024.

BoK watch

Looking to future moves in monetary policy, the Bank of Korea will be put in a difficult situation and disagreements among board members on policy decisions will grow. We already see that one member has expressed that the BoK's policy needs to be "flexible" amid growing uncertainty, but the rest of the five members still think keeping an additional hike option on the table is better with rising inflation and household debt. One of those five members considered that monetary policy might take on a pre-emptive role soon to curb further rises in household debt.

The spectrum between hawk and dove will widen, but the majority of board members will continue to keep their hawkish stance, so the decision outcome itself won't change. However, different voices emerging mean that board members will have varying views on how the monetary policy should respond to given economic situation changes. As a result, the possibility of a policy shift will gradually grow. For now, we have pencilled in the second quarter of 2024, and we're sticking to our base case scenario that the economy will cool down with higher borrowing costs and global headwinds, with inflation beginning to decelerate by that point.

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