Bank of Korea hikes rates by 50bp for first time ever

The BoK showed its strong policy commitment to price stability by raising rates 50bp but it is expected to adjust the pace of rate hikes from now on, as long as inflation does not rise significantly more than expected

2.25% BoK 7-Day Repo Rate

As expected

The BoK has unanimously decided to raise the policy rate to 2.25%

Although today's decision was in line with the market consensus, the larger-than-usual 50bp hike still came as a surprise to the market. We believe that the BoK is trying to send a strong signal to the market that it is willing to do what is necessary to meet its inflation target mandate. This was confirmed by the MPC statement and governor's remarks at the press conference.

The BoK allocated a significant portion of its statement to explaining today's decision, making it clear that the 50bp hike is a preemptive response to avoid locking in high inflation. Also, it was clearly stated, "the Board sees continued rate hikes as warranted, as inflation is expected to run above the target level for a considerable time".

At the press conference, Governor Rhee Chang-yong mentioned that if inflation peaks in late 3Q or early 4Q, which is the BoK's base case scenario, a gradual 25bp increase would be appropriate and an additional one to two rate hikes wouldn't be considered tightening as the current rate of 2.25% is near the bottom range of the so-called neutral rate.

Regarding the recent weakness in the Korean won, Governor Rhee emphasised that it should be viewed in relative terms and that the strength of the US dollar is leading the way. While it is true that KRW has stayed on the weak side, it is probably because Japan and China, the two major central banks in the region, are going against the tide of the global tightening cycle. So, the KRW may have a rather negative spillover effect as Korea's trade volume with the two countries is relatively large.

We maintain our current view of two 25bp hikes in August and October to reach 2.75% by year-end

We agree with Governor Rhee's view on inflation in general. We expect headline inflation to continue rising for a couple more months from the current 6% and will probably start to slow in the fourth quarter. While the risk of rising global commodity prices still exists, we expect to see some impact from earlier rate hikes, which will decelerate the monthly growth of demand-side inflation over time.

However, compared to the BoK's view that next year's GDP will exceed the potential growth rate, we are somewhat pessimistic as it is expected to be lower than potential. Next year, both monetary and fiscal policy will become restrictive while external demand conditions are expected to worsen further. The government recently announced that it would legislate fiscal rules, stating that maintaining fiscal soundness at a good level over the medium term is a policy priority. That's why we believe that the BoK will enter an easing cycle by the end of next year.

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