

The Bank of Korea's hawkish pause continued on the back of inflation concerns

The Bank of Korea unanimously decided to leave its policy rate at 3.5%, extending its no-change action for five consecutive meetings. Meanwhile, the BoK maintained its forecasts for 2023 GDP and CPI while raising that of core CPI in its latest economic outlook



The Bank of Korea is caught between a weak currency and weak growth

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3.5%

 7-day repo rate

As expected

The Bank of Korea won't chase the Fed, but market rates will

The higher-for-longer US narrative is a concern for the BoK considering how it has led to volatile FX

movements and a sharp rise in market interest rates impacting Korea's macro economy. However, we don't think the BoK will chase the Fed like it did last year.

Inflation will likely reaccelerate in the coming months, but we do not believe headline CPI inflation will return to the 3% range as expected by the BoK. And even if it does, it is likely only to be a temporary move that will not reverse the downward inflation trend. So while inflation may keep the BoK hawkish for the time being, it will not be enough to result in additional hikes, especially when considering the rapidly worsening growth outlook.

Inflation and growth outlook

We think that there are several upside risks for inflation.

1. Base effects will continue to push up the headline inflation rate over the remainder of the year;
2. Global commodity prices have risen significantly along with the recent KRW depreciation;
3. Severe weather conditions will likely push up fresh food prices, overlapping with the Chuseok holiday;
4. Public service prices face planned hikes in 3Q23.

But we also see significant downside risks.

- The government has decided to extend its fuel tax cut program until the end of October to stabilize pump prices;
- Rental prices will continue to fall for more than a few quarters;
- and China's disinflation will eventually lower domestic prices over time.

On the growth front, soft survey data releases from the US and EU and ongoing market jitters surrounding China's real estate market will increase downward pressure on Korea's exports. Also, the recent pick-up in market rates will eventually put more downward pressure on household consumption and business investment. Consequently, we expect growth to remain quite subdued for the rest of the year, and that is why we believe that the BoK's 1.4% growth view is quite optimistic.

In our view, the BoK almost fully realizes the upside risk to the inflation outlook, while the downside risk to growth appears to be a relatively modest reflection.

BoK policy outlook

By the end of this year, we think household debt and financial market conditions will become more important factors for monetary policy than inflation. Despite the tight monetary conditions, the impact on the real economy has been diminished as household debt has increased thanks to eased real estate policies. Also, the BoK's lending facility program was revised at the end of last month to provide timely liquidity to the financial market in case of an emergency, indicating the BoK's willingness to take macro-policy as tight as possible until prices stabilize at around 2%. Thus if household debt growth accelerates by the end of this year, the BoK's first rate cut is likely to be postponed to next year, not the end of this year.

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