Scotiabank

GLOBAL ECONOMICS

FLASH REPORT

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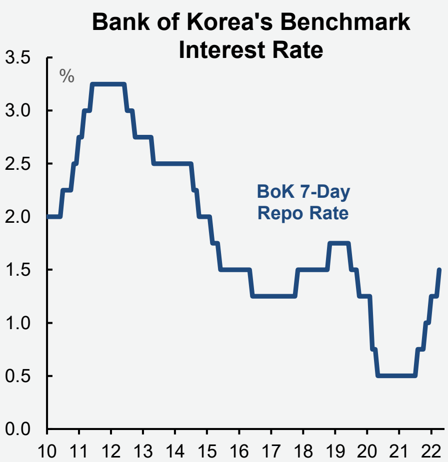
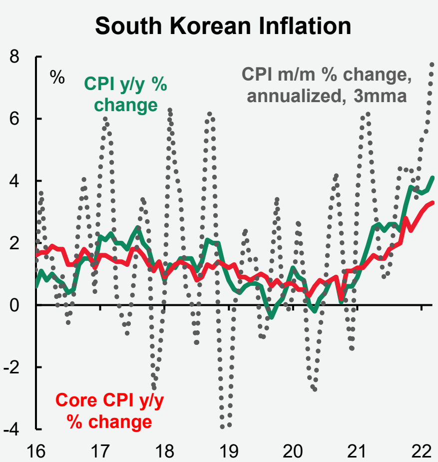
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Accelerating Inflation Triggers Another Policy Rate Increase in South Korea

- **The Bank of Korea continued to normalize monetary conditions by increasing the benchmark interest rate by 25 basis points to 1.50%.**
- **Inflation containment is a policy priority, yet global uncertainties warrant a gradual path of interest rate increases through the rest of 2022.**

The Bank of Korea (BoK) raised its benchmark interest rate by 25 basis points to 1.50% following the April 14 monetary policy meeting (chart 1), in line with our expectation. The decision marks the fourth hike in the ongoing monetary normalization phase, which began in August 2021. The prior rate increase took place at the January meeting. Today's decision was exceptional as the Monetary Policy Board is without a governor. Mr. Rhee Chang-yong has been nominated as the new BoK Governor, but he is not holding the position yet as he is still in the process of parliamentary confirmation hearings (scheduled for April 19). Nonetheless, the decision among the six present board members was unanimous, highlighting the sense of urgency in the BoK's fight against rising inflation.

Inflationary pressures are building in South Korea, requiring a monetary policy response. Prices at the headline level increased by 4.1% y/y in March, while annualized monthly price gains (which allow us to see the current trend in inflation without the impact of year-ago base effects) show that "true" price pressures are twice as high (chart 2). The central bank expects headline inflation to remain "high in the 4% range for some time". Indeed, our estimations point to 4.5–5% y/y inflation through the third quarter of 2022, after which we expect inflation to ease slightly to 3.7% y/y by the end of the year. Similarly, core inflation, at 3.3% y/y in March, remains well above the BoK's 2% inflation target. The BoK expects it to "remain around 3% for a considerable time". We assess that South Korea's fight against inflation will not be short-lived, as prices pressures will likely persist due to elevated core prices, higher inflation expectations by the general public, as well as firms' price-setting behaviour that is likely to pass some of the elevated input costs to consumers. Accordingly, we do not foresee headline inflation returning to the BoK's 2% target before 2024.

Financial stability considerations continue to play a role in the BoK's monetary policy decisions. The US Federal Reserve's monetary tightening has triggered some portfolio outflows from South Korea and the won's weakening bias against the US dollar. Nonetheless, the BoK's Monetary Policy Board member Joo Sang-yong pointed out at today's press conference that South Korea's sound economic fundamentals are set to protect the economy from large scale capital outflows. Considering global economic uncertainties that can have an adverse impact on the export-oriented South Korean economy, we do not expect the BoK to aim for "tight" monetary conditions. We forecast that the BoK will maintain its gradual monetary normalization path over the coming months, taking the benchmark rate to 2.0% by the end of the year. As such, South Korea's real interest rates are set to remain negative in the foreseeable future.

The BoK's policymakers seem confident that South Korea's economic recovery remains on track despite uncertainties related to the pandemic and the war in Ukraine. Household spending prospects are favourable on the back of a strong labour market, but fixed asset investment will likely be affected by higher materials prices and global supply chain disruptions. South Korean exports continue to perform strongly, yet we expect some softening in the months ahead. The BoK expects the nation's real GDP growth to be somewhat below 3% in 2022.

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