Mizuho Flash: Korea

Economics & Strategy | Asia ex-Japan

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Bank of Korea: “Big Step” Hike?

In a nutshell: The **Bank of Korea raised policy rates by 25bps taking the Base Rate to 1.75%.** This is in line with our expectations and market consensus. Notably, the BoK raised their forecast for this year’s headline CPI from 3.1% to 4.5% and GDP growth forecast down from 3% to 2.7%. The **first** takeaway is that with their forecast revision, **headline inflation will stay above mid-4% for the remaining of this year. Second,** while stagflation continues to worry, **the magnitude of inflation’s upward revision outweighing growth’s downward revision** alongside the ***growth estimate still staying at historical trends*** suggest that **inflation remains the priority for now.**

Going forward, our **base case continues to point to further monetary policy tightening**. Looking at *real* policy rates from both ***historical*** inflation outcomes and also inflation ***expectations***, the monetary environment and associated **real borrowing cost remains *accommodative***. **This is consistent with Governor Rhee’s communication during his press conference that current rates are still below neutral.** In addition, our examination from both angles of **real and nominal effective exchange rates point to erosion of the KRW’s purchasing power** and **worsening imported inflation**. A declining terms of trade has also been denting current account flows translating to adverse feedback loops with the KRW.

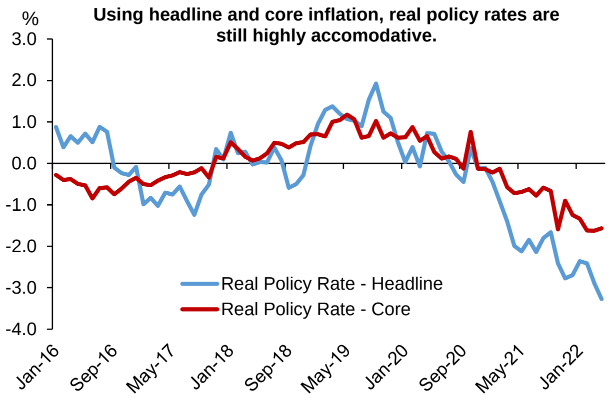
Given the BoK’s 1.4%-point upward revision of inflation estimates and Governor Rhee’s emphasis on fighting inflation, the question turns to the need for a 50bps hike. The **rationale for a big step 50bps** is one of front loading and to **forcefully stamp out the momentum of rising inflation expectations**, which supports our “Kokomo” view to get there fast and take it slow”, specifically **50bps in July and a pause in August**, which leaves **a 3-month window** to their next meeting in October. Before the next policy meeting in July, we will watch for the **two inflation prints** and an **update of** surveyed household **inflation expectations** as these may embolden a big step hike, alongside conditions of **external global tightening**.

Today’s Decision

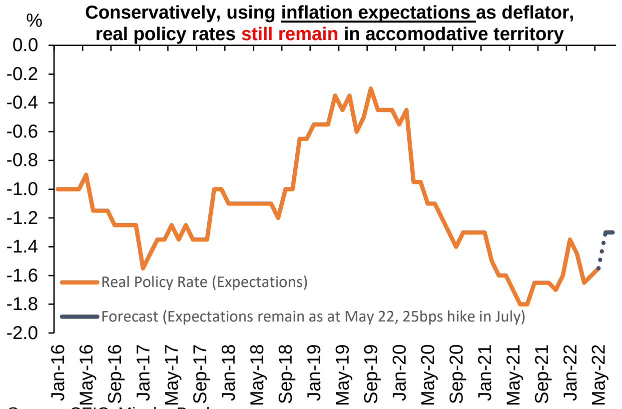
The **Bank of Korea raised policy rates by 25bps taking the Base Rate to 1.75%, in a *unanimous* decision.** This is in line with our expectations and market consensus. Notably, the BoK raised their forecast for this year’s headline CPI from 3.1% to 4.5% and GDP growth forecast down from 3% to 2.7%.

From these revisions, the **first** takeaway is that **headline inflation will stay above mid-4% for the remaining of this year. Second,** while stagflation continues to worry, **the magnitude of inflation’s upward revision outweighing growth’s downward revision** alongside the ***growth estimate still staying near historical trends*** **suggest that inflation remains the priority for now.**

Policy Rates – Accommodative From Real Angles



Source: CEIC, Mizuho Bank

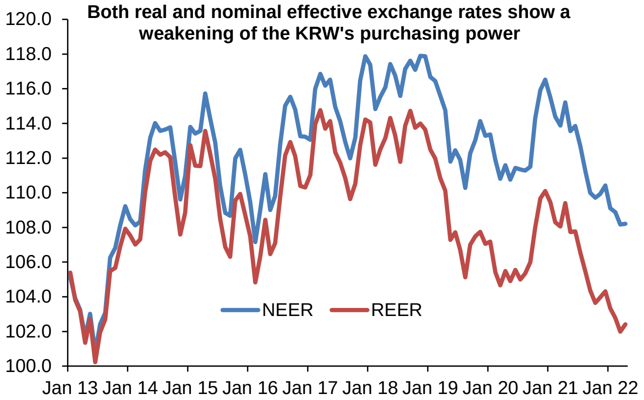


Source: CEIC, Mizuho Bank

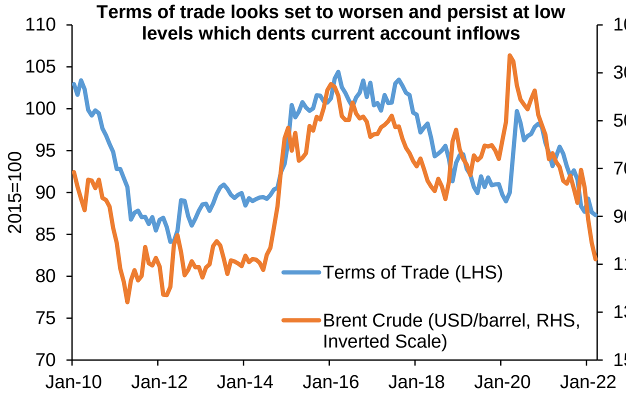
As headline inflation headed up to 4.8% in April, real policy rates are now unprecedentedly negative and therefore constitutes a relatively **accommodative real cost of borrowing**. (See LHS Chart above) The implication of **further aggregate demand stimulation** will not be lost on the BoK's minds as they raised their 2022 forecast for headline inflation from 3.1% to 4.5% today.

More importantly, the BoK will seek to ensure that inflation expectations remain anchored, a pre-requsite for settling at a lower inflation rate when supply side pressures and complications ease. Despite the BoK's valient attempt via their consecutive 5 rate hikes totalling 125bps, **inflation expectations have kept nudging up in recent months from 2.4% in Aug 21 to 3.3% in May 2022** and as such **real policy rates from the expectations perspective also remain accommodative as well. (See RHS Chart above)**

Exchange Rates – Weakening On Multiple Fronts



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

The KRW's depreciation has certainly not helped the BoK's cause to dampen inflation as imports cost keep rising. Aside from the YTD depreciated of the KRW against the USD, the **decline in both real and nominal effective exchange rates** indicate the **erosion of purchasing power measured against major trading partners** and thereby worsening imported inflation via both channels of final finished consumer goods as well as intermediate inputs which precipitate further price pressures downstream.

While Korea' worsening terms of trade has already become increasingly evident as the growth in the price of imports outpaced price of exports. Given the likelihood of elevated energy prices and Korea's import reliance, **the persistence of this undesirable terms of trade will dent the goods account inflows in the months ahead as each unit of export affords lesser in terms of imports.**

Room for One Big Step?

While the base case remains for continued measured **25bps hikes**, a 50bps move can no longer be easily dismissed given the rise in inflation expectations recently. The rationale for a big step 50bps is **one of front loading and to forcefully stamp out the momentum of rising inflation expectations.** This in turn allows the BoK another small window of 2-3 months to pause and "assess the impact", which supports our "Kokomo" view to get there fast and take it slow", specifically **50bps in July and a pause in August**, which leaves **a 3-month window** to their next meeting in October.

Table: Selected Events Before Next Policy Meeting

Date of Data Release	Event
3 June	**Inflation Release (May)**
15 June	Unemployment Rate (May)
30 June	Industrial Production (May)
5 July	**Inflation Release (June)**
7 July	Current Account (May)
13 July	Unemployment Rate (June)
13 July	**BoK Meeting**

In terms of domestic data release, **two inflation prints for May and June along with an updated survey for inflation expectations will serve as key nudges** to determine if a big step hike of 50bps is needed. Externally, the extent of global monetary tightening from the Fed and ECB will also determine KRW's movements and associated imported inflationary pressures. All said, a 50bps move involve risks of landing into a downward spiralling confidence and economic activity. Therefore, a big step move will need to be premised on a sustained near historical trend economic growth and associated levels of incomes.

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