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Economics Group

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Uncertainty of Trade Tension Keeps Rates Steady for BoK

The Bank of Korea left rates unchanged at the close of its July monetary policy meeting. U.S.-China trade tensions present a large area of uncertainty, while economic conditions are still shy of support for a rate hike.

Rates Constant as Conditions Remain Uncertain

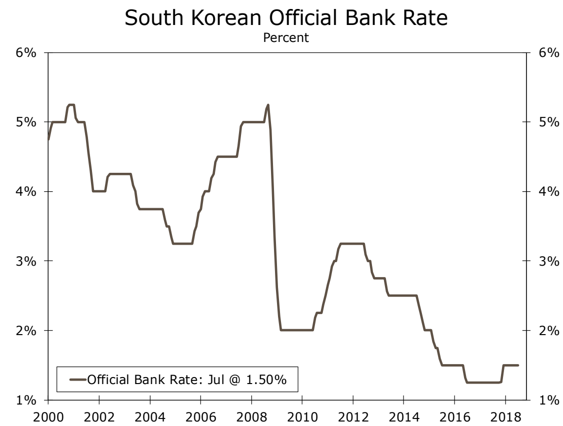
The Bank of Korea (BoK) held its bank rate steady at 1.50 percent at the conclusion of its July monetary policy meeting (top graph). This decision came with little surprise among markets, given the recent indicators pointing to a still sluggish labor market and underwhelming development in CPI inflation. The official policy statement still tilted slightly dovish, as the BoK signaled it would keep policy accommodative to support economic growth.

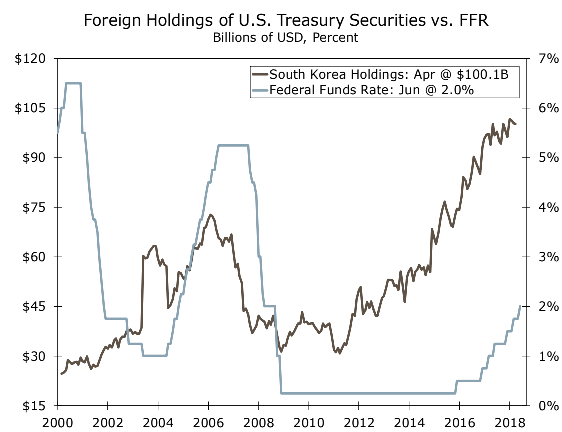
In our view, there were two big outcomes from July's meeting. First, there was a dissenting vote in favor of policy tightening. This shift from a unanimous decision to hold rates steady at the previous meeting offers another indication of the BoK's intention to eventually raise rates. Second, the BoK downgraded its 2018 growth projection to 2.9 percent from 3.0 percent previously, citing corporate earnings and trade tensions as causes for the adjustment.

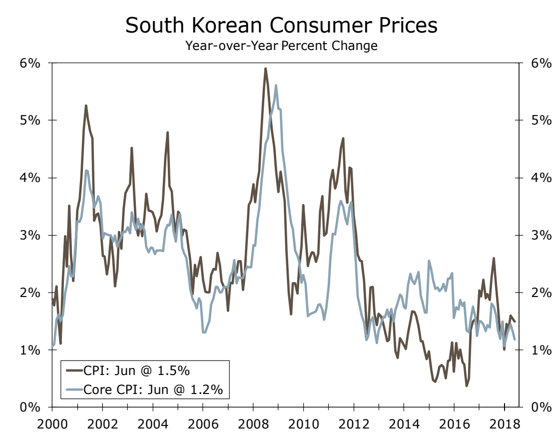
The central bank may be pushed to raise rates in an effort to curb potential capital outflows. If there is no action by the BoK in August, the expected rate hike in September by the U.S. Federal Reserve will push the difference in interest rates between South Korea and the United States up to 75 basis points. The dynamic here suggests if investors have potential to earn more in safe short-term debt, in places like the United States, there is a lack of incentive to keep money on reserve at the BoK. This trend is evident in the middle graph, which depicts increases in South Korea's holdings of U.S. Treasury securities relative to the federal funds rate.

Economic conditions, however, are not yet completely supportive of less policy accommodation. Despite a recent improvement in jobs data, the trend here still points to sluggish growth. While the working-age population is rapidly dwindling due to an aging workforce, the more pressing concern is the fertility rate, which according to World Bank data is the lowest in the world. The unemployment rate remains high and is likely to remain elevated due to structural concerns prevalent in the economy. Although job market worries dominated the previous monetary policy meeting, the escalating trade tensions between the U.S. and China were highlighted as the largest concern to the export-oriented economy at July's meeting. While exports have remained pretty strong this year, they have moderated from the highs registered in 2017. Uncertainties around trade tensions will likely continue to play a large role in the timing of a rate hike this year.

CPI inflation has been below target since October of last year. While averaging 1.4 percent since the start of this year, inflation remains roughly in line with the BoK's forecast, but below the target level (bottom graph). A rise in oil prices may add upward pressure to inflation; however, the middling labor market means there is little room for wage-push inflation. Broad normalization of global policy presents scope for the BoK to raise rates, although trade uncertainties and lackluster inflation still suggest hesitation on just when that may be.







Source: Bloomberg LP, IHS Markit, U.S. Department of Treasury and Wells Fargo Securities

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