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Asian Economic Insights

More Easing To Come in Korea

In our last Asian Weekly published on August 8 (*Korea – BOK's Balancing Act*), we argued that the BOK would adopt a 'neutral' policy stance in the near term, in face of the contradicting trends of surging inflation/strong export expansion and continued sluggishness in domestic demand.

In fact, the BOK cut the benchmark overnight rate by 25bp to a historical low of 3.5% on August 12. The move surprised the market because it indicated a sudden shift of the central bank's policy focus with 'growth supporting' now taking priority. In our view, the rate cut was not in tune with previous regular policy communications from the central bank. This makes us suspect that there was substantial MOFE's influences in the latest monetary action.

The rate action has raised our concern that the sluggishness in local demand and its impact on banks' NPL may be more serious than generally thought. At the same time, the central bank is taking a calculated risk that the current inflation surge is largely transitional in nature, and the subsequent weakening of the KRW will not exacerbate inflationary pressure down the road. In short, the BOK will tolerate a higher short-term inflation risk (core CPI stays above its target of 3.5-4%) than we originally envisaged (**see Display 1**).

We now think that the latest rate cut signals a renewed round of monetary easing and not the last rate reduction in the current easing cycle. Recall that the last 25bp rate cut occurred some 13 months ago when the overnight rate was reduced from 4% to 3.75% on July 2003. We expect that the interest rate policy will shift towards more easing (another 25-50bp reduction) if the macroeconomic data (particularly exports, industrial production and retail sales) over the next few months do not suggest that economic growth is making a comeback.

Korea's strong external position will allow a de-linking of the local interest rate cycle from the US's. However, chances of an appreciation of KRW/USD now look limited. The local bond rally will be extended and we now expect a further decline in the benchmark 3Y government bond yield to 3.60% in six months (3.78% currently). Our six-month KRW/USD forecast has also revised down to 1200 (1162 currently). Given our Yen/USD projection remains at 105, this points to a 9% depreciation of the KRW/Yen cross rate.

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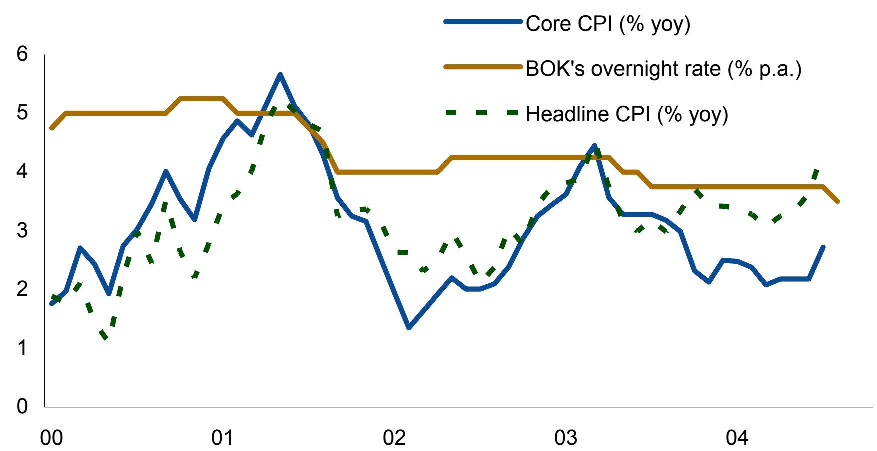
Display 1: BOK Will Tolerate a Higher Inflation Risk
Korea's Inflation and Overnight Call Rate



Source: CEIC and Alliance Fixed Income estimates, August 16th, 2004.