GLOBAL ECONOMIC RESEARCH

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Korea Hikes Rate Amid Evidence of Modest Recovery

The 25 basis-point hike in the Bank of Korea (BOK) overnight call rate to 3.5% on Tuesday was essentially in line with the signals given out by the bank and was therefore fully priced in by the financial markets. Yet though it is the first increase since May 2002, we do not believe it marks the beginning of a protracted hiking cycle. More likely, the bank has departed from a long tradition of inflation targeting and is now focused on preventing a too-low interest-rate environment.

Indeed, the current level of rates may be distorting resource allocation and thus exacerbating Korea's property bubble. The ministry of finance and economy implemented specific measures to curb the property market last month. It wouldn't surprise us if the BOK decided to hike in order to demonstrate that the monetary authority is willing to do its bit in dealing with the property problem.

From our perspective, a higher interest rate may or may not curb property speculations but such a blunt measure may have the unintentional effect of penalizing other sectors of the economy.

A Patchy Recovery

We have argued for some time that a rate hike would be more prudent during the first half of 2006 than in the current quarter, which runs the risk of choking the recovery of economic growth. Domestic demand shows signs of having bottomed out in the third quarter, to be sure, but we have yet to see evidence that the economy is on a firm footing. Despite relative strength in consumer spending and exports, investment in machinery and equipment has remained subdued (**Displays 1–2**).

More importantly, inflation is still under control, notwithstanding surging energy prices. The consumer price index excluding agricultural products and oil (core CPI) has been running below the central bank's target range of 2.5% to 3.5% for some time, falling from its recent peak of 3.3% year-over-year in October 2004 to a low of 1.9% last month (**Display 3**).

One More Hike?

As the economy continues its modest revival, we believe the BOK aims to take back the two 25 basis-point reductions of its overnight call rate made during the second half of 2004.

That said, we expect no more rate hikes before the end of the year, as the surprisingly poor results in the September labor report suggest a pause might be more appropriate in the next two or three months. The unemployment rate (seasonally adjusted) jumped to a four-and-a-half-year high of 4.0% in September from 3.7% in August. Meanwhile, employment growth dipped to a mere 1% year-over-year after firming up nicely since the second quarter (**Display 5**). This worsening trend may be a blip, but does highlight the still-fragile condition of the current recovery, in our view.

The way we see it, the next 25 basis-point increase is likely to occur in the first quarter (assuming evidence of a sustainable recovery asserts itself) and the real overnight call rate should increase to about 75 basis points in six months' time—compared to an average of only 18 basis points in the first half of 2005 (**Display 4**). This would fulfill the policy target and inject a stronger dose of stability to the local bond market. In addition, we expect the benchmark three-year government bond yield to rise to about 5.0% in the first quarter (against 4.7% currently) and stabilize at that level.

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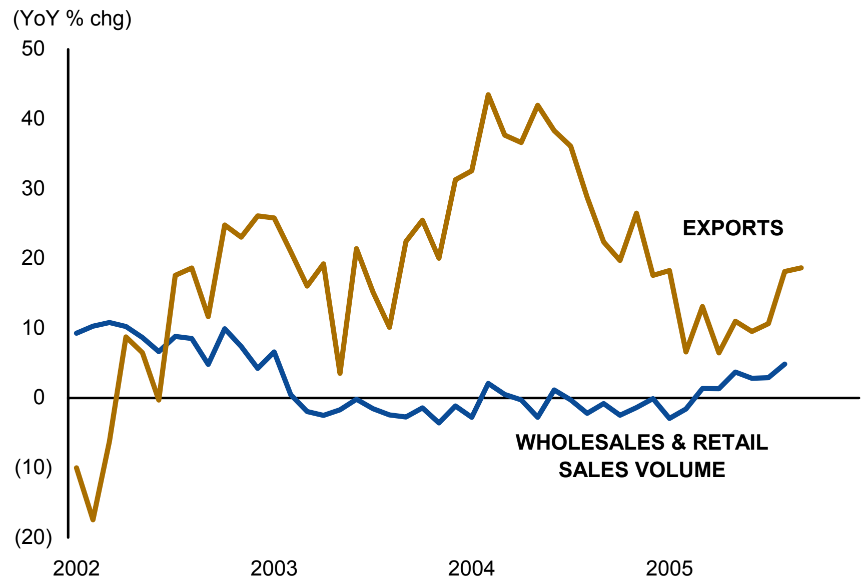
Display 1: Exports And Consumption Are Bottoming Out…

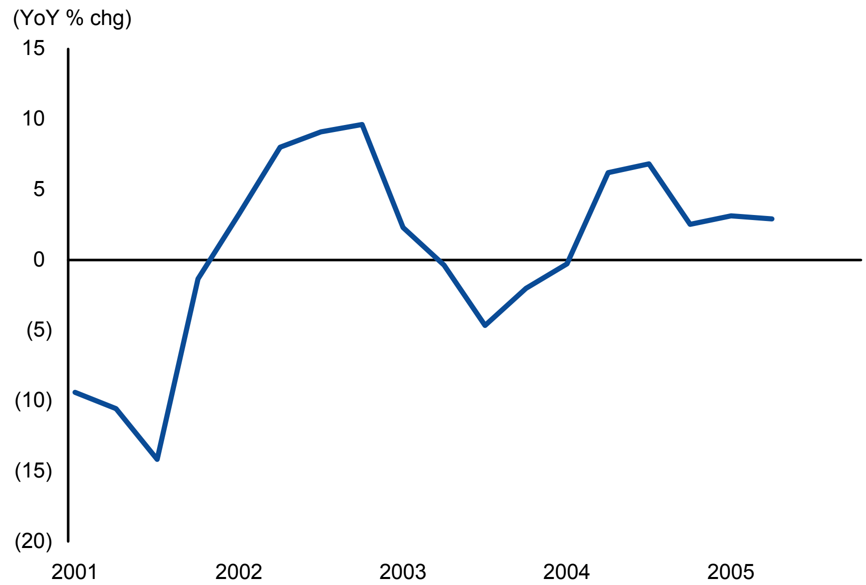
Growth of Exports And Wholesales & Retail Sales Volume



Source: CEIC Data and Alliance Capital Fixed Income estimates; October 14, 2005

Display 2: … But Capex Growth Remains Subdued

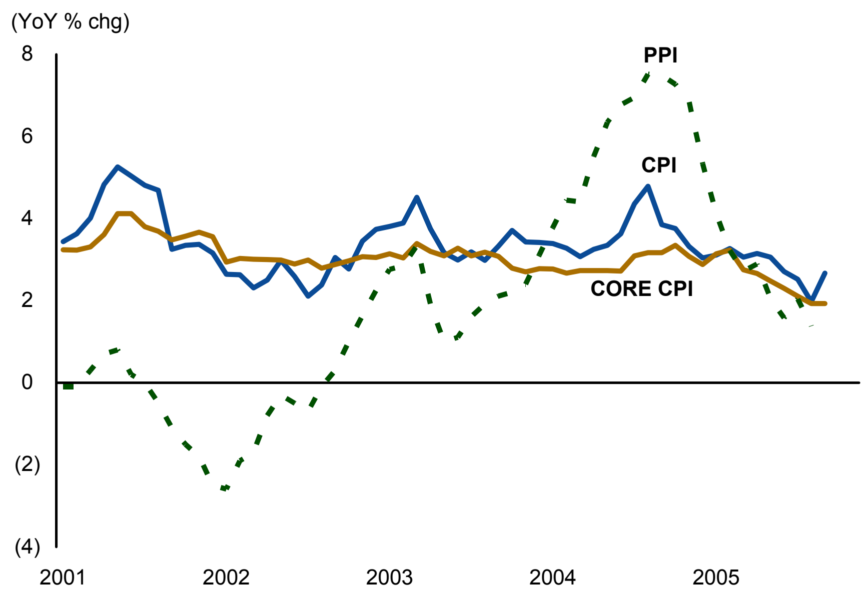
Growth of Machinery & Equipment Investment



Source: CEIC Data and Alliance Capital Fixed Income estimates; October 14, 2005

Display 3: Inflation Continues to Be Well-Behaved

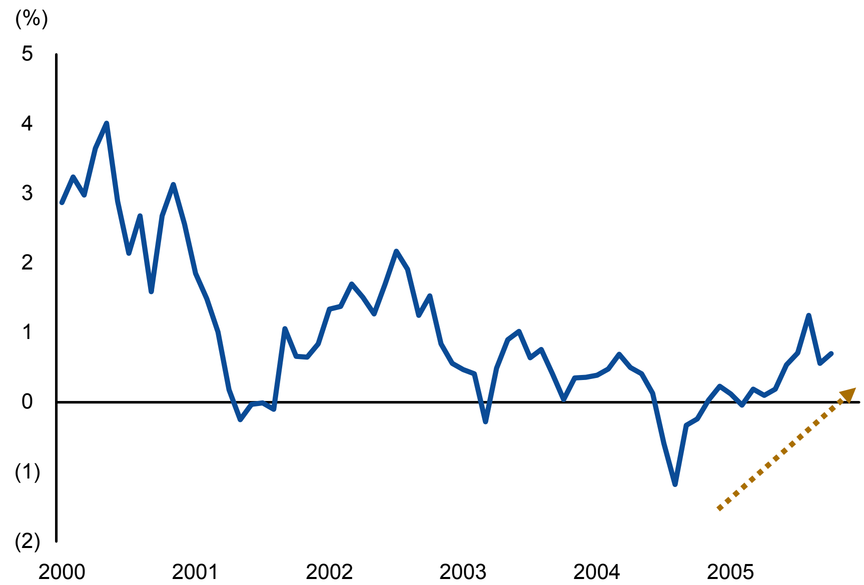
Growth of Consumer and Producer Price Indexes



Source: CEIC Data and Alliance Capital Fixed Income estimates; October 14, 2005

Display 4: A Return to A More Neutral Interest-Rate Environment

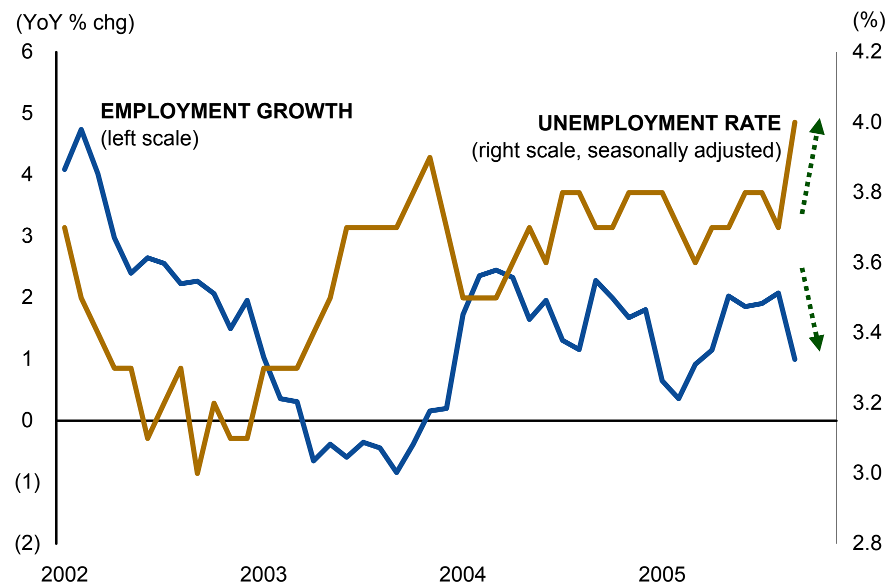
Real Overnight Call Rate



Source: CEIC Data and Alliance Capital Fixed Income estimates; October 14, 2005

Display 5: Labor Market Conditions Worrisome

Unemployment Rate and Employment Growth



Source: CEIC Data and Alliance Capital Fixed Income estimates; October 14, 2005