Economics

DBS Flash

South Korea: First rate cut since 2016; more to come

Economics/Monetary/Korea

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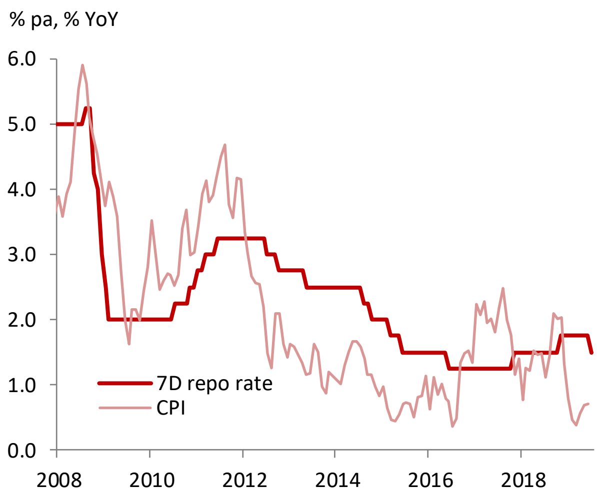
- *The Bank of Korea cut rates by 25bps to 1.50% at today's meeting. The BOK's growth and inflation forecasts for 2019, which have been lowered to 2.2% and 0.7% respectively at today's meeting, remain somewhat optimistic, in our view.*
- *The recent Japan-Korea trade disputes, in addition to global demand weakness, tech sector downturn, property market slowdown, and US-China trade tensions, pose challenges to the 2H growth outlook.*
- ***Implication for our forecasts**: We add one more 25bps rate cut into our forecast and expect the benchmark rate to fall further to 1.25% in 4Q. We also revise the 2019 inflation forecast to 0.5% from 1.1%.*

A policy U-turn

The Bank of Korea (BOK) cut the benchmark 7-day repo rate by 25bps to 1.50% at today's policy meeting. This is the first cut since 2016; this is also the first time for the BOK to make a policy U-turn since the end of the 2008 global financial crisis – cutting rates less than one year after delivering a hike.

South Korea: Policy rate vs inflation



Drastic policy U-turn shows that the authorities' concerns about weak economic fundamentals are serious. BOK governor said at today's press conference that the need of supporting economic recovery has grown bigger. During the quarterly economic outlook report released at the same time today, the BOK revised down the 2019 GDP growth forecast notably to 2.2% from 2.5%, while lowered inflation forecast to 0.7% from 1.1%.

The new official forecasts remain somewhat optimistic and downside surprises remain possible, in our view. We are adding one more

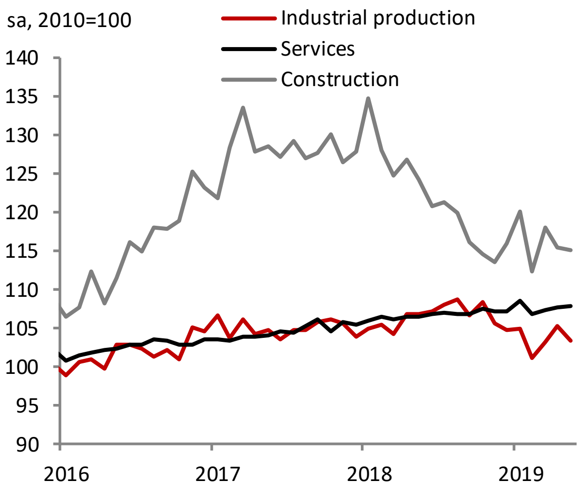
25bps rate cut into our forecast for 2019 and expecting the benchmark repo rate to fall further to 1.25% in 4Q.

Growth outlook remains sluggish

GDP growth contracted -1.4% (QoQ saar) in 1Q. To achieve 2.2% growth in the whole year of 2019, it requires real GDP to grow more than 3.5% (QoQ saar) per quarter in 2Q-4Q. But there is little sign that the economy will stage a strong rebound ahead. High-frequency indicators like exports, PMI, industrial production, and consumer confidence weakened again in May/June after improvement in April.

In fact, both the manufacturing and construction sectors have entered a recession, in the context of global demand weakness, tech sector downturn, property market slowdown, and US-China trade tensions. New headwinds come from the recent rise in Japan-Korea trade disputes. Japan's move of curbing the exports of high-tech materials to South Korea could disrupt the production activities among South Korean semiconductor and flat panel display companies, which highly rely on Japan for the supply of crucial materials.

South Korea: Output indices

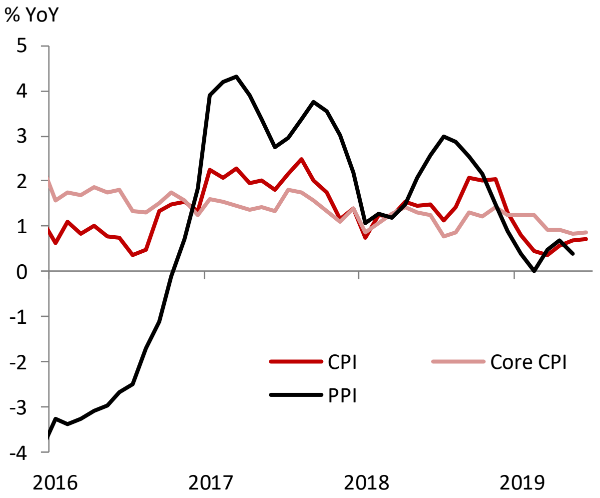


We have been projecting real GDP to grow 2.1% this year, more conservative than the BOK's old (and new) forecast. We keep this estimate unchanged for the time being, but see risks tilted towards the downside.

… and also inflation

On the inflation front, headline CPI posted only 0.6% YoY on average in 1H. The BOK's full-year forecast of 0.7% implies a slightly higher inflation trajectory in 2H. But the high base effects will emerge in 2H (CPI spiked to 2% in Sep-Nov18 on food prices), which is likely to depress the inflation figures on YoY basis. Leading indicators also suggest that price pressures in the pipeline are muted. The upstream PPI inflation has been staying subdued at 0.5% YoY for five consecutive months as of May. Inflation expectations, as revealed by the consumer confidence survey, have been falling persistently through 1H.

South Korea: CPI and PPI inflation



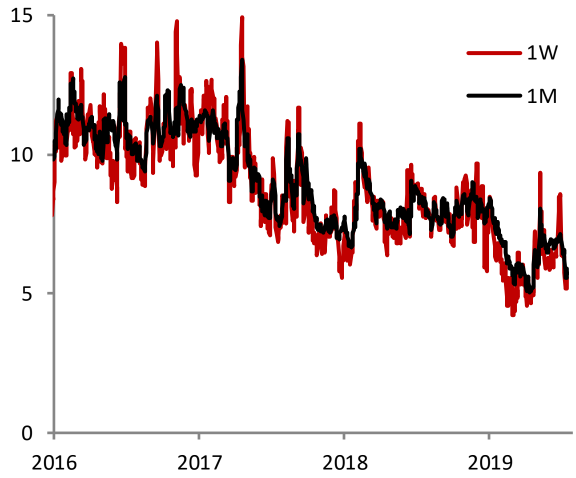
We are revising down our 2019 CPI inflation forecast to 0.5% from 1.1%, below the BOK's new forecast of 0.7%. And we foresee the possibility of zero/slightly negative CPI figures during the Sep-Oct period.

Capital outflow pressures abating

On the external front, capital outflow pressures are abating. The current account swung back to a USD 4.9bn surplus in May from the USD 0.7bn deficit in April (during the peak season of dividend payments to foreign investors). Foreign investment in KRW bonds surged consecutively in May (KRW 7.1tn) and June (KRW 5.8tn). Foreign reserves increased by USD 1.1bn in June after shrinking USD 1.2bn in April and USD 2.1bn in May. The volatility of the USD/KRW has declined, accordingly.

Given the dovish Fed/ECB and the fall in DM yields into negative territory, the low yields of KRW assets are no longer a distinct disadvantage. In line with our forecast of two 25bps Fed rate cuts in 2H, we think the BOK also has the room to deliver one more cut towards the end of this year and bring the total magnitude of rate cuts to 50bps.

USD/KRW volatility (implied)



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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).