

South Korea: BoK Signalled Possibility to Hike Rate Soon

The BoK kept its benchmark base rate unchanged at 2.0% for the seventh consecutive meeting on Thur, in line with market's expectation. In its policy decision statement, the central bank cited uncertainty in the economic growth path as the key motivation to maintain the loose monetary policy although "mortgage loans continued their large-scale expansion".

However, BoK governor Lee Seong-tae sounded surprisingly hawkish in the press briefing, indicating that a near-term rate hike is possible if property prices continued to run up. Even then, he said this is still in line with an accommodative policy stance – true actually since the Bok was the most aggressive central bank in Asia to have cut its benchmark rate by 325bps since the global downturn. Central to the concern is that recent imposition of more stringent limits on bank mortgage lending could still fail to rein in the greater-than-expected increase in property prices and transactions in the country even as economic growth has not stabilised.

Property 'bubble' is a Concern

The property price index for Seoul has been rising on a m/m basis since April this year and in August, the index was just 0.9% below the peak in September 2008. Further indicating the rebound in the property market, apartment transaction volume in June has also risen to its highest since 2007. Household mortgage loans rose by 10.9% y/y in June, the fastest growth rate since April 2007.

To keep a lid on the real estate market, the government has recently expanded the debt-to-income ratio regulation to the Seoul metropolitan area for mortgage loans exceeding 50 million won, which requires that the total mortgage cannot exceed 50% of a borrower's annual income in Seoul and 60% of income in the Incheon and Gyeonggi Province. The regulators are now watching mortgage loans extended by non-banking institutions which are not subject to the stricter regulation.

Inflation Risks Fairly Contained

On inflation, the risk is still fairly contained with headline inflation at 2.2%/y/y in August. We expect the inflation rate to rise to an average of 3.1%/y/y in 4Q09 and 1H10. This is still within the BoK's inflation target of 2.5%-3.5%. While this suggests a negative real interest rate situation, we noted that there is scope for the country to tolerate short bouts of negative real interest rate as seen in late 2008 to the early part of the year.

Risk has Shifted Towards Earlier Rate Normalisation

While the risk has now shifted higher for a sooner rate hike as a result of worries over the property market, we are still maintaining our forecast for the BoK to start normalising interest rates in 2Q10 with total hikes totalling around 125bps next year. The growth trajectory will be the key in driving monetary policy decision in South Korea and we are expecting y/y growth to rebound into the positive territory only in 4Q09. This suggests that the BoK would be more comfortable hiking rates in early 2Q10.

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