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Thursday, 10 March 2011

Flash Notes

Less Hawkish BoK Despite Rate Hike

The BoK raised its benchmark base rate by 25 bps to 3.00% today, in line with market's expectation. It also increased its interest rate on soft loans to commercial banks which are available to small companies, by 25 bps to 1.50%. The hike today is largely driven by the acceleration in the inflation which rose above 4% y/y in Jan and Feb to its 27-month high. This is above the ceiling of the BoK's inflation target of 2%-4%. Recently, the government has also come up with measures to control inflation including import tariff cuts, freezing government charges and initiating energy saving programs in the country.

Supply side inflation appears to be the key concern now as a result of the high oil prices although demand side inflationary pressure could also continue to pick up as the economy strengthens. The disruption to global oil supply due to the unrest in the Middle-Eastern and North African countries will bring about greater upward pressure to the inflation, depending on whether the situation intensifies. For the inflation trajectory, there is a risk that the headline CPI will stay above 4% y/y in the first 3 quarters of this year before moderating in 4Q11. We are more hawkish than the BoK which forecasts inflation of 3.7% y/y in 1H11 and 3.3% in the second half.

The inflation forecast supports frontloading of interest rate hikes in the earlier part of the year with the next one probably in May. To date, the central bank has raised interest rates by 100 bps since Jul-2010 and we expect a further 50 bps move this year to bring the rate to 3.50% by end-2011. BoK Governor Kim Choong-soo said that the current pace of interest rate normalisation is sufficient to anchor inflation expectation. This suggests that another 50 bps hike this year will be in order. This will bring the rate close to the 'neutral' rate which we estimate to be around 3.50%-4.00% based on the long-term inflation trend in South Korea.

On the currency front, USD/KRW was higher today, led by elevated oil prices and China's surprise trade deficit which suggests that appreciation pressure on the RMB could ease in the near-term. Investors also took profit on the KRW following less hawkish comments from the BoK. We are maintaining our call for USD/KRW to fall to 1,110 by end-1Q11 and 1,080 by 4Q11.