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Flash Notes

South Korea: Centering on Inflation Risks

The BoK surprised market with a 25 bps hike to its benchmark base rate on Thur, bringing it to 2.75%. This is the third interest rate hike since the central bank began normalizing rates in July 2010.

In its statement, the BoK highlighted inflationary pressure arising from high food and commodity prices as well as demand side pressure as the domestic economy rebounds. The central bank remains optimistic in its growth outlook although it flagged some downside risk from the Eurozone. The BoK said future monetary policy will be conducted "in such a way as to firmly anchor the basis for price stability while the economy continues its sound growth." This suggests that inflation management has become a more pressing concern in South Korea, similar to other parts of Asia which have experienced large capital inflows in the last two years.

Domestic headline inflation has risen to 3.5%y/y in Dec 2010, bringing the full-year price increase to 3.0%. We estimate that the CPI would continue to rise to around 4% y/y sometime during 3Q11 before easing off in the last quarter of the year. Our 2011 inflation forecast remains at 3.5% although there could be upside risks from supply-side factors. The BoK targets inflation of 2%-4% this year.

Following the policy rate announcement, the South Korean government unveiled measures to control domestic prices as scheduled, highlighting that the policy priority in 1H11 is price stability. The government has ordered a review of fuel oil prices and will cut import tariffs on more than the 67 items planned earlier, including coffee beans and powdered milk. Public service charges such as electricity and gas tariffs and rail transport fares will also be frozen. Furthermore, the government will attempt to boost stocks of grain to stabilise prices and increase the supply of rental apartments.

Interest Rate and FX Expectation

Market is now expecting the BoK to stand pat in Feb after the surprise 25 bps hike today. We are still maintaining our forecast for a total of 100 bps rate hike this year (base rate rising to 3.50%) although it appears that those moves will be frontloaded in the first three quarters of the year in order to manage the inflation expectation.

On the currency, BoK governor Kim Choong-soo said it is unlikely to use the exchange rate to tackle inflation concerns. However, we would still expect to see KRW strengthening on the back of capital inflows and RMB appreciation pressure.

USD/KRW briefly slipped below 1,110 this morning (from 1,119.45 close on Wed) ahead of the interest rate announcement as market was pricing in some chance of a surprise move by the BoK due to the more hawkish comments from the government earlier as well as greater concern over Asian inflation trajectory this year. The pair has rebounded to around 1,114. USD/KRW is likely to trend lower over the course of the year, falling to 1,110 by end-1Q11 and 1,080 by 4Q11.