

South Korea: No Surprise In Decision To Hold Rates In July

The BoK kept its benchmark base rate steady at 3.25% on Thur. With the last rate hike just handled out in June, the decision today was well within market's expectation. Since July 2010, the central bank has raised its interest rates by a cumulative 125 bps compared with 325 bps cut during the crisis.

In its statement today, the BoK has maintained its positive tone on the economy which will continue to be supported by both exports and domestic demand. It continued to expect high inflation in the months ahead which would most likely be driven by demand-side pressure and inflation expectation. Core inflation has edged up to 2-year high in June and the headline inflation remained stubbornly high at 4.4% y/y in June despite coming off its 26-month high in March. We expect headline CPI to stay above the central bank's target of 2%-4% in July and August before moderating in 4Q11. In the short-term, inflation will likely remain the focus. The BoK said that it "will conduct monetary policy with a greater emphasis on ensuring that the basis for price stability is firmly anchored while the economy continues its sound growth."

Going forward, the growth and inflation trajectories suggest that the probability of a 25 bps rate hike is high in August/September while the BoK would most likely maintain its interest rates in the fourth quarter as price pressure is expected to ease, particularly taking into consideration the high household indebtedness. That would bring the total interest rate increase to 100 bps for 2011.

Impact on FX

USD/KRW eased to 1,058.20 on Thur from 1,060.55 close on Wed, driven by broad USD direction. The pair is currently around our target for end-3Q11 but we expect more downside to 1,040/USD by end of the year.