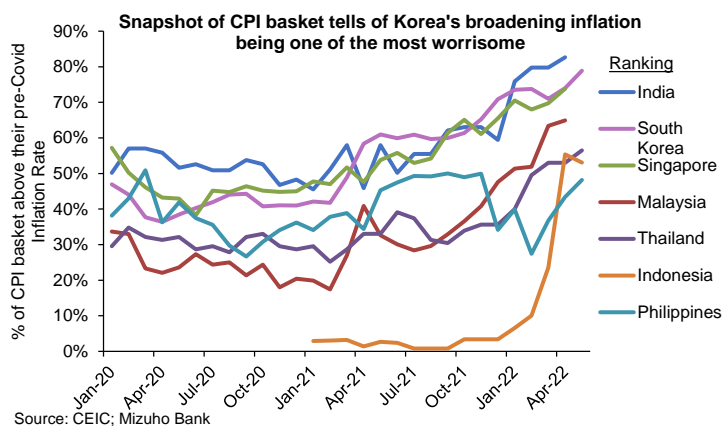
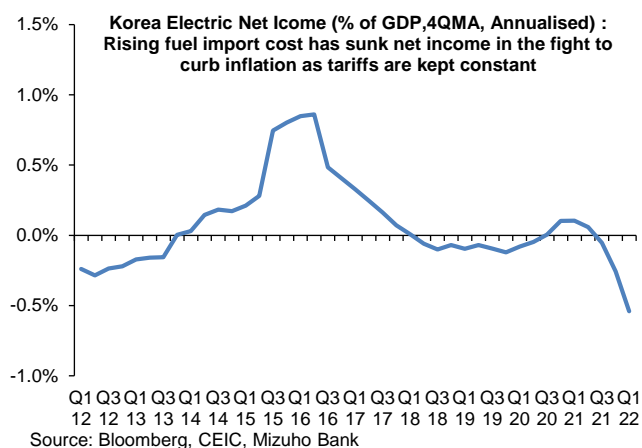
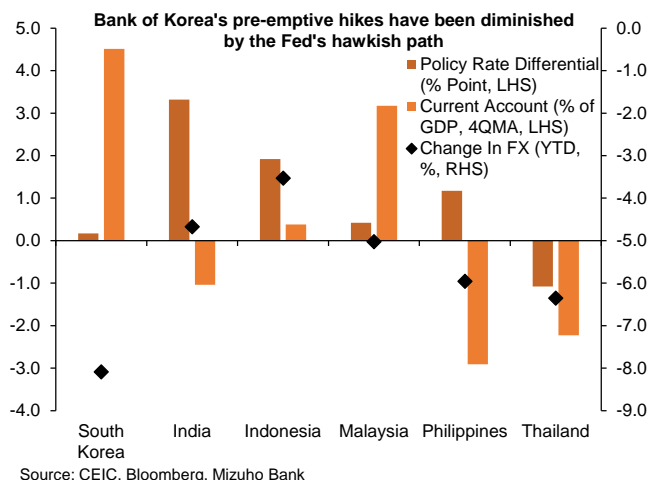
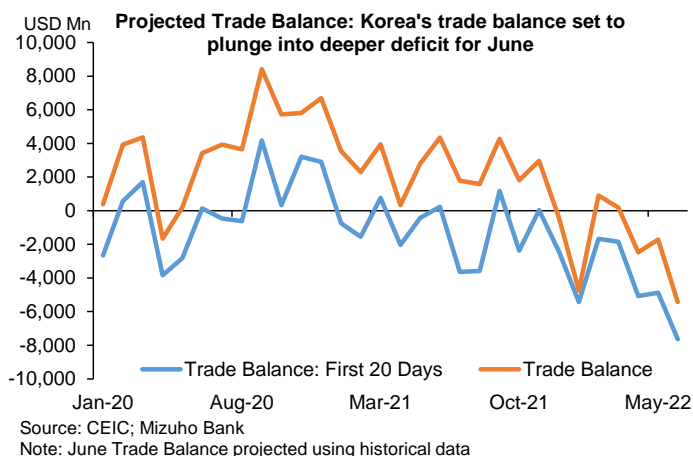


## Korea: Headwinds Manifest



- During the release of the Bank of Korea's biannual report on inflation yesterday, they have **upgraded their inflation forecast for 2022 by stating that it will exceed their 4.5% projection in May, though a point estimate eluded**. Notably, aside from citing that headline inflation in June and July will be **higher than May's 5.4%**, Governor Rhee acknowledged heightened risks surrounding **currency stability and capital outflows**.
- Certainly, these **external headwinds are increasingly manifesting** themselves. First 20 days' data for trade balance reveals an increasingly deep deficit as Brent crude prices edging higher and remain elevated and therefore, trade balance for **June is estimated to be on track for an unprecedented trade deficit** even as we account for a historically present boost in the later part of each month.
- Even as the Bank of Korea was credibility pre-emptive by hiking rates nine months ago to curb inflationary pressures, their **policy rate differential with the Fed has been swiftly diminished and the KRW has come under increasing pressures**.
- The issue being that **rising inflation has come in spite of the rate increase as well as other fiscal efforts** such as **fuel tax cuts being increased** from 30% to 37% and **extended** till the end of 2022. Enterprises have also been enlisted to chip in to this fight against inflation. Korea Electric Power Corporation (majority state owned) also sustained huge losses as they were prohibited from raising electricity tariff, in order to alleviate the cost of living impact on households.

- The challenge here is an acute one, allowing these supply side pressures to feed through to higher fuel and electricity cost is by no means a direct reduction in fiscal pressures. At many times, the government will in turn provide transfers to alleviate these higher cost, though albeit more appropriately catering to those in greater need rather than broad based price ceilings/cuts.
- In addition, the feed-through of supply sides pressures to inflation expectations and lowering real borrowing costs remains a valid and worrying one as we had alluded to earlier. (See [Mizuho Flash: Korea: “Big Step Hike?”](#), 26 May)
- Given Korea remains one of the leaders in terms of our broadening inflation gauge, **we now favour a big step hike of 50bps to take the policy rate to 2.25%** and allow a pause in August, barring a surprise sharp drop of inflation print for June. That said, more importantly, **all roads lead to Rome**, with meetings in July and August, 2.25% will still be reached in Q3 given the path of **domestic** inflation and growth.
- Beyond 2.25%, **external** headwinds from hawkish Fed flex looks to dictate especially the capital outflow pressures intensify and the KRW entrenches in a depreciating spiral. **These ventures of higher nominal rates may be increasingly costly given that Korea’s growth potential has slowed considerably** after 2010 with recent estimates from BoK and OECD ranging 2-2.2%, which in turn heightens the importance of the neutral rate.

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