Every Reason Why the Bank of Korea Should Not Lower the Base Rate

Whenever the Bank of Korea’s (BOK) Monetary Policy Board meeting is held every month to determine its policy issues regarding the base rate (equivalent to the federal funds rate in the United States), almost all of Seoul’s financial analysts do not hesitate to openly express their views. Amid stagnant economic growth and the congressional election looming large on April 13, it seems unanimous this time that the market favors and bets on the BOK’s Monetary Policy Board to lower the rate. Although it is understandable why the Board hopes to lower its rate, here are some reasons why it shouldn’t.

First, the rate has been lowered too much under the current administration. Since the change of the monetary policy regime under the IMF recommendation in the early 2000s, the base rate has been lowered the most. In the three years under the current Park Geun-hye administration, the rate has already lowered from 4.5 percent to 2.75 percent to 1.5 percent. The government argued deflation as the rationale for the rate-debasement, but Korea has been nowhere near deflation then and now.

Second, rate debasement has shown little effect other than creating an economic bubble. Despite the country’s record-breaking low rate since 2013, private consumption and investments have remained dull and shown little growth. Indeed the interest rate’s ineffectiveness on domestic demand has become a sort of ‘stylized fact’ since the early 2000s. On the one hand, private deposits amount to more than KRW 2000 trillion (USD 1.7 trillion) as opposed to KRW 1200 trillion (USD 1 trillion) of household debts. Meanwhile on the other hand, lowering the base rate has a stronger impact on lowering the deposit rate than on lending. The debasement of the rate thus would surely hamper the interest income for the depositor than reduce interest costs for the borrower, rendering less spending.

Third, the current economic slump is not caused by the high interest rate. Therefore, if policymakers want to cure economic sluggishness in Korea, they have to find the real cause somewhere else. In my view, there are two fundamental reasons for low economic growth in Korea—poor export performance and stagnating income.

Fourth, huge capital is already flowing out of Korea. In 2015, the repatriation of foreign investment in Korea amounted to USD 53.3 billion, but the amount of overseas investments made by Korea was even bigger at USD 57.9 billion. Altogether it amounted to USD 111.2 billion, which is even greater than the current account surplus of USD 106 billion in 2015. The funds of foreign as well as domestic investors are flowing outside of Korea and one of the main reasons for this, in my opinion, is the lowered interest rate or expectation thereof.

Fifth, the rate of the Korean won is fairly unstable. One of the key determining factors of investment in Korea is undoubt-
edly the stability of the won’s exchange rate, but it has shown some volatility since late 2014. Most investors either hesitate from making future investments or withdraw their investments from Korea as they focus more on the won’s potential weakness rather than its strength. Its increased uncertainty is further strengthened by external pressure not to intervene in the exchange market, as well as the gradual drawing down of official reserves since June 2015.

Sixth, the banking industry will gradually lose its strength. The current low rate hinders the banking industry’s profitability as more depositors withdraw their deposits from banks and less people want to borrow due to gloomy economic prospects. The continued rate has deteriorated bank profitability and a number of weaker banks all over the world are showing serious risks of collapse.

Seventh, the Fed is likely to raise the funds rate at least by June 2016. The recent FOMC meeting in March has frozen the rate between 0.25 percent and 0.5 percent as anticipated by the market, but a series of public talks by Fed officials, as well the comments by Fed Chair Janet Yellen, have strongly hinted the rate hike to take place no later than June and at least twice this year. Yellen pointed out at the press conference that the American economic growth has been fairly good and stable at 2 percent, its job market is particularly strong, and prices and inflation are showing unequivocal improvements. If the Fed is expected to raise the rate twice this year, it is hard to expect the BOK to lower its rate against the head wind from the US.

Eighth, geopolitical tension in the Korean Peninsula has dramatically heightened. Recent provocations of nuclear testing and missile launches by North Korea has heightened South Korea’s alertness, causing the South to naturally increase countermeasures against the North. Although the perceptions of potential geopolitical risks in the minds of investors seem less acute than in past provocations, it is still hard to turn a blind eye to its impact on foreign investment decision making.

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