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BOK 'Behind' After Record Run of Negative Real Rates (Update1)
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(Updates with Credit Suisse forecast in 10th paragraph.)

By Eunkyung Seo and William Sim

Nov. 17 (Bloomberg) -- The Bank of Korea's second interest- rate increase this year leaves its benchmark below the pace of inflation, a sign the central bank will need to add to its move in coming months or risk eroding households' savings.

Governor Kim Choong Soo raised borrowing costs by 0.25 percentage point to 2.5 percent yesterday. The benchmark is 1.6 percentage point below October's annual pace of inflation, and has remained under the gains in consumer prices for 12 straight months, the longest stretch since the base rate's introduction in 1999, according to data compiled by Bloomberg.

"The BOK has realized finally that it is dangerously behind the curve in terms of monetary policy," said Erik Lueth, a Hong Kong-based senior economist at Royal Bank of Scotland Group Plc, who previously worked at the International Monetary Fund.

Negative real interest rates, when the benchmark is less than the pace of inflation, skew incentives toward spending rather than saving, elevating pressure on consumer prices. With the central bank likely to raise rates again as soon as next quarter, the nation's currency is poised to climb, according to Goldman Sachs Group Inc.

The won appreciated 0.2 percent yesterday to close at 1,129.47 per dollar in Seoul, according to data compiled by Bloomberg. It has climbed 7.2 percent since the end of June, the third strongest performance in Asia excluding Japan. The currency will reach 1,050 over the next 12 months, Goohoon Kwon, a Seoul-based economist at Goldman Sachs, said in a note.

The Kospi share index fell 0.8 percent to a two-week low of 1,899.13. The yield on the 3.75 percent note due June 2013 fell 16 basis points to 3.32 percent, the most in a month, according to Korea Stock Exchange.

Capital Flows

A stronger exchange rate risks crimping exports, which account for about half the $832.5 billion economy. South Korea is preparing to combat the gains by introducing a system to counter capital inflows that have driven up the currency.

"Korea won't be able to introduce capital controls strong enough to scare off foreign investors but most likely will take mild steps," said Oh Suk Tae, an economist at SC First Bank Korea Ltd. in Seoul. The won will probably rise to less than 1,100 per dollar next year, Oh said.

Other forecasters also expect an appreciation. The currency will advance to 1,090 by the end of the year and 1,080 by June, Ho Woei Chen, a regional economist at United Overseas Bank Ltd. in Singapore, said in a note yesterday.

100 Basis Points

The central bank is likely to raise interest rates by another 100 basis points to 3.5 percent next year after holding back on any increase next month, Credit Suisse Group AG analysts Dong Tao and Christiaan Tuntono wrote in a report.

South Korea joined India and Australia in boosting borrowing costs this month. The central bank had paused its rate campaign from August to October, citing concern that growth in advanced economies was slowing.

"With the economy coasting close to potential there is a need to push up interest rates," Frederic Neumann, co-head of Asian economics at HSBC Group Plc in Hong Kong, said in an e- mail interview. "Prolonged monetary accommodation raises the risk of asset bubbles and overheating."

Neumann expects the central bank to raise the benchmark rate by at least 0.75 percentage point next year. Royal Bank of Scotland's Lueth expects quarter-point increases each quarter through 2012. South Korea's neutral interest, which supports employment and activity without creating inflation, may be around 4 percent, the IMF said in September.

Consumer-price inflation accelerated to a 20-month high of 4.1 percent in October. The Bank of Korea aims for 2 percent to 4 percent on average through 2012.

The bank yesterday dropped its pledge to keep monetary policy "accommodative" for the first time since the global financial crisis. While the benchmark isn't currently at a neutral level, the economy isn't ready for "normal" rates yet, Governor Kim said.

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