

## Republic of Korea

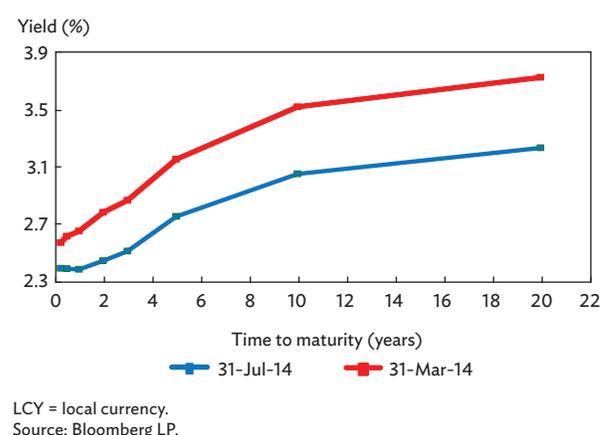
### Yield Movements

The Republic of Korea's local currency (LCY) government bond yield curve shifted downward between end-March and end-July as yields fell for all tenors, with the sharpest drop at the longer-end of the curve, amid market expectations of a policy rate cut (**Figure 1**). Meanwhile, the yield spread between 2- and 10-year tenors narrowed 13 basis points (bps) between end-March and end-July, resulting in a flattening of the yield curve.

Real gross domestic product (GDP) growth in the Republic of Korea moderated to 0.5% quarter-on-quarter (q-o-q) in 2Q14 from 0.9% q-o-q in 1Q14, and to 3.5% year-on-year (y-o-y) from 3.9% y-o-y, based on preliminary estimates released by The Bank of Korea. On a q-o-q basis, the decline in real GDP growth stemmed from a contraction in household consumption and domestic investment on the demand side. On the production side, weaker output growth in manufacturing and construction was accompanied by contractions in agriculture, fishery, and forestry, and utilities.

Consumer price inflation leveled off at 1.4% y-o-y in August, led by relatively high price hikes in housing and utilities. In the first half of 2014, the monthly y-o-y inflation rate ranged from 1.0% in February to 1.7% in May and June. Following 14 consecutive months of leaving the base rate unchanged, The Bank of Korea's Monetary

**Figure 1: The Republic of Korea's Benchmark Yield Curve—LCY Government Bonds**



Policy Committee decided on 14 August to reduce the base rate by 25 bps from 2.50% to 2.25%.

### Size and Composition

The outstanding size of the LCY bond market in the Republic of Korea expanded on both a quarterly and annual basis in 2Q14, bolstered by relatively strong growth in the stock of LCY government bonds (**Table 1**). Central government bonds continued to dominate the LCY government bond market, accounting for 69% of outstanding government bonds. Growth in central government bonds in 2Q14 was led by Korea Treasury

**Table 1: Size and Composition of the LCY Bond Market in the Republic of Korea**

	Outstanding Amount (billion)						Growth Rate (%)			
	2Q13		1Q14		2Q14		2Q13		2Q14	
	KRW	US\$	KRW	US\$	KRW	US\$	q-o-q	y-o-y	q-o-q	y-o-y
<b>Total</b>	1,650,267	1,445	1,754,188	1,648	1,779,533	1,759	2.2	10.6	1.4	7.8
Government	637,277	558	676,491	635	700,464	692	2.3	6.0	3.5	9.9
Central Bank Bonds	165,420	145	170,800	160	174,000	172	(1.4)	0.5	1.9	5.2
Central Government Bonds	439,059	384	466,463	438	485,792	480	2.9	7.5	4.1	10.6
Industrial Finance Debentures	32,798	29	39,227	37	40,671	40	16.6	16.2	3.7	24.0
Corporate	1,012,990	887	1,077,697	1,012	1,079,069	1,066	2.1	13.8	0.1	6.5

( ) = negative, LCY = local currency, q-o-q = quarter-on-quarter, y-o-y = year-on-year.

Notes:

1. Calculated using data from national sources.

2. Bloomberg LP end-of-period LCY-US\$ rates are used.

3. Growth rates are calculated from LCY base and do not include currency effects.

4. Central government bonds include Korea Treasury bonds, National Housing bonds, and Seoul Metro bonds.

Sources: EDAILY BondWeb and The Bank of Korea.

Bonds (KTBs), which climbed 4.6% q-o-q and 11.7% y-o-y. Meanwhile, central bank bonds, or Monetary Stabilization Bonds (MSBs), expanded on both a q-o-q and y-o-y basis in 2Q14, albeit at relatively modest paces, while industrial finance debentures also registered positive growth. Issuance of LCY government bonds rose 4.6% q-o-q in 2Q14, led by a 10.3% increase in central government bond issuance. On a y-o-y basis, LCY government bond issuance climbed 9.0% in 2Q14, induced by 25.1% growth in central government bond issuance and a 6.1% rise in MSB issuance.

LCY corporate bonds outstanding also rose in 2Q14, only marginally on a q-o-q basis and moderately on a y-o-y basis. On a q-o-q basis, the 0.1% growth resulted from an expansion in private corporate bonds that was almost negated by declines in special public bonds and financial debentures—excluding Korea Development Bank bonds. On a y-o-y basis, the 6.5% expansion was driven by 10.6% growth in the stock of private corporate bonds. Meanwhile, LCY corporate bond issuance was down 30.0% q-o-q and 31.3% y-o-y in 2Q14, amid lower issues of special public bonds, financial debentures, and private corporate bonds.

As of end-June, the top 30 LCY corporate issuers' share of total LCY corporate bonds outstanding stood at 61.9% (**Table 2**), up 0.5 percentage points from 3 months earlier. Korea Land & Housing Corporation overtook Korea Housing Finance Corporation in 2Q14 as the largest issuer of LCY corporate bonds. Of the five largest LCY corporate bond issues in 2Q14, three were from banks, one from a housing finance entity, and one from a shipbuilding company (**Table 3**).

## Liquidity

Liquidity tightened in the LCY government bond market in 2Q14, with the turnover ratio falling to 0.80 from 0.85 in 1Q14. The quarterly drop stemmed from lower trading volumes for central government and central bank bonds. Between 1Q14 and 2Q14, the turnover ratio for central government bonds declined from 0.88 to 0.84, and for central bank bonds from 0.99 to 0.88 (**Figure 2**).

Liquidity in the KTB futures market improved marginally in 2Q14, as the total number of traded 3- and 10-year KTB futures contracts inched up to 6.6 million from 6.4 million in 1Q14 (**Figure 3**). Between 1Q14 and 2Q14, the share of 3-year KTB futures contracts traded declined from 73%

to 61% of the total, while the share of 10-year KTB futures contracts rose from 27% to 39%.

Liquidity tightened in the LCY corporate bond market in 2Q14, with the turnover ratio for LCY corporate bonds slipping, marginally to 0.13 from 0.14 in 1Q14. The fall is attributed to q-o-q declines in the trading volumes of special public bonds, financial debentures, and private corporate bonds. Between 1Q14 and 2Q14, the turnover ratio for special public bonds fell from 0.13 to 0.10, financial debentures remained unchanged at 0.35, while private corporate bonds slipped from 0.06 to 0.05 (**Figure 4**).

## Investor Profile

Insurance companies and pension funds remained the largest investor group in the LCY government bond market in the Republic of Korea in 1Q14 (**Figure 5**). They were followed by other financial institutions (financial institutions other than banks, insurance companies, and pension funds), the general government, banks, and foreign investors. Between end-March 2013 and end-March 2014, the share of total LCY government bond holdings of insurance companies and pension funds rose 3 percentage points, while other financial institutions' share inched up 1 percentage point. In contrast, the shares of the general government and foreign investors fell 4 percentage points and 1 percentage point, respectively.

Insurance companies and pension funds and other financial institutions each held 33% of total LCY corporate bonds outstanding at the end of 1Q14, with their shares up 3 percentage points and 2 percentage points, respectively, compared to a year earlier (**Figure 6**). In contrast, the shares of banks, households and non-profit institutions, and non-financial corporations dropped 1 percentage point, 3 percentage points, and 1 percentage point, respectively.

Net foreign investment in the Republic of Korea's LCY bond market was positive for the fifth consecutive month in July, according to Financial Supervisory Service data (**Figure 7**). Relatively large bond purchases by foreign investors, compared with bond redemptions, contributed to the net foreign bond inflow position for the month. In the first 7 months of the year, the cumulative amount of foreign investors' net bond investment was KRW3.1 trillion, down from KRW11.9 trillion in January–July 2013.

Table 2: Top 30 Issuers of LCY Corporate Bonds in the Republic of Korea

Issuers	Outstanding Amount		State-Owned	Listed on		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US\$ billion)		KOSPI	KOSDAQ	
1. Korea Land & Housing	57,646	57.0	Yes	No	No	Real Estate
2. Korea Housing Finance	54,823	54.2	Yes	No	No	Financial
3. Korea Finance	47,151	46.6	Yes	No	No	Financial
4. Korea Deposit Insurance	42,200	41.7	Yes	No	No	Insurance
5. KDB Daewoo Securities	38,281	37.8	Yes	Yes	No	Securities
6. Korea Investment and Securities	35,319	34.9	No	No	No	Securities
7. Woori Investment and Securities	34,783	34.4	Yes	Yes	No	Securities
8. Korea Electric Power	30,910	30.5	Yes	Yes	No	Utilities
9. Industrial Bank of Korea	29,561	29.2	Yes	Yes	No	Bank
10. Hana Daetoo Securities	25,858	25.6	No	No	No	Securities
11. Mirae Asset Securities	25,385	25.1	No	Yes	No	Securities
12. Korea Expressway	21,280	21.0	Yes	No	No	Infrastructure
13. Kookmin Bank	17,211	17.0	No	No	No	Bank
14. Korea Rail Network Authority	17,010	16.8	Yes	No	No	Infrastructure
15. Small & Medium Business Corp.	15,405	15.2	Yes	No	No	Financial
16. Korea Gas	14,995	14.8	Yes	Yes	No	Utilities
17. Hyundai Securities	14,623	14.5	No	Yes	No	Securities
18. Shinhan Bank	14,614	14.4	No	No	No	Bank
19. Woori Bank	14,412	14.2	Yes	No	No	Bank
20. Shinhan Investment	13,847	13.7	No	No	No	Securities
21. Tong Yang Securities	11,472	11.3	No	Yes	No	Securities
22. Korea Railroad	11,150	11.0	Yes	No	No	Infrastructure
23. Standard Chartered First Bank Korea	11,130	11.0	No	No	No	Bank
24. Hana Bank	10,762	10.6	No	No	No	Bank
25. Samsung Securities	10,613	10.5	No	Yes	No	Securities
26. Korea Water Resources	10,304	10.2	Yes	Yes	No	Utilities
27. Korea Eximbank	9,900	9.8	Yes	No	No	Bank
28. Korea Student Aid Foundation	9,630	9.5	Yes	No	No	Financial
29. Shinhan Card	9,156	9.0	No	No	No	Financial
30. Hyundai Capital Services	8,805	8.7	No	No	No	Financial
<b>Total Top 30 LCY Corporate Issuers</b>	<b>668,235.8</b>	<b>660.4</b>				
<b>Total LCY Corporate Bonds</b>	<b>1,079,069.0</b>	<b>1,066.4</b>				
<b>Top 30 as % of Total LCY Corporate Bonds</b>	<b>61.9%</b>	<b>61.9%</b>				

KOSDAQ = Korean Securities Dealers Automated Quotations, KOSPI = Korea Composite Stock Price Index, LCY = local currency.

Notes:

1. Data as of end-June 2014.

2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.

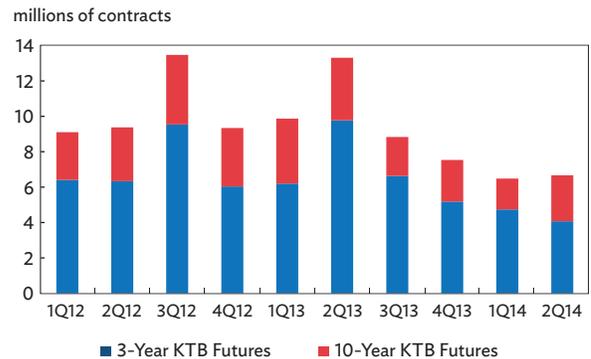
Sources: *AsianBondsOnline* calculations based on Bloomberg and EDAILY *BondWeb* data.

**Table 3: Notable LCY Corporate Bond Issuance in 2Q14**

Corporate Issuers	Coupon Rate (%)	Issued Amount (KRW billion)
Industrial Bank of Korea		
1-year bond	2.63	580
Korea Finance Corporation		
2-year bond	2.85	600
Daewoo Shipbuilding & Marine Engineering		
3-year bond	3.37	440
Woori Bank		
1-year bond	2.65	410
1.5-year bond	2.80	380

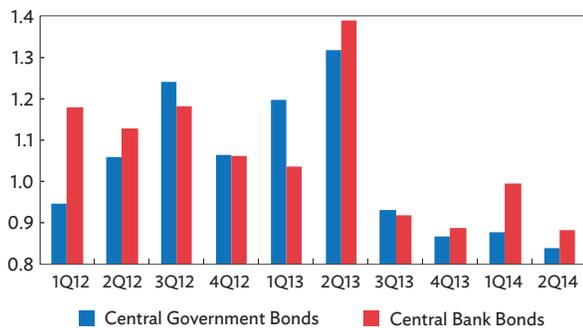
LCY = local currency.  
 Note: Coupon rates for 1-year bond of Industrial Bank of Korea and Woori Bank are indicative yields as of end-June 2014.  
 Source: Bloomberg LP.

**Figure 3: Trading Volume of KTB Futures Contracts**



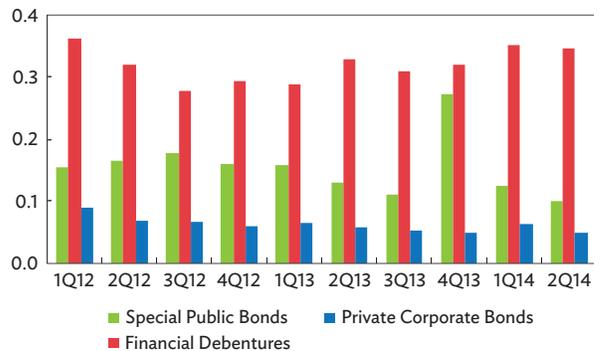
KTB = Korea Treasury Bond.  
 Source: Korea Exchange.

**Figure 2: Turnover Ratios for Central Government and Central Bank Bonds**



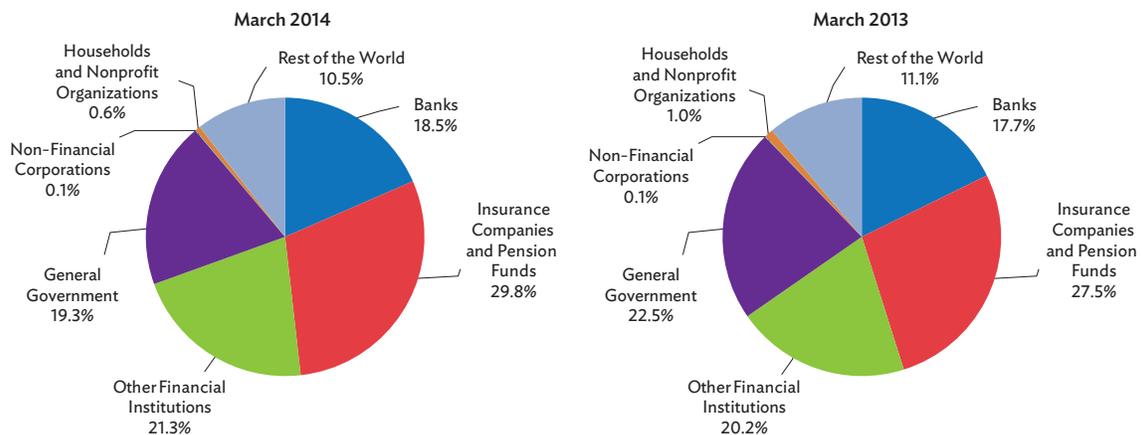
Note: Central government bonds include Korea Treasury Bonds and National Housing Bonds.  
 Sources: The Bank of Korea and EDAILY BondWeb.

**Figure 4: Turnover Ratios for Special Public Bonds, Financial Debentures, and Private Corporate Bonds**

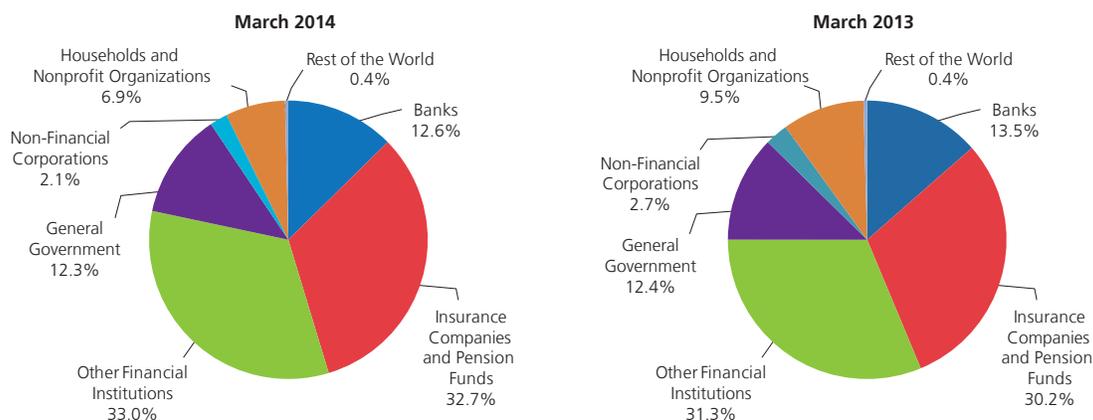


Source: EDAILY BondWeb.

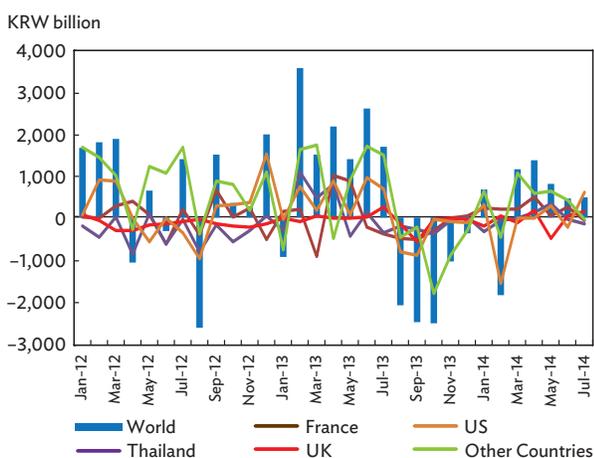
**Figure 5: LCY Government Bonds Investor Profile**



LCY = local currency.  
 Sources: AsianBondsOnline and The Bank of Korea.

**Figure 6: LCY Corporate Bonds Investor Profile**


LCY = local currency.  
Sources: *AsianBondsOnline* and The Bank of Korea.

**Figure 7: Net Foreign Investment by Country in LCY Bonds in the Republic of Korea**


LCY = local currency, UK = United Kingdom, US = United States.  
Source: Financial Supervisory Service.

## Policy, Institutional, and Regulatory Developments

### Financial Regulatory Reforms Announced

The Republic of Korea's Financial Services Commission announced in July plans for financial regulatory reform, including (i) building a financial regulatory system with "better regulation," (ii) mitigating inconveniences facing financial consumers and enhancing support for the real economy, (iii) creating growth opportunities

and new markets for the financial sector, (iv) abolishing implicit regulations, (v) establishing a permanent system for financial regulatory reform, and (vi) tightening internal controls and market discipline for financial institutions.

### Road Map for Derivatives Market Unveiled

The Financial Services Commission introduced in June a road map for the development of the country's derivatives market. The road map seeks to develop the exchange-traded derivatives market into a "risk-managed market" by promoting greater autonomy in market operations and introducing new derivatives products. The road map also calls for the over-the-counter derivatives market to utilize a central counterparty for a wider range of derivatives contracts and to introduce a trade repository system. In the derivatives-linked securities market, the road map calls for the listing of exchange-traded notes, enhancing public disclosure and sales of equity-linked securities and derivatives-linked securities, and standardizing issuance of equity-linked warrants.

### Public Institutions' Debt Reduction Plans Approved

The Republic of Korea's Ministry of Strategy and Finance announced in June the acceptance of the revised debt reduction plans—totaling KRW6.2 trillion—submitted by 10 highly-indebted public institutions to frontload debt reduction in 2014.