

Republic of Korea

Yield Movements

Yields on local currency (LCY) government bonds fell for all maturities between 1 June and 15 August, resulting in a downward shift in the yield curve (**Figure 1**). The decrease in yields ranged from 19 basis points (bps) for the 1-year tenor to 41 bps for the 30-year tenor. The fall in yields was influenced by the Bank of Korea's policy rate cut in June, the United Kingdom's decision to leave the European Union, and declines in Treasury bond yields in major economies. The yield spread between the 2-year and 10-year tenors narrowed 15 bps during the review period.

The Bank of Korea's Monetary Policy Board decided in its 14 July and 11 August meetings to maintain the base rate at 1.25%. The last policy rate cut occurred on 9 June when the board lowered the base rate by 25 bps.

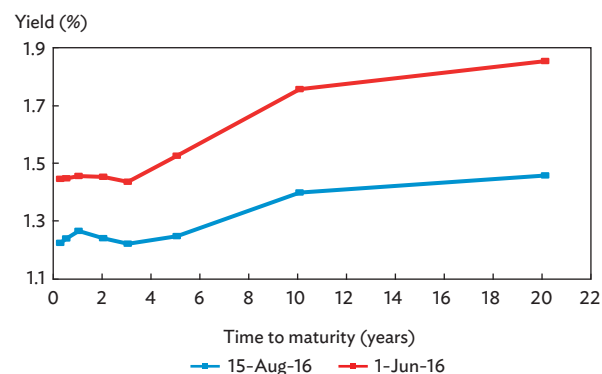
Real gross domestic product (GDP) growth stood at 0.8% quarter-on-quarter (q-o-q) and 3.3% year-on-year (y-o-y) in the second quarter (Q2) of 2016, up from first quarter growth rates of 0.5% q-o-q and 2.8% y-o-y. The higher q-o-q growth in Q2 2016 was led by stronger household spending, domestic investment, and exports on the expenditure side; and more buoyant economic activity in the manufacturing and utility sectors on the production side. The stronger y-o-y growth in the second quarter also stemmed from more robust household spending, domestic investment, and exports; as well as faster growth in construction, manufacturing, and services sectors. In its economic outlook announced in July, the Bank of Korea forecast real GDP growth of 2.4% y-o-y for the second half of 2016 and 2.7% for full-year 2016.

Consumer price inflation remained relatively low, with the Consumer Price Index (CPI) inflation rate slipping to 0.4% y-o-y in August from 0.7% y-o-y in July. The Bank of Korea forecast in July that consumer price inflation would rise to 1.3% y-o-y in the second half of 2016 and settle at 1.1% for full-year 2016.

Size and Composition

LCY bonds outstanding in the Republic of Korea expanded 1.0% q-o-q and 5.4% y-o-y in Q2 2016, leveling off at

Figure 1: The Republic of Korea's Benchmark Yield Curve—Local Currency Government Bonds



Source: Based on data from Bloomberg LP.

KRW2,064.0 trillion (USD1,792 billion) at the end of June (**Table 1**). The outstanding stock of LCY government bonds climbed 1.6% q-o-q and 5.9% y-o-y in Q2 2016 to reach KRW853.0 trillion at the end of June, bolstered by an expansion in LCY central government bonds.

Q2 2016 issuance of LCY government bonds tallied KRW87.0 trillion, up 0.7% q-o-q but down 1.6% y-o-y. The q-o-q uptick was driven by increases in the issuance of Korea Treasury Bonds and Monetary Stabilization Bonds. The y-o-y downturn was mainly led by lower Monetary Stabilization Bond issuance.

The outstanding size of LCY corporate bonds in the Republic of Korea expanded 0.5% q-o-q and 5.1% y-o-y in Q2 2016, buoyed by increases in stocks of financial debentures and the bonds of privately owned corporates, leveling off at KRW1,211.0 trillion at the end of June. In Q2 2016, LCY corporate bond issuance was valued at KRW90.4 trillion, down 5.5% q-o-q and 33.7% y-o-y.

The top 30 corporate issuers of LCY bonds had a cumulative outstanding bond stock worth KRW768.4 trillion (or 63.5% of total LCY corporate bonds outstanding) at the end of June, led by Korea Housing Finance Corporation (**Table 2**). The relatively large LCY corporate bond issuances in Q2 2016 were from two domestic banks—Industrial Bank of Korea and NongHyup Bank—and from a railway operator—Korea Rail Network Authority (**Table 3**).

Table 1: Size and Composition of the Local Currency Bond Market in the Republic of Korea

	Outstanding Amount (billion)						Growth Rate (%)			
	Q2 2015		Q1 2016		Q2 2016		Q2 2015		Q2 2016	
	KRW	USD	KRW	USD	KRW	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	1,958,273	1,756	2,044,415	1,788	2,064,024	1,792	3.1	10.0	1.0	5.4
Government	805,593	722	839,618	734	853,009	741	2.0	15.0	1.6	5.9
Central Bank Bonds	188,310	169	181,390	159	181,420	158	1.8	8.2	0.02	(3.7)
Central Government Bonds	527,583	473	566,919	496	583,402	507	2.7	8.6	2.9	10.6
Industrial Finance Debentures	89,700	80	91,309	80	88,188	77	(1.6)	120.5	(3.4)	(1.7)
Corporate	1,152,680	1,033	1,204,797	1,054	1,211,015	1,051	3.8	6.8	0.5	5.1

() = negative, KRW = Korean won, q-o-q = quarter-on-quarter, Q1 = first quarter, Q2 = second quarter, USD = United States dollar, y-o-y = year-on-year.

Notes:

1. Calculated using data from national sources.

2. Bloomberg LP end-of-period local currency-USD rates are used.

3. Growth rates are calculated from local currency 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.

Investor Profile

Insurance companies and pension funds comprised the largest investor group in LCY government bonds in the Republic of Korea with holdings equivalent to 31.8% of the total LCY government bond stock at the end of March (**Figure 2**). Nonfinancial corporations were the smallest investor group with less than a 1% share. In the 12 months through the end of March, households and nonprofit institutions recorded the biggest increase in their share of LCY government bond holdings with a gain of 1.2 percentage points, while banks posted the biggest decline at 1.8 percentage points.

In the LCY corporate bond market, insurance companies and pension funds are also the largest investor group with holdings constituting 37.4% of the total corporate bond market at the end of March (**Figure 3**). In the 12 months through the end of March, this investor group and other financial institutions (except banks) posted relatively large increases in corporate bond holding shares of 2.0 and 2.1 percentage points, respectively. Over the same period, the share of LCY corporate bonds held by households and nonprofit institutions posted the sharpest y-o-y drop at -2.3 percentage points.

Foreign investors' net LCY bond outflow in the Republic of Korea declined to KRW1,229 billion in Q2 2016 from KRW4,149 billion in the previous quarter. On a monthly basis, net foreign bond investment turned negative in June at -KRW2,748 billion following positive

amounts of KRW888 billion and KRW631 billion in May and April, respectively (**Figure 4**). In July, foreign investors' net bond investment totaled KRW588 billion.

Ratings Update

S&P Global Ratings announced in August that it had raised its long-term sovereign credit rating on the Republic of Korea to AA from AA-, giving the new rating a stable outlook, and has affirmed its short-term rating at A-1+. S&P Global Ratings stated that its rating upgrade was due to the Republic of Korea's "strong record of steady growth," which has "generated a prosperous economy, greater fiscal and monetary flexibility, and continual improvements in external metrics." The rating agency also stated that despite expectations of slower GDP growth in the next 3-5 years compared with pre-global financial crisis growth levels, it believes that the economy's prospects are "superior" to that of most developed economies.

Rating and Investment Information (R&I) reported in July that it has affirmed its foreign currency issuer and domestic currency issuer ratings on the Republic of Korea at A+ and AA-, respectively, giving stable outlooks for both ratings. R&I stated that its rating affirmation was made based on the Republic of Korea's "sluggish" economic recovery, "prudent" fiscal management amid "modest" government debt levels, and "consistent" surpluses in the current account.

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

	Issuers	Outstanding Amount		State-Owned	Listed on		Type of Industry
		LCY Bonds (KRW billion)	LCY Bonds (USD billion)		KOSPI	KOSDAQ	
1.	Korea Housing Finance Corporation	92,724	80.5	Yes	No	No	Housing Finance
2.	NH Investment & Securities	59,816	51.9	Yes	Yes	No	Securities
3.	Mirae Asset Daewoo Securities	55,327	48.0	No	Yes	No	Securities
4.	Korea Land & Housing Corporation	50,705	44.0	Yes	No	No	Real Estate
5.	Korea Investment and Securities	48,329	42.0	No	No	No	Securities
6.	Mirae Asset Securities	40,282	35.0	No	Yes	No	Securities
7.	Industrial Bank of Korea	38,942	33.8	Yes	Yes	No	Banking
8.	Hana Financial Investment	34,824	30.2	No	No	No	Securities
9.	Korea Deposit Insurance Corporation	29,650	25.7	Yes	No	No	Insurance
10.	Korea Electric Power Corporation	23,970	20.8	Yes	Yes	No	Electricity, Energy, and Power
11.	Hyundai Securities	23,491	20.4	No	No	No	Securities
12.	Korea Expressway	22,000	19.1	Yes	No	No	Transport Infrastructure
13.	Korea Rail Network Authority	19,160	16.6	Yes	No	No	Transport Infrastructure
14.	Kookmin Bank	18,673	16.2	No	No	No	Banking
15.	Shinhan Bank	18,563	16.1	No	No	No	Banking
16.	Woori Bank	17,865	15.5	Yes	Yes	No	Banking
17.	Samsung Securities	17,757	15.4	No	Yes	No	Securities
18.	Daishin Securities	16,514	14.3	No	Yes	No	Securities
19.	NongHyup Bank	15,960	13.9	Yes	No	No	Banking
20.	Korea Gas	15,429	13.4	Yes	Yes	No	Gas Utility
21.	Small & Medium Business Corporation	13,510	11.7	Yes	No	No	SME Development
22.	Korea Eximbank	12,260	10.6	Yes	No	No	Banking
23.	Korea Student Aid Foundation	11,690	10.1	Yes	No	No	Student Loan
24.	Standard Chartered First Bank Korea	11,380	9.9	No	No	No	Banking
25.	Hyundai Capital Services	10,489	9.1	No	No	No	Consumer Finance
26.	Korea Water Resources Corporation	10,441	9.1	Yes	No	No	Water
27.	Shinhan Card	10,169	8.8	No	No	No	Credit Card
28.	Korea Railroad Corporation	9,680	8.4	Yes	No	No	Transport Infrastructure
29.	Shinyoung Securities	9,659	8.4	No	Yes	No	Securities
30.	NongHyup	9,190	8.0	Yes	No	No	Diversified
Total Top 30 LCY Corporate Issuers		768,448.1	667.2				
Total LCY Corporate Bonds		1,211,015.0	1,051.4				
Top 30 as % of Total LCY Corporate Bonds		63.5%	63.5%				

KOSDAQ = Korean Securities Dealers Automated Quotations, KOSPI = Korea Composite Stock Price Index, KRW = Korean won, LCY = local currency, USD = United States dollar.

Notes:

1. Data as of end-June 2016.

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

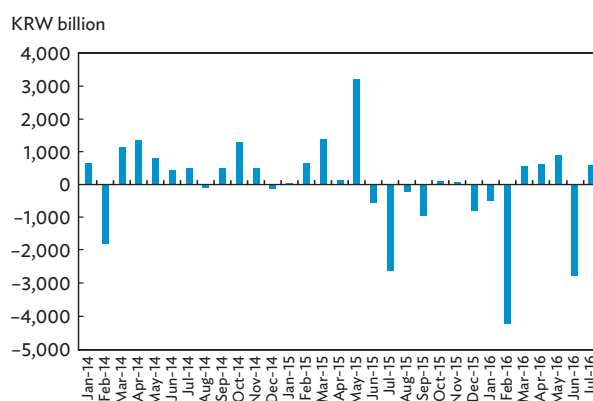
Sources: *AsianBondsOnline* calculations based on Bloomberg LP and EDAILY *BondWeb* data.

Table 3: Notable Local Currency Corporate Bond Issuance in Q2 2016

Corporate Issuers	Coupon Rate (%)	Issued Amount (KRW billion)
NongHyup Bank		
0.75-year bond	1.32	470
1-year bond	1.34	770
1-year bond	1.34	500
5-year bond	1.69	400
Industrial Bank of Korea		
3-year bond	1.56	640
10-year bond	2.37	400
Korea Rail Network Authority		
30-year bond	2.13	390

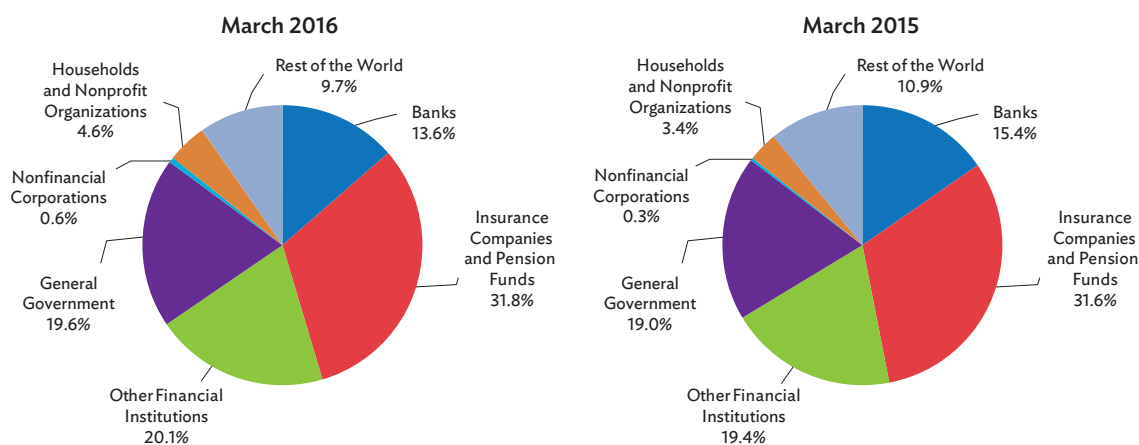
KRW = Korean won, Q2 = second quarter.
 Note: Coupon rates for 0.75- and 1-year bonds of NongHyup Bank are indicative yields at end-June 2016.
 Source: Based on data from Bloomberg LP.

Figure 4: Net Foreign Investment in Local Currency Bonds in the Republic of Korea



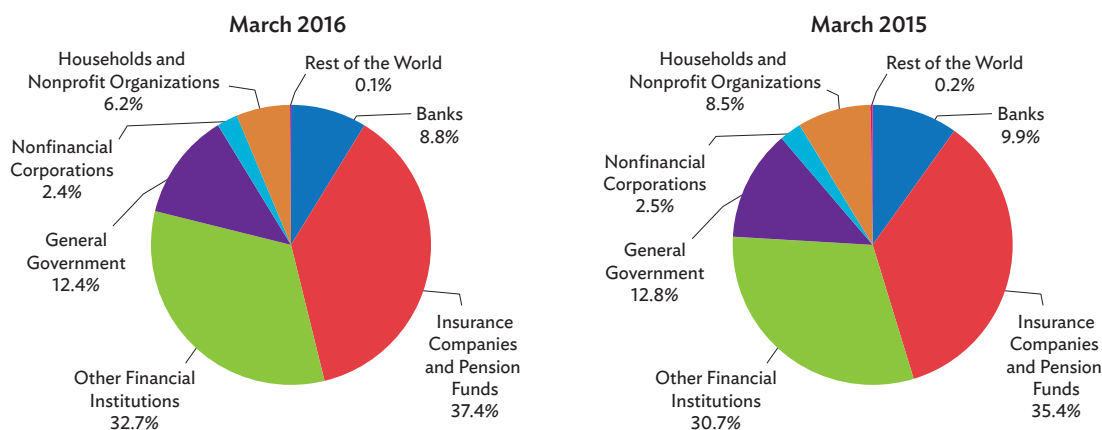
KRW = Korean won.
 Source: Financial Supervisory Service.

Figure 2: Local Currency Government Bonds Investor Profile



Sources: AsianBondsOnline and The Bank of Korea.

Figure 3: Local Currency Corporate Bonds Investor Profile



Sources: AsianBondsOnline and The Bank of Korea.

Policy, Institutional, and Regulatory Developments

Financial Services Commission Introduces Plan to Develop “Mega-Investment Banks”

The Financial Services Commission (FSC) announced in August its plan to develop “mega-investment banks” by enabling investment banks to acquire more than KRW10 trillion of equity capital and to broaden their scope of new business. The FSC stated that it plans for securities firms with more than KRW4 trillion of equity capital to be allowed to sell promissory notes and conduct foreign exchange transactions; for securities firms with equity capital of nearly KRW10 trillion to create investment management accounts and conduct property

trust business; and for securities firms with equity capital of less than KRW4 trillion to be subjected to certain reforms to enable them to secure enough capital for corporate financing purposes. The plan is envisioned to take effect starting in 2017.

Financial Services Commission to Apply Foreign Currency Liquidity Coverage Ratio to Banks

The FSC reported in June its plan to apply a foreign currency liquidity coverage ratio rule in 2017. The rule will require commercial banks to hold 60% of their foreign exchange debt in the form of high-quality liquid assets starting in 2017, with the ratio increasing to 70% in 2018 and 80% in 2019.