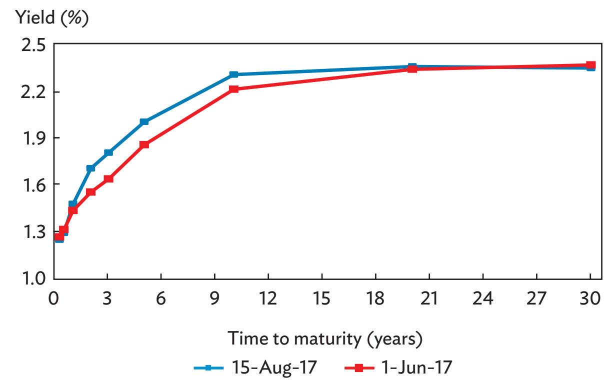
Republic of Korea

Yield Movements

Between 1 June and 15 August, local currency (LCY) government bond yields in the Republic of Korea rose for most tenors (**Figure 1**). The increase was most pronounced in the belly of the curve, where medium-term tenors of 2, 3, and 5 years rose 15 basis points (bps) on average. The yield for the 10-year bond also advanced, rising 9 bps, and yields for the 1-year and 20-year tenors rose 4 bps and 2 bps, respectively. Meanwhile, yields for the 3-month, 6-month, and 30-year tenors declined an average of 2 bps. The spread between the 2-year and 10-year yields narrowed to 60 bps on 15 August from 65 bps on 1 June.

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



Source: Based on data from Bloomberg LP.

The rise in yields, particularly for medium-term tenors, reflected uncertainty over the timing of anticipated monetary tightening policies both domestically and in major developed markets, as well as the implementation of economic and fiscal policies by the new administration in the Republic of Korea.

Yields rose in June after the United States (US) Federal Reserve raised the target range on its key policy rate. Other international factors contributing to the increase in yields during the review period included speculation that the Federal Reserve's balance sheet reduction would commence earlier than expected, the European Central Bank hinting at an eventual tapering of its quantitative monetary easing policy, and increased geopolitical concerns.

On the domestic front, continued economic growth and the release of the new administration's economic policies have put upward pressure on yields, as have increased expectations of a tightening stance by the Bank of Korea and the predicted expansion of the supply of government bonds to fund planned increases in fiscal spending over the next 5 years. In July, the Republic of Korea's Parliament approved a KRW11.2 trillion supplementary budget for 2017; at the same time, the Ministry of Finance stated that no additional bonds would be issued to fund the budget. The market is also monitoring the submission of the 2018 budget proposal in September.

Yield movements for short-term tenors reflected foreign bond investment flows. Foreign investors have been actively participating in the arbitrage trading of short-term LCY bonds, taking advantage of the continued strengthening of the Korean won. Year-to-date, the domestic currency has appreciated 6.2% against the US dollar. Despite episodes of foreign selling that led to the rise in short-term yields, demand for LCY bonds remained strong overall during the review period, resulting in only small yield movements at the short-end of the curve.

In line with expectations of improved economic growth, the Bank of Korea in July raised its 2017 gross domestic product (GDP) growth forecast to 2.8% from April's projection of 2.6%. The 2018 GDP forecast of 2.9% growth was maintained. According to the Bank of Korea, domestic growth will continue to be supported by investments, as exports are expected to be below the July forecast mainly due to slowdown in service exports. Meanwhile, consumption is expected to continue to recover. Monthly inflation is expected to stay close to the 2.0% y-o-y target level, with full-year 2017 inflation expected to be near the 1.9% projection made in July. Given stable inflation and the continued economic recovery, the Bank of Korea maintained its base rate at 1.25% in its 13 July and 31 August Monetary Policy Board meetings. However, the central bank noted volatility in financial markets brought about by increased geopolitical concerns. Moving forward, the Bank of Korea will continue to monitor the paces of monetary policy normalization and trade conditions with major countries, trend in domestic household debt, and geopolitical developments.

The Republic of Korea's GDP growth eased to 2.7% year-on-year (y-o-y) in the second quarter (Q2) of 2017 from 2.9% y-o-y in the first quarter (Q1) of 2017. The slower growth was driven by a smaller increase in gross fixed capital formation, led by slowing growth in construction investment. Exports also posted no growth in Q2 2017 following a 3.9% y-o-y increase in the previous quarter. On a quarter-on-quarter (q-o-q) basis, the Republic of Korea's economic growth slowed to 0.6% q-o-q in Q2 2017 from 1.1% q-o-q in Q1 2017.

Consumer price inflation in the Republic of Korea remained within the central bank's 2.0% target level in Q2 2017, averaging 1.9% y-o-y. Inflation picked up in July to 2.2% y-o-y due to a rise in food and utilities prices.

Size and Composition

The Republic of Korea's LCY bond market expanded 2.1% q-o-q to KRW2,138 trillion (USD1,869 billion) at the end of June, driven by growth in both the government and corporate sectors (**Table 1**). Corporate bonds accounted for a majority of bonds outstanding, totaling KRW1,246 trillion. Government bonds summed to KRW892 trillion. On a y-o-y basis, the LCY bond market expanded 3.6%.

Government bonds. LCY government bonds outstanding rose 2.3% q-o-q to KRW892 trillion at the end of June. The increase was primarily driven by the 3.6% q-o-q rise in the outstanding stock of central government bonds. Issuance of Korea Treasury Bonds rose in Q2 2017 from the previous quarter in line with the government's continued frontloading policy to prop up the economy. The government has spent 59% of its full-year budget in the first half of 2017. Meanwhile, the outstanding stocks of central bank bonds and other government bonds were almost unchanged from Q1 2017 at KRW175 trillion and KRW165 trillion, respectively.

Government bond issuance in Q2 2017 amounted to KRW89 trillion, which was almost at par with Q1 2017. The increase in issuance of Korea Treasury Bonds was capped by the decline in issuance of other government bonds, particularly Korea Development Bank bonds.

Corporate bonds. LCY corporate bonds outstanding expanded 1.9% q-o-q to KRW1,246 trillion at the end of June. The top 30 LCY corporate bond issuers in the Republic of Korea continued to comprise the majority of total LCY corporate bonds outstanding, with a share of 64.5% and aggregate bonds of KRW804 trillion at the end of June (**Table 2**). Financial companies involved in securities trading, investments, and banking continued to account for a majority of the top 30 largest debt issuers, with total bonds outstanding worth KRW474 trillion. Korea Housing Finance Corporation remained the largest issuer with outstanding bonds valued at KRW116 trillion.

Corporate bond issuance in Q2 2017 was the highest it has been since Q2 2015, surging 17.5% q-o-q to KRW112 trillion as companies took advantage of relatively low interest rates in anticipation of an upward trend in

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

	Outstanding Amount (billion)						Growth Rate (%)			
	Q2 2016		Q1 2017		Q2 2017		Q2 2016		Q2 2017	
	KRW	USD	KRW	USD	KRW	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**2,064,024**	**1,792**	**2,094,915**	**1,873**	**2,138,183**	**1,869**	**1.0**	**5.4**	**2.1**	**3.6**
Government	853,009	741	872,215	780	892,171	780	1.6	5.9	2.3	4.6
Central Government Bonds	516,517	448	533,303	477	552,288	483	3.1	10.7	3.6	6.9
Central Bank Bonds	181,420	158	174,860	156	174,810	153	0.02	(3.7)	(0.03)	(3.6)
Others	155,072	135	164,052	147	165,073	144	(1.3)	3.0	0.6	6.4
Corporate	1,211,015	1,051	1,222,700	1,093	1,246,012	1,089	0.5	5.1	1.9	2.9

( ) = negative, KRW = Korean won, LCY = local currency, 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 LCY–USD rates are used.
3. Growth rates are calculated from local currency (LCY) base and do not include currency effects.
4. "Others" comprise Korea Development Bank Bonds, National Housing Bonds, and Seoul Metro Bonds.
5. Corporate bonds include equity-linked securities and derivatives-linked securities.
Sources: The Bank of Korea and *EDAILY BondWeb*.

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	115,881	101.3	Yes	No	No	Housing Finance
2.	NH Investment & Securities	65,449	57.2	Yes	Yes	No	Securities
3.	Mirae Asset Daewoo Co.	58,547	51.2	No	Yes	No	Securities
4.	Korea Investment and Securities	52,721	46.1	No	No	No	Securities
5.	Korea Land & Housing Corporation	43,096	37.7	Yes	No	No	Real Estate
6.	Industrial Bank of Korea	36,849	32.2	Yes	Yes	No	Banking
7.	Hana Financial Investment	36,407	31.8	No	No	No	Securities
8.	Mirae Asset Securities	32,765	28.6	No	Yes	No	Securities
9.	KB Securities	29,059	25.4	No	No	No	Securities
10.	Korea Deposit Insurance Corporation	26,190	22.9	Yes	No	No	Insurance
11.	Korea Electric Power Corporation	22,890	20.0	Yes	Yes	No	Electricity, Energy, and Power
12.	Samsung Securities	22,389	19.6	No	Yes	No	Securities
13.	Shinhan Bank	21,522	18.8	No	No	No	Banking
14.	Korea Expressway	20,830	18.2	Yes	No	No	Transport Infrastructure
15.	Korea Rail Network Authority	19,970	17.5	Yes	No	No	Transport Infrastructure
16.	Kookmin Bank	19,396	17.0	No	No	No	Banking
17.	Woori Bank	19,245	16.8	Yes	Yes	No	Banking
18.	Daishin Securities	17,338	15.2	No	Yes	No	Securities
19.	The Export-Import Bank of Korea	14,990	13.1	Yes	No	No	Banking
20.	Korea Gas Corporation	13,969	12.2	Yes	Yes	No	Gas Utility
21.	KEB Hana Bank	13,120	11.5	No	No	No	Banking
22.	NongHyup Bank	12,660	11.1	Yes	No	No	Banking
23.	Small & Medium Business Corporation	12,330	10.8	Yes	No	No	SME Development
24.	Shinhan Card	12,070	10.5	No	No	No	Credit Card
25.	Korea Student Aid Foundation	11,750	10.3	Yes	No	No	Student Loan
26.	Hyundai Capital Services	11,584	10.1	No	No	No	Consumer Finance
27.	Standard Charted Bank Korea	10,830	9.5	No	No	No	Banking
28.	Shinyoung Securities	10,330	9.0	No	Yes	No	Securities
29.	Korea Railroad Corporation	10,070	8.8	Yes	No	No	Transport Infrastructure
30.	NongHyup	9,610	8.4	Yes	No	No	Financial
Total Top 30 LCY Corporate Issuers		**803,858**	**703**				
Total LCY Corporate Bonds		**1,246,012**	**1,089**				
Top 30 as % of Total LCY Corporate Bonds		**64.5%**	**64.5%**				

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 2017.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
3. Corporate bonds include equity-linked securities and derivatives-linked securities.
Sources: *AsianBondsOnline* calculations based on Bloomberg LP and *EDAILY BondWeb* data.

yields. **Table 3** lists notable corporate bond issuances in Q2 2017. The KRW1,285 billion convertible bond issued by Daewoo Shipbuilding and Marine Engineering was the largest issuance in Q2 2017 with 30-year tenor and a coupon rate of 1.0%. The bond sale was part of its rescue package plan with existing creditors as the convertible bond was sold to one of its creditors, the Export–Import Bank of Korea. Other notable bond issuances in the quarter were from banks, insurance companies, and heavy industries.

Table 3: Notable Local Currency Corporate Bond Issuance in the Second Quarter of 2017

Corporate Issuers	Coupon Rate (%)	Issued Amount (KRW billion)
Daewoo Shipbuilding and Marine Engineering		
30-year bond	1.00	1,285
Woori Bank		
3-year bond	1.95	880
3-year bond	1.90	370
Shinhan Bank		
2-year bond	1.73	300
2-year bond	1.73	300
3-year bond	1.88	330
Doosan Heavy Industries		
5-year bond	1.00	500
Hanwha Life Insurance		
30-year bond	4.58	500
Nonghyup Bank		
3-year bond	1.88	500
LG Chem		
5-year bond	2.28	400

KRW = Korean won.
Source: Based on data from Bloomberg LP.

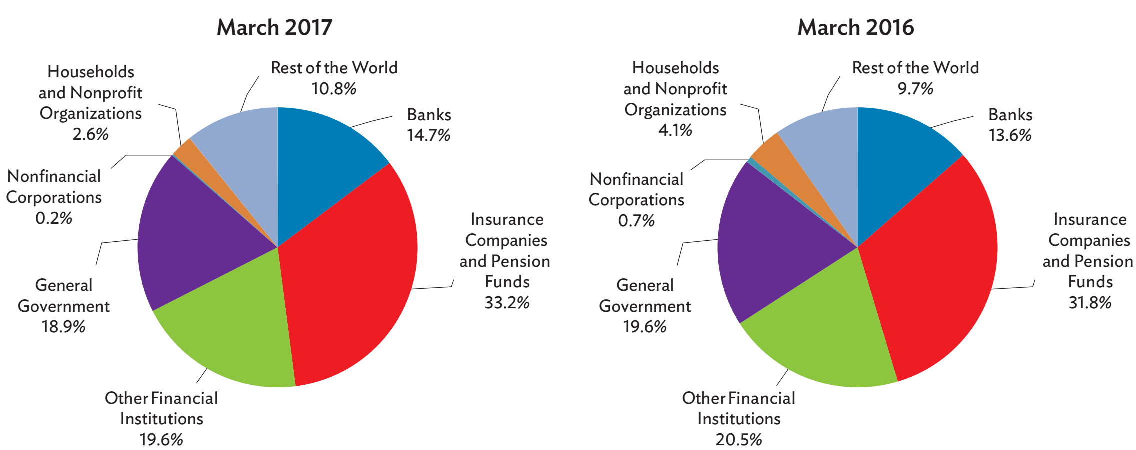
Investor Profile

Insurance companies and pension funds remained the largest investor group in the LCY government bond market at the end of March with an aggregate share of 33.2%, up from 31.8% in March 2016 (**Figure 2**). Other financial institutions accounted for the next largest holdings with a share of 19.6%, slightly down from 20.5% a year earlier. The share of general government also fell to 18.9% at the end of March from 19.6% a year earlier. The shares of banks and foreign investors inched up during the review period to 14.7% and 10.8%, respectively.

Insurance companies and pension funds continued to account for the largest share of holdings in the Republic of Korea's LCY corporate bond market at 38.5% at the end of March, up slightly from 38.1% in March 2016 (**Figure 3**). The share of other financial institutions rose to 33.4% from 31.8% during the review period, while the share of foreign investors in the Republic of Korea's LCY corporate bond market remained negligible.

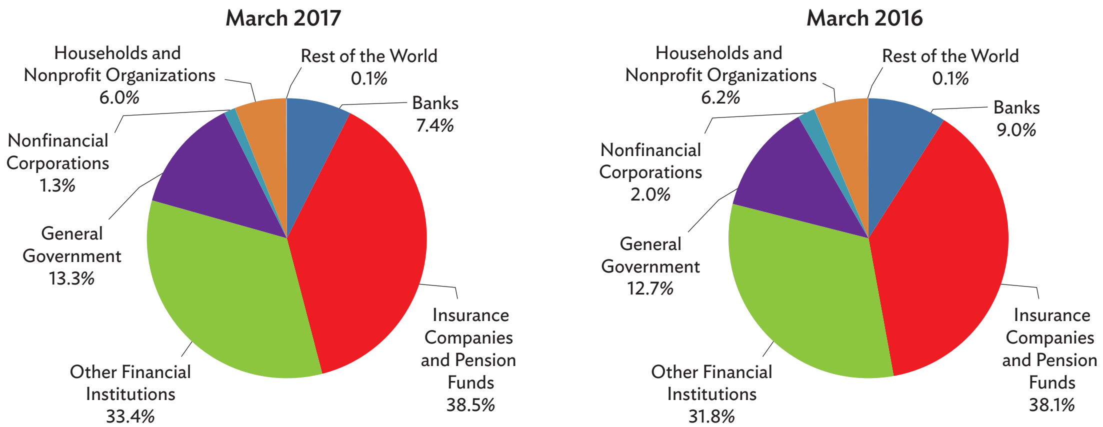
Net foreign investments in the Republic of Korea's local currency bond market remained strong in Q2 2017 (**Figure 4**). Net foreign investments amounted to KRW1,375 billion in April and rose to KRW2,136 billion in May. In June, net foreign investments eased to KRW1,551 billion, partly due to a large foreign institutional

Figure 2: Local Currency Government Bonds Investor Profile



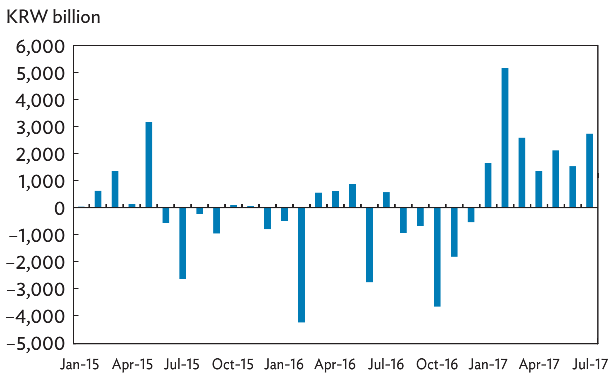
Sources: *AsianBondsOnline* and the Bank of Korea.

Figure 3: Local Currency Corporate Bonds Investor Profile



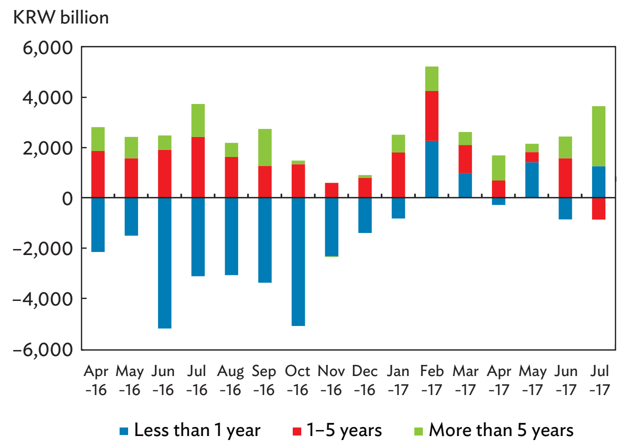
Sources: *AsianBondsOnline* and the Bank of Korea.

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



KRW = Korean won.
Source: Financial Supervisory Service.

Figure 5: Net Foreign Investment in Local Currency Bonds in the Republic of Korea, by Tenor



KRW = Korean won.
Source: Financial Supervisory Service.

fund selling its short-term holdings as part of its portfolio adjustment.[17] Foreign investors increased their holdings in July with net investments jumping to KRW2,755 billion.

There was a notable drop in volatility in net foreign investments in 2017 compared with 2016, particularly for bonds with tenors of less than 1 year (**Figure 5**). Foreign demand for bonds with tenors longer than 5 years was also more stable in 2017, with net foreign investments reaching a high of KRW2,394 billion in July.

Ratings Update

In August, S&P Global affirmed its AA long-term and A-1+ short-term sovereign credit ratings for the Republic of Korea. S&P Global also maintained a stable outlook on the long-term rating, citing the Republic of Korea's steady economic growth, favorable policy environment, sound fiscal position, and net external creditor position

[17] Reuters. 2017. *Franklin Templeton Trims Korea Treasury Bonds as Part of Portfolio Adjustment*. 29 June. http://www.reuters.com/article/us-southkorea-economy-bonds-idUSKBN19K053

as reasons for its decision. S&P Global noted the recent heightened geopolitical tension with the Democratic People's Republic of Korea, but believes a conflict is unlikely. The rating agency also noted concern over high levels of household debt, while recognizing the government's efforts to address it.

Policy, Institutional, and Regulatory Developments

National Assembly Approves KRW11.2 Trillion Supplementary Budget

In July, the Republic of Korea's National Assembly approved the government's KRW11.2 trillion supplementary budget proposal. The supplementary budget will allocate KRW4.2 trillion to increase hiring in the public sector and provide more regular jobs in small and medium-sized enterprises. Of the total supplementary budget, KRW1.2 trillion will be allotted to programs that expand employment, particularly among the youth and women who want to return to the workforce; KRW2.3 trillion will be spent on policies to support the working class, including an expansion of the number of basic social security beneficiaries; and KRW3.5 trillion will be used to support local governments, particularly education programs.

Financial Services Commission Announces New Mortgage Rules

In August, the Financial Services Commission announced new measures to curb speculative demand in the Republic of Korea's housing market. Measures include tightening the loan-to-value and debt-to-income ratios to 40% each for home buyers in "bubble-prone areas." For multiple homeowners, mortgage borrowing will also be subject to tighter loan-to-value and debt-to-income ratios; the ratios for both will be trimmed by 10 percentage points.