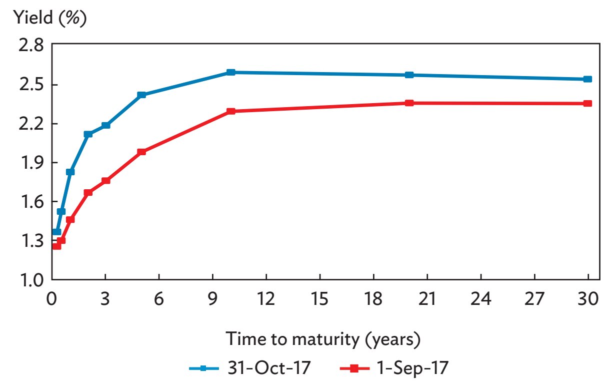
Republic of Korea

Yield Movements

Between 1 September and 31 October, local currency (LCY) government bond yields in the Republic of Korea rose for all tenors (**Figure 1**). The rise was most pronounced in the belly of the curve, with medium-term tenors of 2, 3, and 5 years gaining 43 basis points (bps) on average. At the short-end of the curve, the yield for the 1-year bond rose 36 bps and yields for 3-month and 6-month tenors rose 11 bps and 22 bps, respectively. The yields for tenors of 10 years and longer rose 23 bps on average. The spread between the 2-year and 10-year yields narrowed to 47 bps on 31 October from 62 bps on 1 September.

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



Source: Based on data from Bloomberg LP.

Yields rose during the period in review on increased expectations of a rate hike by the Bank of Korea in response to tighter monetary stances in advanced economies and given current accommodative domestic conditions. This view was further supported following the 19 October Monetary Policy Board meeting when the central bank again raised its 2017 gross domestic product growth forecast. At this meeting, one board member also voted for a policy rate hike. These developments have fueled speculation of a rate hike sooner than expected, with the market anticipating a hike as early as the next monetary policy meeting in November. Yields rose further the week upon the release of the Bank of Korea's advance estimate of accelerated economic growth in the third quarter (Q3) of 2017.

The last week of September also saw an uptick in yields due to a sell-off by major foreign investment funds reducing their holdings of Korean domestic bonds. September saw the largest net foreign bond investment outflows for the year at KRW3.7 trillion.

In its Monetary Policy Board meeting on 19 October, the Bank of Korea decided to maintain the base rate at 1.25%. The central bank also raised its 2017 gross domestic product growth forecast to 3.0% from July's projection of 2.8%, while the 2018 growth forecast of 2.9% was maintained. The central bank stated that growth will continue to improve, supported by strong exports and facilities investments amid the global recovery. Consumption is recovering moderately. Full-year 2017 inflation is expected to average 2.0% before dipping to 1.8% in full-year 2018 due to weakening energy prices.

In line with a higher growth rate forecast, the Republic of Korea's gross domestic product growth accelerated to 3.6% year-on-year (y-o-y) in Q3 2017 from 2.9% y-o-y in the second quarter (Q2), based on advance estimates from the Bank of Korea. The faster growth was driven by a rebound in exports and larger annual increases in both private and government consumption. Exports grew 5.0% y-o-y in Q3 2017 after posting no growth in the previous quarter. Private consumption also rose 2.4% y-o-y in Q3 2017, slightly up from the 2.3% y-o-y growth posted in Q2 2017. Government consumption expanded 4.6% y-o-y, up from 3.1% y-o-y, mainly a result of higher spending from the supplementary budget. Meanwhile, gross fixed capital formation posted slightly lower growth in Q3 2017. By industry, the accelerated growth was driven by higher growth rates posted in manufacturing; electricity, gas, and water supply; and services. Growth in the construction sector eased in Q3 2017, while output in the agriculture sector contracted. On a quarter-on-quarter (q-o-q) basis, the Republic of Korea's economy grew 1.4% following a 0.6% expansion in Q2 2017.

Consumer price inflation in the Republic of Korea saw an uptick in Q3 2017 with the quarterly average rising to 2.3% y-o-y from 1.9% y-o-y in Q2 2017. Inflation rose to 2.6% y-o-y in August, the highest level in 5 years, from 2.2% y-o-y in July, before easing to 2.1% y-o-y in September. In October, inflation eased further to 1.8% y-o-y due to slower increases in food and utility prices.

Size and Composition

The Republic of Korea's LCY bond market posted growth of 1.4% q-o-q to reach KRW2,169 trillion (USD1,894 billion) at the end of September (**Table 1**). Government bonds increased 1.3% q-o-q to KRW904 trillion, primarily driven by growth in central government bonds. Corporate bonds rose 1.5% q-o-q to KRW1,265 trillion. On a y-o-y basis, the LCY bond market expanded 4.4%.

Government bonds. LCY government bonds outstanding posted modest growth of 1.3% q-o-q to reach KRW904 trillion at the end of September. The growth was led by a rise in the outstanding stock of central government bonds, composed largely of Korea Treasury Bonds (KTBs), which were up 2.2% q-o-q to KRW564 trillion. Meanwhile, the outstanding stocks of central bank bonds and other government bonds were almost unchanged from Q2 2017 at KRW174 trillion and KRW165 trillion, respectively.

Government bond issuance in Q3 2017 fell 1.3% q-o-q to KRW88 trillion due to lower issuance of central bank bonds and KTBs. The planned issuance of KTBs was lower in Q3 2017 versus Q2 2017 due to the more frequent auctions in Q2 2017 as part of the government's frontloading policy in the first half of 2017.

Corporate bonds. LCY corporate bonds outstanding also posted minimal growth in Q3 2017, rising 1.5% q-o-q to KRW1,265 trillion. **Table 2** provides a breakdown of the top 30 LCY corporate bond issuers in the Republic of Korea at the end of September, with aggregate LCY bonds outstanding of KRW808 trillion, representing 64% of the LCY corporate bond market. Financial companies such as banks and securities and investment firms continued to comprise a majority of the 30 largest corporate bond issuers. Korea Housing Finance Corporation remained the largest issuer with outstanding bonds valued at KRW116 trillion.

The marginal increase in the outstanding amount of corporate bonds was due to fewer new corporate issues in Q3 2017. Issuance fell 8.3% q-o-q to KRW103 trillion as some companies waited out the uncertainty in the market being generated by increased geopolitical risks and the subsequent uptick in yields. **Table 3** lists the notable corporate bond issuances in Q3 2017, which were mostly from banks. Doosan Infracore, a company that manufactures heavy machinery, had the single largest bond issuance (5-year bond) worth KRW500 billion.

Investor Profile

Insurance companies and pension funds remained the largest investor group in the LCY government bond market in the Republic of Korea at the end of June with

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

	Outstanding Amount (billion)						Growth Rate (%)			
	Q3 2016		Q2 2017		Q3 2017		Q3 2016		Q3 2017	
	KRW	USD	KRW	USD	KRW	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**2,076,602**	**1,886**	**2,138,183**	**1,869**	**2,168,965**	**1,894**	**0.6**	**3.9**	**1.4**	**4.4**
Government	855,763	777	892,171	780	903,697	789	0.3	5.2	1.3	5.6
Central Government Bonds	517,267	470	552,288	483	564,414	493	0.1	9.0	2.2	9.1
Central Bank Bonds	179,680	163	174,810	153	174,460	152	(1.0)	(3.6)	(0.2)	(2.9)
Others	158,816	144	165,073	144	164,823	144	2.4	4.0	(0.2)	3.8
Corporate	1,220,839	1,109	1,246,012	1,089	1,265,268	1,105	0.8	3.0	1.5	3.6

( ) = negative, KRW = Korean won, LCY = local currency, q-o-q = quarter-on-quarter, Q2 = second quarter, Q3 = third quarter, USD = United States dollar, y-o-y = year-on-year.
Notes:
1. Data for government bonds as of end-August 2017.
2. Calculated using data from national sources.
3. Bloomberg LP end-of-period LCY–USD rates are used.
4. Growth rates are calculated from local currency (LCY) base and do not include currency effects.
5. "Others" comprise Korea Development Bank Bonds, National Housing Bonds, and Seoul Metro Bonds.
6. 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	115,566	100.9	Yes	No	No	Housing Finance
2.	NH Investment & Securities	65,223	56.9	Yes	Yes	No	Securities
3.	Mirae Asset Daewoo Co.	59,693	52.1	No	Yes	No	Securities
4.	Korea Investment and Securities	52,790	46.1	No	No	No	Securities
5.	Korea Land & Housing Corporation	42,002	36.7	Yes	No	No	Real Estate
6.	Industrial Bank of Korea	37,364	32.6	Yes	Yes	No	Banking
7.	Hana Financial Investment	36,056	31.5	No	No	No	Securities
8.	KB Securities	31,090	27.1	No	No	No	Securities
9.	Mirae Asset Securities	29,067	25.4	No	Yes	No	Securities
10.	Samsung Securities	24,247	21.2	No	Yes	No	Securities
11.	Korea Deposit Insurance Corporation	23,510	20.5	Yes	No	No	Insurance
12.	Korea Electric Power Corporation	22,550	19.7	Yes	Yes	No	Electricity, Energy, and Power
13.	Shinhan Bank	21,872	19.1	No	No	No	Banking
14.	Korea Expressway	21,440	18.7	Yes	No	No	Transport Infrastructure
15.	Kookmin Bank	20,876	18.2	No	No	No	Banking
16.	Woori Bank	20,265	17.7	Yes	Yes	No	Banking
17.	Korea Rail Network Authority	19,360	16.9	Yes	No	No	Transport Infrastructure
18.	Daishin Securities	16,323	14.3	No	Yes	No	Securities
19.	Yhe Export-Import Bank of Korea	15,620	13.6	Yes	No	No	Banking
20.	NongHyup Bank	15,540	13.6	Yes	No	No	Banking
21.	KEB Hana Bank	15,260	13.3	No	No	No	Banking
22.	Korea Gas Corporation	13,279	11.6	Yes	Yes	No	Gas Utility
23.	Hyundai Capital Services	12,076	10.5	No	No	No	Consumer Finance
24.	Small & Medium Business Corporation	12,000	10.5	Yes	No	No	SME Development
25.	Shinhan Card	11,857	10.4	No	No	No	Credit Card
26.	Korea Student Aid Foundation	11,250	9.8	Yes	No	No	Student Loan
27.	Shinyoung Securities	11,049	9.6	No	Yes	No	Securities
28.	Standard Charted Bank Korea	10,740	9.4	No	No	No	Banking
29.	Korea Railroad Corporation	10,190	8.9	Yes	No	No	Transport Infrastructure
30.	Nonghyup	10,160	8.9	Yes	No	No	Financial
Total Top 30 LCY Corporate Issuers		**808,314**	**706**				
Total LCY Corporate Bonds		**1,265,268**	**1,105**				
Top 30 as % of Total LCY Corporate Bonds		**63.9%**	**63.9%**				

KOSDAQ = Korean Securities Dealers Automated Quotations, KOSPI = Korea Composite Stock Price Index, KRW = Korean won, LCY = local currency, SME = small and medium enterprise, USD = United States dollar.
Notes:
1. Data as of end-September 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.

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

Corporate Issuers	Coupon Rate (%)	Issued Amount (KRW billion)
Doosan Infracore		
5-year bond	2.00	500
Woori Bank		
3-year bond	2.00	370
Industrial Bank of Korea		
3-year bond	1.90	370
Kookmin Bank		
3-year bond	1.90	350
Shinhan Bank		
3-year bond	1.95	300
Hyundai Steel		
5-year bond	2.60	220
NongHyup Financial Group		
3-year bond	2.10	200

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

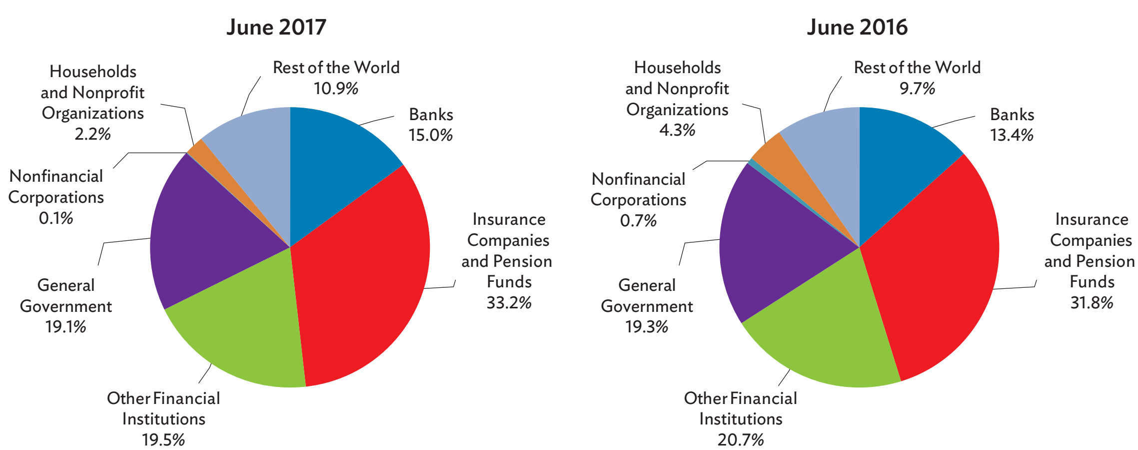
an aggregate share of 33.2%, up slightly from 31.8% in June 2016 (**Figure 2**). Other financial institutions and the general government held shares of 19.5% and 19.1%, respectively. The shares of banks and foreign investors inched up during the review period to 15.0% and 10.9%, respectively.

Insurance companies and pension funds also continued to comprise the largest share of the LCY corporate bond market at the end of June at 38.4% (**Figure 3**). The share of other financial institutions rose to 33.9% from 32.7% a year earlier; the share of the general government inched up to 13.0%. Meanwhile, the shares of banks, households and nonprofit institutions, and nonfinancial corporations fell slightly during the review period. The share of foreign investors in the Republic of Korea's LCY corporate bond market continued to be negligible.

Following consistent and strong net foreign investment inflows into the Republic of Korea's LCY bond market in the first half of 2017, Q3 2017 saw a massive sell-off (**Figure 4**). July saw the second highest monthly net foreign investment inflows of KRW2,755 billion before 2 consecutive months of net foreign outflows. In August, foreign investors sold a net KRW2,168 billion worth of LCY bonds. The outflows can be attributed to increased geopolitical tensions with the Democratic People's Republic of Korea. There was also a sizable amount of maturing Monetary Stabilization Bonds issued by the Bank of Korea, particularly those with tenors of 2 years or less.

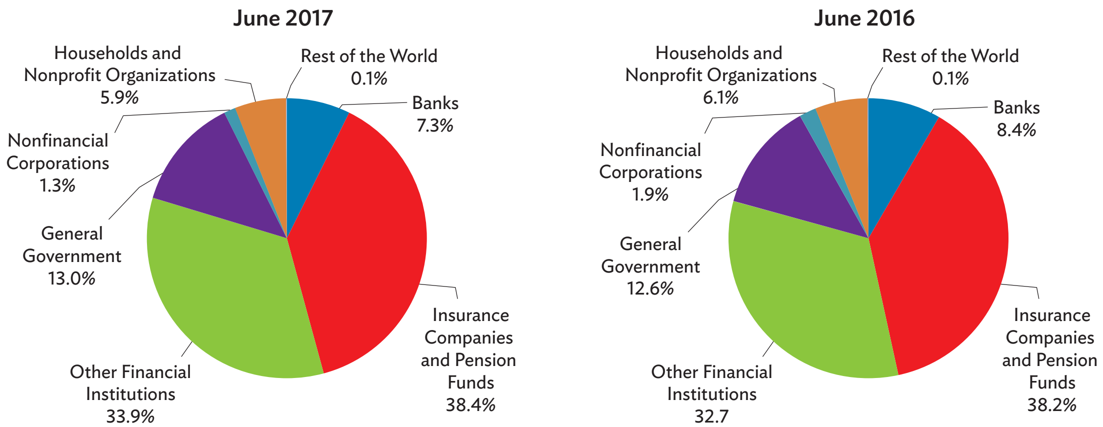
Foreign outflows accelerated in September as investors sold a net KRW3,732 billion of bonds. The bulk of the outflows occurred in the last week of September when major foreign funds withdrew from the local bond market, particularly bonds with medium-term tenors, and redeemed maturing commercial paper (**Figure 5**). Aside from heightened geopolitical risks, the outflows can be attributed to the decreasing real returns of investing in the Republic of Korea's bond market given an uptick in inflation as well as narrowing interest rate differentials with advanced economies.

Figure 2: Local Currency Government Bonds Investor Profile



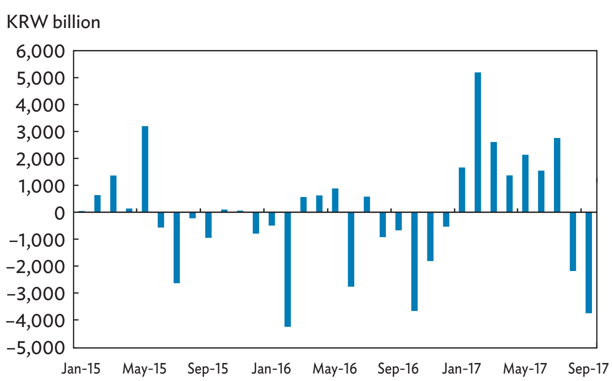
Sources: *AsianBondsOnline* and the Bank of Korea.

Figure 3: Local Currency Corporate Bonds Investor Profile



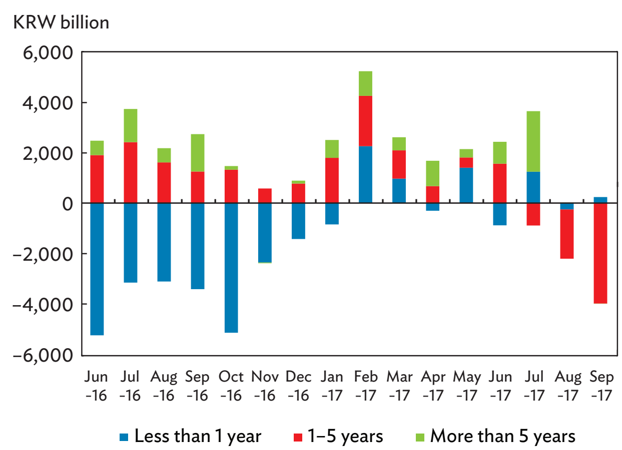
Sources: *AsianBondsOnline* and the Bank of Korea.

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.

Policy, Institutional, and Regulatory Developments

Financial Services Commission Announces Comprehensive Measures for Household Debt Management

In October, the Financial Services Commission announced new measures to manage the Republic of Korea's growing household debt. These measures are intended to "reduce financial risks in the short-term; and to strengthen macroeconomic soundness and household income and repayment ability in the mid- to long-term."

The measures include providing tailored assistance based on a borrower's capacity to repay debt. To manage risks affecting consumption and economic growth, the government will manage the household debt aiming to bring down and maintain its growth rate over the next 5 years at below 8.2%. The government will also adjust the calculation of debt-to-income ratios and introduce a debt service ratio to evaluate the credit risk profiles of borrowers more accurately. Lastly, the government will take measures to manage household debt from sectors that are more vulnerable to financial risk.