Seong-Tae Lee: Recent development of the Korean bond market

Dinner speech by Mr Seong-Tae Lee, Deputy Governor of the Bank of Korea, at the Korea University/ BIS Conference on Asian Bond Market Research, Seoul, 22 March 2004.

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Ladies and gentlemen,

I am very pleased to speak here today at this Asian Bond Market Research Conference, co-hosted by Korea University and the BIS.

As you are well aware, over the past half century the Asian region has achieved unprecedentedly high economic growth, and it has now emerged as among the key players in the world economy. With this continuing remarkable economic growth, trade within the Asian region is growing rapidly, and there is also a greatly increasing demand for financial funds. However, regional financial markets have so far not developed sufficiently to meet this demand.

Asia's bond markets, in particular, are in far less developed states than those of developed countries. According to IMF statistics, the amount outstanding of the primary bond markets of Asia's nine emerging market economies combined totaled 1 trillion 473 billion dollars as of the end of 2002. This is only 8% the size of the U.S. primary bond market, 12% that of the 15 EU countries combined and 21% that of Japan. The ratio of Asia's outstanding stock of bonds to GDP is a mere 43%, far lower than the figures of 182% in the U.S., 146% in the EU and 175% in Japan. In their secondary bond markets as well, almost all regional economies have much smaller ratios of turnover to average outstanding stocks compared with advanced nations.

There is an argument that the 1997 financial crisis was aggravated by these poorly developed regional bond markets. The argument goes that because the financial structures of Asian economies were overly reliant on banks and their bond markets were poorly developed, the Asian countries had to rely for investment on short-term foreign borrowings, which were inevitably drawn out in a hurry once the regional crisis hit.

Recently, the Asian countries have accumulated significant amounts of foreign assets, thanks to their continued current account surpluses. However, due to the underdeveloped bond markets here, some say that there have been some inefficiencies in both the raising and the managing of foreign funds in the region.

In the wake of the financial crisis, therefore, countries in the region came to realize the necessity of developing their bond markets and related infrastructure. This enlightenment has become the momentum driving the countries in the region to make the necessary efforts. Let me now share with you the efforts Korea has made since the financial crisis in order to develop its bond markets, and tell you what we have achieved so far.

Before the financial crisis, Korea did not have to issue large quantities of government bonds, due to observing its balanced budget principle. Once the crisis had broken out, however, the long-cherished principle of maintaining balanced budgets was abandoned, and the government began to actively issue bonds, as a means of financing the soaring fiscal deficit and supporting economic recovery. With technical support from the IMF and the World Bank, Korea also embarked, in a step-by-step manner, on a series of institutional improvements. These included the introduction of regular government bond auctions, the establishment of a primary dealer system, the integration of different types of government bonds, the opening of the Korea Government Bond futures market and the introduction of a fungible issue system.

For its part, the Bank of Korea has also made considerable efforts to help develop the country's bond markets, including the government bond market.

Before the crisis, Korean government bond issuance was to some extent not carried out in accordance with the market mechanism. A portion of any bond issuance was discretionarily allocated for underwriting to certain financial institutions. The remaining part of the bonds was taken over by the Bank of Korea, the nation's central bank. The government also sometimes financed its fiscal needs by relying on borrowings from the BOK rather than by issuing bonds. Since June 1998, however, the BOK has not accepted government requests to underwrite government bonds and has advised the government to issue all government bonds in the market, based on market interest rates. In addition, the BOK has improved the infrastructure related to bond transactions. It has introduced an electronic competitive bidding process for government bonds using BOK-Wire and adopted delivery-versus-payment system of government bonds.

As a result of these efforts, the outstanding volume of Korean government bonds has grown almost seven times since 1997, while the turnover ratio for these bonds has skyrocketed 23 times in the same period. In 2003 the issuance of five-year government bonds increased substantially thanks to the government's efforts to meet growing demand for longer-term bonds on the part of institutional investors such as pension funds and insurance companies. The five-year Korea Government Bond Futures market was also set up in order to allow hedging against the associated risks. In line with these developments, the proportion of five-year government bonds in total bond issuance increased by 7 percentage points in 2003, to 36%.

Korea's corporate bond markets are also in the process of becoming more advanced, through the introduction of new financial instruments and the establishment of relevant institutions that will support bond market development. Since 1999, new products such as ABSs (Asset-Backed Securities), MBSs (Mortgage-Backed Securities), ABCP (Asset-Backed CP), CLOs (Collateralized Loan Obligations) and CBOs (Collateralized Bond Obligations) have been introduced. After the financial crisis, the market structure for corporate bonds shifted to focus on secured bonds rather than unsecured bonds, and this change required more scientific analysis of issuers' credit risk. In response to this need, the setting up of new credit rating agencies was allowed, and the fiercer competition among credit rating agencies has led to a significant development of credit risk analysis techniques.

There have also been many improvements in terms of market behavior. With the implementation of mark-to-market bond valuation, rates of return on fund management are now evaluated and disclosed in accordance with daily bond yields. The introduction of a system for interest rate risk management has also made institutional investors respond more sensitively to changes in bond rates. Accordingly, it is now becoming common practice for market participants to closely watch the BOK's monetary policy, along with economic developments at home and abroad.

As I have just described it, Korea's bond markets have gone through remarkable changes, in terms of both quality and quantity, since the financial crisis. The government bond market, in particular, has been totally reshaped across the primary and the secondary markets, as well as its infrastructure. We believe that Korea's bond markets will develop further in the future by making continuous efforts to heighten bond market efficiency and to push on with corporate restructuring.

There is considerable discussion going on recently, in various international cooperative forums such as ASEAN+3 and the EMEAP (Executives' Meeting of East Asia and Pacific Central Banks), over the development of regional bond markets. In ASEAN+3, in particular, views on securitization and credit guarantees have been discussed. In relation to this issue, Korea has put together a two-tier securitization draft proposal making the most of the securitization and credit guarantee mechanism. Other nations have also developed plausible draft proposals in these fields. Meanwhile, the EMEAP, comprising 11 central banks and monetary authorities in the East Asia and Pacific region, has raised a one-billion dollar fund and invested it in dollar-denominated bonds issued by countries in the region. Taking this arrangement one step further, the EMEAP is now actively discussing ways to expand the fund and invest it in local currency-denominated bonds in the region.

Under these circumstances, I think that this conference is very significant, in that it brings together distinguished scholars and experts from both at home and abroad, to diagnose the reasons why Asia's bond markets are not being developed sufficiently and to propose new visions and ideas on the ways to facilitate them.

I hope there will be as many active discussions tomorrow as there were today, through which a variety of epoch-making views will be advanced concerning the development of our regional bond markets.

Thank you for your attention, and I hope you all enjoy your dinner.