Market Report (KOREA)

Presented by
Korea Financial Investment Association
Macro-Economic Overview 2017-2018

Korea’s per capita gross national income (GNI) registered USD 29,744 in 2017, up by 7.5% from the USD 27,681 posted a year ago. Real GDP grew 3.0% last year.

Statistics on annual real gross domestic product (GDP) growth by industry showed that the service and construction industries posted marginal growth, whereas the manufacturing industry displayed slower growth. The construction industry enjoyed growth of 7.6%, while the service industry saw GDP advance 2.1% in 2017. Weakened growth of the wholesale, retail, transportation industries had offset the stronger growth of the service industry, including the financial and insurance sectors. Persistently unfavorable weather conditions took a toll on the GDP of the agriculture and fishing industries, increasing only slightly by 0.3% compared to a year ago.

The Korean economy has been maintaining moderate growth year to date with continued improvements in the service sector despite a sluggish construction industry. The manufacturing sector has been showing slightly higher growth from 2nd quarter in terms of the value added in the national account. Domestic demand has remained on a growth track with strong consumption significantly offsetting the slowdown in investment growth. As for construction investment, slowing growth is mostly witnessed in the residential housing sector. Meanwhile, facilities investment has been posting moderate growth due to a higher comparison base of last year’s spike in semiconductor manufacturing equipment investment.

The unemployment rate in 2017 remained flat year-on-year at 3.7%. However, the unemployment rate has been slightly increasing in 2018 with a lower rate registered by major sectors with high employment creation effects such as manufacturing and consumption-related services. The consumer price index (CPI) has increased in the mid to high 1% range, which results from higher oil prices. Consequently, the core inflation rate has been showing slightly decelerated growth.

In 2018, the Korean economy should benefit from higher exports and facilities investments following the global economic recovery trend. Real GDP is projected to grow by 2.9%. Despite unfavorable factors including sluggish production, negative indices and uptrend in oil prices, the global economy is still expected to restore its growth momentum. As the global economic growth rate and trade volume steadily increases, export growth is also forecast to exceed GDP growth. Facilities investment is likely to improve around the IT and semiconductor-related industries.

### Table 1. Macroeconomic indices (YoY, %)

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>18.1H</th>
<th>18.2H</th>
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<tbody>
<tr>
<td>Real GDP Growth Rate</td>
<td>2.8</td>
<td>2.9</td>
<td>3.1</td>
<td>2.9</td>
<td>2.8</td>
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<tr>
<td>Private Consumption</td>
<td>2.2</td>
<td>2.5</td>
<td>2.6</td>
<td>3.1</td>
<td>2.5</td>
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<tr>
<td>Facilities Investment</td>
<td>4.7</td>
<td>-1.0</td>
<td>14.6</td>
<td>5.1</td>
<td>1.9</td>
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<tr>
<td>Construction Investment</td>
<td>6.6</td>
<td>10.3</td>
<td>7.6</td>
<td>1.2</td>
<td>-1.5</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>0.7</td>
<td>1.0</td>
<td>1.9</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Core Inflation</td>
<td>2.2</td>
<td>1.6</td>
<td>1.5</td>
<td>1.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>3.6</td>
<td>3.7</td>
<td>3.7</td>
<td>4.1</td>
<td>3.3</td>
</tr>
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</table>
Capital Market Overview 2017

Korea’s stock market capitalization was KRW 1,889tn at the end of 2017, 25.1% higher than the previous year. The outstanding balance of bond issues registered KRW 1,830tn, up by 4.5% year-on-year. The stock market capitalization to GDP ratio advanced 17.1%pts to 109.1%, while the bond market capitalization to GDP ratio recorded 105.7%, slightly retreating from a year earlier.

Put into a global context, Korea’s stock market capitalization to GDP ratio is still lower than those of advanced economies, such as the US at 165%, UK at 169%, and Japan at 126%.

Household Asset Composition

Non-financial assets including real estate accounted for 62.4% of household assets in 2017, still higher than the share of financial assets, which stood at 37.6%. However, it should be noted that the share of financial assets continues to be on the rise.

Although cash and deposits maintained the largest share of 43.1% among financial assets, their percentage is on a downtrend. Financial investment instruments such as equities, bonds and investment funds assumed 24.6%, a 0.6%pts increase year-on-year.
**Equity Market**

At the end of 2017, the KOSPI index advanced 21.7% to 2,467.49pts, with turnover growing by KRW 181tn compared to 2016 to reach KRW 1,294tn. As for the KOSDAQ, the index soared 26.4% over a year to 798.42pts at end-2017, with turnover also increasing by 7.3% year-on-year to KRW 896tn.

Graph 2. Stock Market Trend

In 2017, the KOSPI index broke out of the trading channel for the first time in seven years and posted a historic high of 2,557.97pts on November 3. Thanks to positive factors including improved internal and external economic conditions and stronger corporate earnings momentum, the KOSPI remained on an upward trend for four consecutive quarters. The KOSDAQ index was boosted by 22.3% in the 4th quarter of 2017 on expectations over the Korean government’s plan to facilitate the KOSDAQ market.

Graph 3. Listed Companies and Market Capitalization

![Graph showing listed companies and market capitalization](source: KRX)
In the KOSPI market, the total number of listed companies decreased by five to 774 at the end of 2017. However, market capitalization gained 22.7% year-on-year to reach KRW 1,606tn. Meanwhile, the KOSDAQ market added 57 new listed companies, which brought the total number of listed companies to 1,263 at end-2017. Market capitalization soared 38.4% to KRW 279tn over the same period.

Individual investors accounted for 46.7% of the total turnover in the KOSPI market in 2017, while foreigners took up 31.0%.

Institutional investors, encompassing investment trusts, pension funds and mutual aid associations, assumed 21.0%. The higher share of foreign investors since 2014 contributed to a more balanced market. However, the percentage of individual investors picked up again in 2016, before slightly slowing down in 2017.

Unlike the KOSPI market, the KOSDAQ market is still dominated by individual investors, who comprised 87.2% of the total turnover. The portion of foreign investors moved up by 1.8%pts compared to the previous year.

There were a total of 55 securities firms in Korea at the end of 2017, an increase by two compared to a year earlier. The number of securities firms peaked in 2013 at 62, but then dropped by nine over the next three years. This was due to the corporate restructuring and reorganization of securities companies following a prolonged market recession, and consequently two new players began operations in 2017.

Total equity capital, which displays the size of a securities company, remained on an upward track. At end-2017, the equity capital of securities companies totalled KRW 52.3tn, increasing the average equity capital per one
securities firm to KRW 0.95tn. This is a result of securities firms growing their size through measures including capital increases on the back of the government’s policy to foster mega investment banks.

**Bond Market**

Bond trading declined overall in 2017 as market rates moved up on normalized monetary policies of major countries (e.g. The US Fed’s three interest rate hikes and the Bank of Korea’s first benchmark interest rate hike in 6.5 years) coupled with stronger expectations for better economic conditions.

Bond trading volume dropped 12.0% to KRW 6,943.8tn in 2017. The share of OTC market trading in total bond trading remains at around 70% (90.5% in 2010; 65.0% in 2017).

An analysis of trading volume by bond type shows that the proportion taken up by Korea Treasury Bonds (KTB) steadily increased since the 2000s, currently accounting for a lion’s share of more than 50% in the secondary bond market.

Improvements in government policies to nurture the KTB market, such as the introduction of fungible issues in May 2000 and the increase in KTB issuance, greatly aided this growth.

With government and public bonds having come to represent a bigger slice of the pie, the share of corporate bonds, including ABS, has comparatively diminished. Corporate bonds assumed 14.7% of total trading volume back in 2000. However, the share declined since 2004 to a mere 3.7% at the end of 2017.
Another special aspect of the Korean bond market that can be found after breaking it down by bond type is that the exchange market is more concentrated on KTBs compared to the OTC market. When excluding KTBs, monetary stabilization bonds (MSB), municipal bonds and other bonds comprise less than 1% of the exchange market.

This mostly owes to the exchange trading of on the run KTBs required for primary dealers by the government. (This policy was repealed in July 2008.)

Simply put, institutional investors that are the major participants of the Korean bond market are rarely using the exchange market for trading bonds other than KTBs and MSBs. In the case of special bonds, financial bonds and corporate bonds, the majority of trading takes place on the OTC market.
Derivatives Market

Korea’s derivatives market is divided into the Korea Exchange (KRX), where standardized products are traded, and the over-the-counter (OTC) market, where non-standardized products change hands. The KRX strengthened risk control for blue chip stocks and provided further investment opportunities by additionally listing equity futures and options. Equity options with KOSDAQ-listed stocks as underlying assets were listed for the first time in June 2017.

The turnover of the OTC derivatives market has been on a steady uptrend since 2014, increasing 7.9% year-on-year to KRW 13,962tn in 2017 whereas the turnover of the exchange-traded derivatives showed wavering steps in recent years.

Derivatives-linked securities (DLS) that were first introduced to South Korea in 2003 saw issuance volume soar 30 times from KRW 3.5tn to KRW 101tn in just over ten years, earning them recognition as attractive mid-risk and mid-return products in the low economic growth and interest rate environment.

Equity-linked securities (ELS) and derivatives-linked securities (DLS) were first issued in 2003 in the amount of KRW 3.5tn. In only 13 years, the market exponentially expanded by more than 30 times to post a record high of KRW 101.3tn in 2015 including ELS (KRW 77tn) and DLS (KRW 24.3tn), allowing them to position themselves as mid-risk, mid-return products. The issuance volume of ELS and DLS was valued at KRW 111.6tn in 2017, a 42.9% increase compared to 2016, when issuance had faltered.
Market and Regulatory Issues

2017-2018

1. Financial Authority Pushes to Grant Short-Term Financing Licenses to Mega Investment Banks and Introduce New Products such as IMAs

The Financial Services Commission (FSC) introduced the “Scheme for Comprehensive Financial Investment Business Entities” in 2013, which outlines providing corporate lending licenses to brokerage firms with equity capital of more than KRW 3 trillion. Then in August 2016, the FSC announced “Plans to Improve the Comprehensive Financial Investment Business Entity System to Foster Mega Investment Banks,” laying the mid-to-long term groundwork for supporting the birth of mega investment banks with shareholder equity of at least KRW 10 trillion. These plans allow comprehensive financial investment business entities to leverage wide-ranging and efficient measures for fully financing themselves. A graded incentive scheme will be applied to three tiers that will be categorized based on shareholder equity of at least KRW 3 trillion, 4 trillion and 8 trillion.

At present, a comprehensive financial investment business entity with shareholder equity of at least KRW 4 trillion can engage in short-term financing operations in Korean won after receiving the license for short-term financing from the FSC. Korea Investment & Securities (Korea I&S) obtained the license in November 2017 followed by NH Investment & Securities (NH I&S) in May 2018. Two more brokerage firms are in the process of getting the license.

After licensing the two mega banks mentioned above for short-term financing operations, the FSC is reviewing plans to allow comprehensive financial business entities operate the Investment Management Account (IMA) business, when they meet the shareholder equity criteria of KRW 8 trillion or above.

IMA is an arrangement where the assets deposited by the customer are managed as corporate financial assets, etc. before the principal along with profits are returned to the customer. The funds raised are excluded from leverage regulations, there is no issuance limit, and at least 50%
of the fund raised in case of short-term financing and at least 70% in case of IMAs have to be invested in corporate financing. This increases capital supply for companies, translating into more capital injections for venture companies and new profit structure-changing opportunities for brokerage firms.

2. Overseas Remittance Operations Allowed for Brokerage Firms; Short-Term Financing in Foreign Currency Allowed for Comprehensive Financial Investment Business Entities

The Ministry of Economy and Finance (MOEF) announced “Plans to Improve the Foreign Exchange and Supervision Systems” on September 28th, 2018. Accordingly, overseas remittance operations, previously allowed only for banks, are now also open to brokerage firms and credit card companies. Beginning from the first quarter of next year, brokerage firms and credit card companies can send a small amount of money overseas, up to USD 3,000 per remittance and USD 30,000 a year. The annual overseas remittance ceiling applied to branch companies of the National Agricultural Cooperative Federation and National Federation of Fisheries Cooperatives was raised to USD 50,000 from USD 30,000.

Another point to note is that the MOEF’s plan allowed comprehensive financial investment business entities to engage in short-term financing in foreign currencies upon gaining license. This widened the business scope of non-banking financial institutions such as brokerage firms and allowed comprehensive financial investment business entities that meet the criteria to use their foreign currency capital in various ways. In the past, brokerage firms had to borrow foreign currency from overseas through FX swap arrangements or directly at a high interest rate. However, the institutional improvement provides more options to finance in foreign currencies, which should work positively for brokerage firms.

Currently, two brokerage firms - Korea I&S and NH I&S – provide short-term financing in Korean won. Korea I&S aims to roll out short-term financing services in foreign currencies within this year, while NH I&S has plans to launch new services within the first half of next year.
The allowance of these new business operations will enable brokerage firms to provide one-stop forex services, which in turn should enhance consumer convenience. Stronger competition induced by the MOEF’s plans is also projected to give consumers more options to choose from. Furthermore, the application of wide-ranging FinTech solutions to foreign exchange operations including overseas remittances should result in more efficient and innovative services. We hope the MOEF’s plans will contribute to the shared growth between FinTech companies and the financial industry and create more jobs.

3. Pilot Launch of “Chain ID,” a Blockchain-Based Joint Authentication System for the Financial Investment Industry

In October 2017, the Korea Financial Investment Association (KOFIA) launched “Chain ID,” a joint authentication system of the financial investment industry that is based on the blockchain technology. Established with the collaboration of 8 brokerage firms, the system supports self-authentication that is required for online stock trading and money transfers. A user can decide on the authentication method among the choices of PIN, PW or biometric.

Financial companies can substantially cut back on certification costs as customers can self-authenticate, while customers can enjoy transaction convenience by using the issued certificate to transact with any participating company without having to register everytime. In addition, the system is distributed not centralized, which means security improves with each addition of a participating member.

As of October 2018, development is underway for the PC solutions for Chain ID, which KOFIA aims to introduce within this year. Industries other than the financial investment industry, such as banking, credit and insurance, have either adopted blockchain-based authentication services or are preparing for adoption. The joint blockchain-based authentication system that will be used across the financial industry is also under development with a launch target of 2018.