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# South Korea's Inclusion in the WGBI and Its Impact on the Won

The South Korean sovereign bond's inclusion in the FTSE Russell's World Government Bond Index (WGBI) is a positive domestic development and serves as recognition of the South Korean government's efforts to open its capital market. This decision has been expected ever since South Korea was added to the watch list in September 2022. The South Korean government also introduced an FX liberalization program allowing third-party FX transactions and extending FX trading hours.

The inclusion in the WGBI will be effective in November 2025 and the eventual weight will be phased in on a quarterly basis over a one-year period. Based on the market data as of October 2024, 62 won-denominated South Korean government bonds worth USD 712.5bn will be eligible for the WGBI index, accounting for 2.22% of the index on a market value-weighted basis. This translates into 2.47% of the WGBI ex-Japan and 2.77% WGBI ex-Japan, ex-China indices.

According to FTSE, upon its full inclusion South Korea is expected to rank 9th in the WGBI, higher than Canada at 1.68%, but behind Spain (3.97%) and the UK (4.75%). The US weighting will be most affected, falling by 0.92% but still ranking at the top (40.39%), while the weightings for Japan and China will be adjusted lower by just over 0.2%. With an estimated $2.5trn in assets tracking the WGBI, more than $55bn in passive capital flows may eventually enter the South Korean bond market.

How significant are the anticipated passive flows? The potential inflows are sizeable, but nothing new to the South Korean government bond market. We have identified an underlying trend and structural demand for South Korean government bonds over the past few years. The latest South Korean Financial Supervisory Service (FSS) data show foreign investors' cumulative holdings of listed bonds totaling KRW 240trn, or 10.3% of all listed bonds in South Korea. Foreign holdings of South Korean listed bonds has risen steadily, starting from a low of 5.6% in 2016, gradually climbing to 7.3% in 2020 and reaching 9.6% at the end of 2021. Foreign ownership of local bonds exceeded the 10% mark in August 2024.

Korean Treasury Bonds (KTBs) were likely included in the WGBI to accelerate foreign ownership of these bonds, which should improve domestic bond market liquidity but also carries the risk of higher volatility in the event of stress or aggressive foreign investor outflows.

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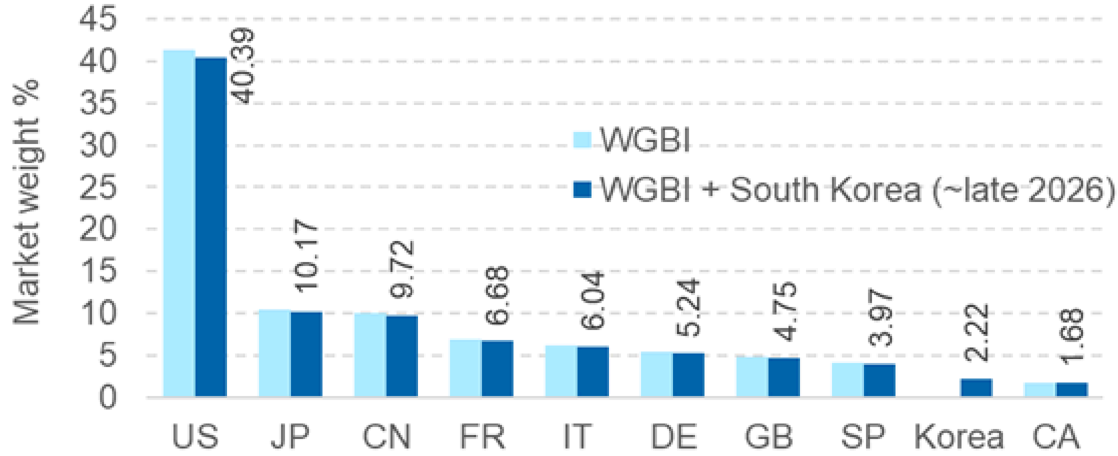
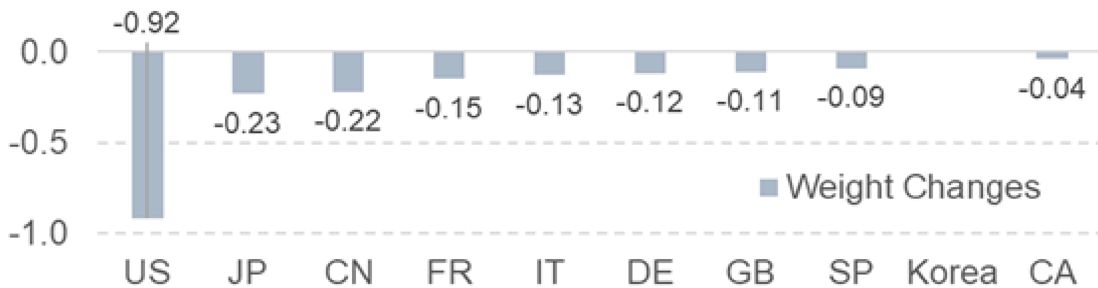
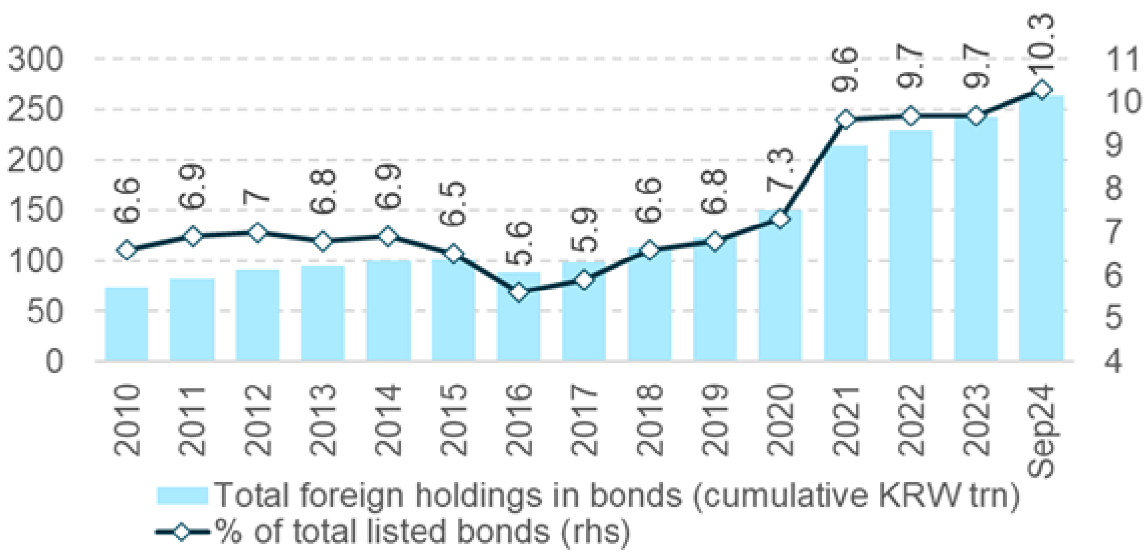
**Exhibit #1: Inclusion of KTBs in the WGBI / Foreign Ownership of Korean Bonds on the Rise**




Source: BNY, Bloomberg L.P.

The inclusion of KTBs in the WGBI was hotly discussed among clients. Domestic asset managers are especially interested in this topic and want to know what impact the inclusion of KTBs in the index will have on the Korean won. It is possible to argue that increasing bond investment inflows will be positive from a balance of payments perspective and therefore will be supportive for the currency, but it might not be the overriding or primary driver.

We can take China as an example. Bloomberg announced in January 2019 that Chinese RMB-denominated government and policy bank securities would be added to the Bloomberg

Barclays Global Aggregate Index starting on April 1, 2019 and phased in over 20 months. This and their subsequent inclusion in the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) in February 2020 resulted in strong bond investment inflows into China. Between April 2019 and early 2020, no sustained abnormal or excessive relative rise in the value of CNY was observed. USDCNY developments were in line with DXY and Asiadollar movements (see chart in Exhibit #2). Indeed, the sizeable bond investment inflows over the past few years have not managed to shield KRW from depreciation forces.

We welcome positive market reform in South Korea but at the same time believe that there are more significant drivers of the Korean won, such as interest rate differentials, foreign equity flows, export growth, the trade balance and government fiscal discipline. Commodity prices play a role, too, from a terms of trade perspective, where high crude oil prices lead to higher import costs and lower trade balances.

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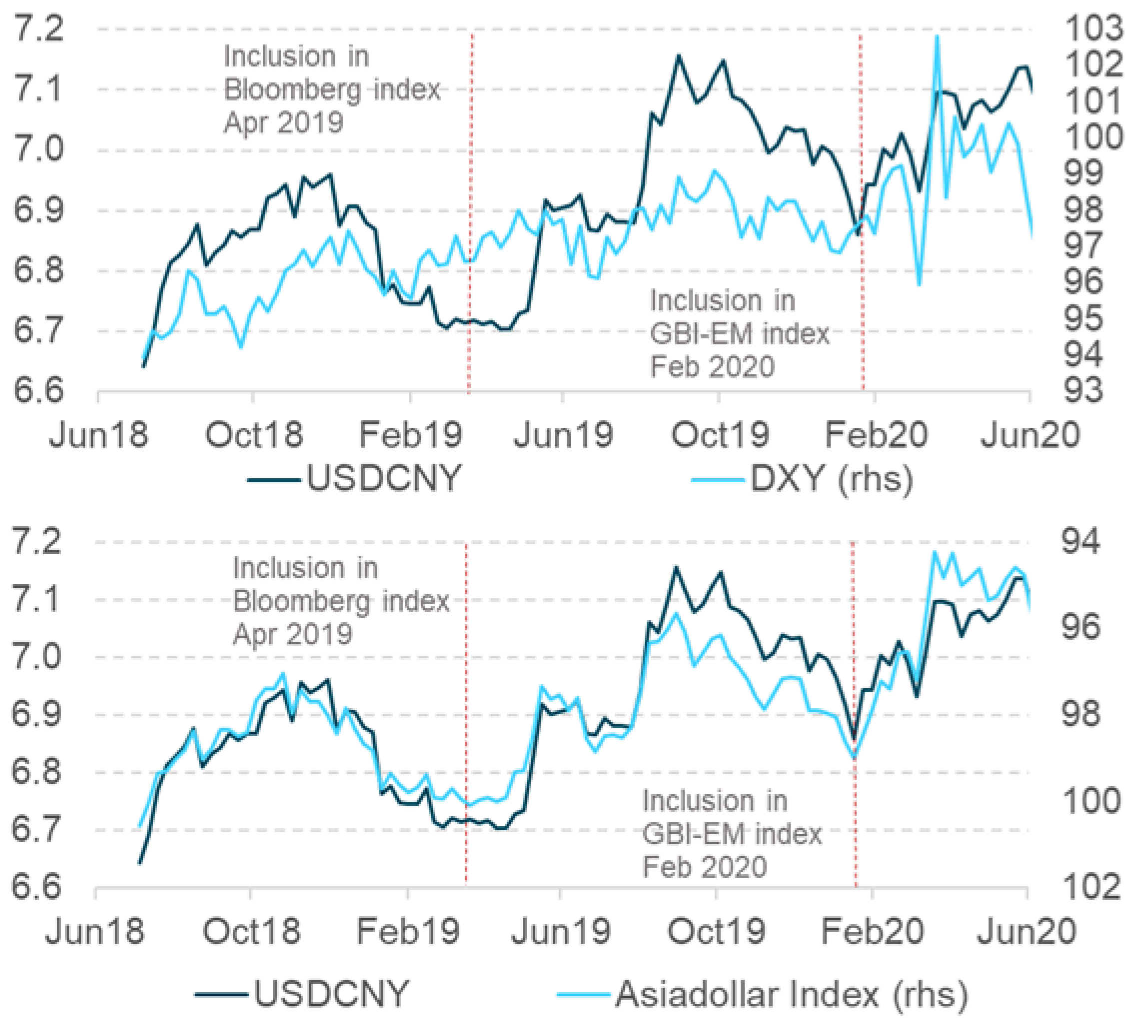
**Exhibit #2: Limited Impact of CNY on the Inclusion of Chinese Bonds in Indices**



Source: BNY, Bloomberg L.P.

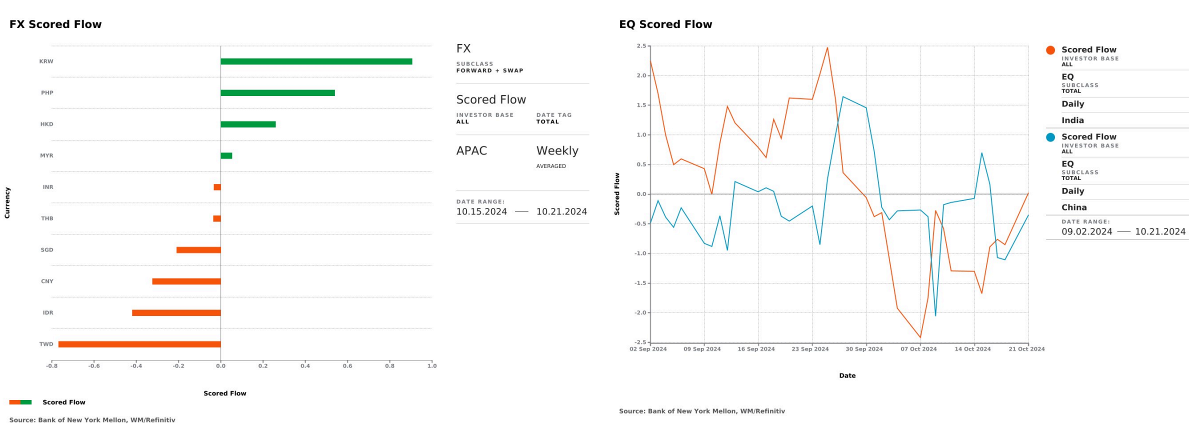
Over the past few weeks, US dollar strength, with month-to-date gains of over 3%, has led to heightened market volatility. That said, USD strength was not accompanied by substantive USD demand or outflows in emerging market currencies. According to iFlow data, US dollar monthly average scored flows is almost neutral at 0.06, LatAm currencies have posted inflows, led by CLP and PEN, and APAC currencies were lightly sold on aggregate.

Among APAC currencies, investor flows over the past week were mixed, with TWD, IDR and CNY leading the outflows, with weekly average scored flows of -0.77, -0.42 and -0.32, respectively, against larger inflows in KRW and PHP, with weekly average scored flows of 0.91 and 0.54, respectively.

The more interesting developments over the past week were in the asset space. Indian equity flows abruptly turned into outflows and in good magnitude after two months of strong buying momentum in August and September. Investor appetite for Chinese equities only lasted for one week before resuming its outflow trend. Lastly, demand for Indonesian equities remains insatiable, with 18 straight weeks of inflows.

With respect to bonds, Chinese sovereign bond outflow momentum continued for the 11th consecutive week, while Indonesian government bonds saw accelerated demand, with weekly scored flows of 0.93.

## Exhibit #3: KRW, TWD in Opposite Flow Directions / Chinese, Indian Equity Outflows




Source: BNY, Bloomberg L.P.

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