Analysis of Korea's Term Structure of Interest Rates

Bonds with identical risk, liquidity and tax characteristics may have different interest rates because the time remaining to maturity is different. A plot of the yields on bonds with differing terms to maturity but the same risk, liquidity and tax considerations is called a yield curve, and it describes the term structure of interest rates for particular type of bonds, such as government bonds. Generally, the term structure has an upward slope because long-term interest rates are higher than short-term rates, being affected by the term premium. But in case an economic slowdown is expected in future, long-term interest rates will fall, causing the term structure to have a mild upward slope or to become inverted.

Since the term structure of interest rates in this way not only reflects the financial market's expectations of future economic activities but also offers many advantages over other economic indicators in the promptness of its acquisition, financially advanced countries have long used it as a useful information variable for monetary policy. This study divides Korea's term structure of interest rates into periods before and after the currency crisis while placing emphasis on the availability of the term structure as an information variable for monetary policy.

The findings of the study show that before the currency crisis, the yield curve fluctuated regardless of changes in inflation or transition of business cycles and did not have particular characteristics. This appears to have been a result of the inadequate liberalization of interest rates, the

segmentation of long-and short-term financial market and a number of regulations on the financial market. Following the currency crisis, however, the yield curve had an upward slope and interest rates on bonds of different maturities tended to move together over time. In other words, this can be interpreted as showing that the term structure of interest rates of Korea became similar to that of industrialized countries.

This change of the term structure of interest rates following the currency crisis is mainly due to the shift of the monetary policy regime from monetary targeting to an interest rate–oriented system. In addition, the strengthened linkages between the long-and short-term financial markets thanks to the liberalization of interest rates and development of the financial market facilitated arbitrage transactions. Another factor was the improvement of the bond market infrastructure with the adoption of market based valuation and introduction of a Treasury Bonds futures market.

Using econometric models, this paper analyzes the predictability of the term structure of interest rates concerning inflation, business activities and other future economic conditions. The results show the enhanced predictability and increased usefulness of the term structure of interest rates as an information variable for monetary policy. Taking into consideration the relatively short period of time since the term structure has become normal, more efforts should be exerted to increase its usefulness.

First, since the role of yields on Treasury Bonds as a benchmark is important in shaping the term structure of interest rates, it is necessary to improve the Treasury bond market through the diversification of maturities.

In addition, because price stability is another important factor contributing to the development of the financial market, price stability should be achieved through the stable operation of monetary policy. Through real-time disclosure of information on the bond market and the establishment of a reliable credit rating system, the infrastructure of the financial market should be improved and the market' s efficiency heightened.