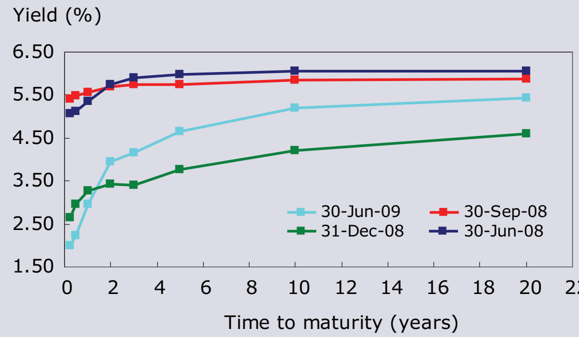
Republic of Korea—Update

Yield Movements

The Republic of Korea's (Korea) government bond yield curve—from 2 year maturities to the longer end of the curve—steepened significantly in June compared to the end of December 2008 **(Figure 1)**. The rise in yields over the middle to long end of the curve reflected a number of different trends, including recovery of the Korean stock market and concerns over continued bond issuance by the Korean government, government-owned corporations, and financial institutions in both Korean won and United States (US) dollars.

Figure 1: Benchmark Yield Curve—Local Currency Government Bonds



Source: Bloomberg LP.

The Korean economy contracted 2.2% year-on-year (y-o-y) in 2Q09. While GDP growth remained in negative territory, signs of economic recovery are beginning to show.

On a quarter-on-quarter (q-o-q) basis, the economy expanded 2.6% in 2Q09—the fastest pace in 7 years—boosted by improvements in exports and consumer demand. The Finance Ministry expects the economy to contract 1.5% in 2009, which is an improvement over its earlier forecast of a 2.0% contraction.

Consumer price inflation eased to a 9-year low in July at 1.6%. However, there is a growing threat that inflation could rise again due to increasing oil prices and excessive global liquidity.

Meanwhile, the Bank of Korea (BOK) has kept its key benchmark rate steady at a record low of 2.0% since February, following reductions totaling 325 basis points beginning in October 2008. The policy rate is expected to remain at its current level for the next 2–3 months.

Size and Composition

The local currency (LCY) bond market in Korea recovered in 2Q09. The bond market rose 5.3% q-o-q (on an LCY basis) in June. On a y-o-y basis, bonds outstanding grew by 13.1% **(Table 1)**.

Government bonds outstanding were up 5.9% q-o-q (on an LCY basis) in 2Q09. The stock of central government bonds—comprising Treasury bills, Treasury bonds, Seoul Metropolitan bonds[3], and National Housing bonds—were up 2.6% q-o-q. Central bank bonds— mainly comprising monetary stabilization bonds—grew 14.5% q-o-q. Industrial finance debentures rose slightly.

On a y-o-y basis, total government bonds outstanding rose 10.7% boosted by double digit increases in central bank bonds (16.3%) and industrial finance debentures (16.7%). The stock of central government bonds also rose by 7.0% y-o-y.

The Korean government issued more treasury instruments this year to help finance its budget expenditures. Originally, the government planned to issue KRW74.3 trillion worth of bonds in 2009. The government announced in March that additional bonds will be sold to help finance its supplementary budget.

Meanwhile, corporate bonds outstanding grew 4.8% q-o-q in 2Q09, and by a more substantial 15.2% on a y-o-y basis.

[3]Bank of Korea classifies Seoul Metropolitan Subway bonds as part of government bonds.

Table 1: Size and Composition of Local Currency Bond Market

	Amount (billion)								**Growth Rate** (%)						
	Mar-09		Apr-09		May-09		Jun-09		Mar-09		Apr-09	May-09	Jun-09		
	KRW	USD	KRW	USD	KRW	USD	KRW	USD	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	1,088,932	796	1,109,871	865	1,133,575	904	1,146,610	901	10.3	5.9	1.9	2.1	13.1	5.3	1.1
Government	498,403	365	511,649	399	523,441	417	527,678	415	5.5	7.4	2.7	2.3	10.7	5.9	0.8
Central Govt Bonds	303,391	222	311,631	243	318,755	254	311,405	245	7.8	5.5	2.7	2.3	7.0	2.6	(2.3)
Central Bank Bonds	144,657	106	150,977	118	156,847	125	165,677	130	(2.0)	14.0	4.4	3.9	16.3	14.5	5.6
Industrial Finance Debentures	50,355	37	49,041	38	47,839	38	50,596	40	16.8	1.6	(2.6)	(2.5)	16.7	0.5	5.8
Corporate	590,529	432	598,223	466	610,134	486	618,931	486	14.6	4.6	1.3	2.0	15.2	4.8	1.4

y-o-y = year-on-year, q-o-q =quarter-on-quarter, m-o-m = month-on-month.
Note:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY–USD rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.

Source: Bank of Korea and *KoreaBondWeb*.

Table 2: Structure of the Korean Corporate Bond Market (KRW billion)

Total Corporate Bonds	**618,932**	**Banks**	**213,451**
Special Public Corps	**171,991**	of which: Kookmin	37,362
of which:		IBK	32,013
KDIC	28,091	**Private Corporates**	**233,490**
KHFC	22,899	Sec. Companies and other Finls	91,997
Korea Land	17,830	Non-Financial Companies	141,493
KEPCO	14,993	of which: KT Corp	5,020
Korea Highway	15,235	Korea Air	3,250
SBC	12,433	SK Energy	3,470
Korea Gas	8,518	Posco	2,640
Korea Train Express	8,425	SK Corp.	2,450

Source: *KoreaBondWeb* and Bloomberg LP.

About 23% of corporate bonds outstanding were issued by private non-financial corporates. Banks are the largest segment of the corporate bond market, accounting for 35% of the total **(Table 2)**.

Kookmin Bank and the Industrial Bank of Korea were among the biggest financial issuers of LCY bonds, accounting for 18% and 15% of bonds issued by financial companies, respectively.

Foreign Currency Bonds

In April, the government raised USD3 billion overseas through the sale of USD-denominated foreign exchange stabilization bonds. The bonds carried a 5-year tenor.

Hana Bank also sold USD1 billion worth of government-guaranteed bonds with a 3-year maturity. The bonds were oversubscribed with demand reaching USD6 billion. Hana Bank was the first lender to tap Korea's USD100 billion debt guarantee program for overseas bond sales, which was established in October of last year.

In May, Kookmin Bank became the first commercial bank to issue covered bonds in Asia. It sold

USD1 billion worth of 5-year covered bonds carrying a coupon of 7.25%.

Turnover

The monthly government bond turnover ratio in Korea rose to 0.30 in June, after dropping to a low of 0.19 in November. Trading value has also recovered reaching KRW158.32 trillion in June **(Figure 2)**.

The corporate bond turnover ratio improved to 0.08 in February through April before dropping to a low of 0.06 in June. Trading value reached KRW33.96 trillion.

Rating Changes

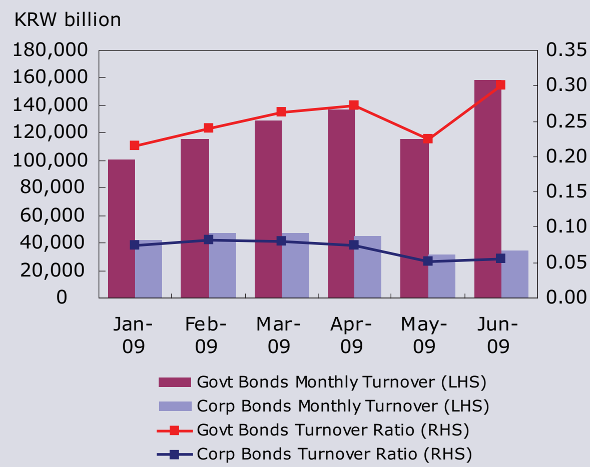
In February, Standard & Poor's (S&P) affirmed Korea's sovereign credit rating. According to S&P, the country's sovereign rating is underpinned by a dynamic economy, and sound fiscal and external positions. The stable outlook on the ratings reflects the view that financial stability will be maintained despite an anticipated weakening of banks' financial profiles in the near term.

	Moody's	S&P	Fitch
Sovereign FCY LT Ratings	A2	A	A+
Outlook	stable	stable	negative

Investor Profile

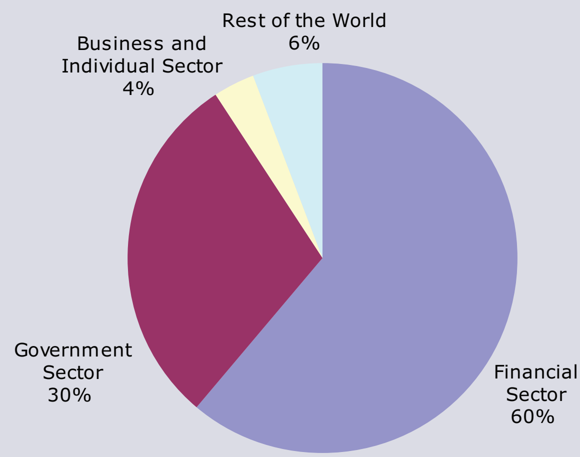
The financial sector held more than half of government bonds as of March 2009 amounting to KRW245 trillion. This was 7.0% above end-December levels. Foreign holdings, however, dropped slightly from 7.0% in end-December to 6.0% as of end-March.

Figure 2: Monthly Bond Trading Volume and Turnover Ratio



Source: Bank of Korea and *KoreaBondWeb*.

Figure 3: Investor Profile for Local Currency Government Bonds (March 2009)



Source: Bank of Korea.

Policy, Institutional, and Regulatory Developments

Approval of Supplementary Budget in the Amount of KRW28.4 trillion

The National Assembly (Parliament) approved the government's supplementary budget in the amount of KRW28.4 trillion in April to help boost domestic demand and jumpstart the slumping economy. This is the largest extra-budgetary measure since the 1997/98 Asian financial crisis. Of this amount, KRW17.2 trillion is earmarked for additional spending, while the remaining KRW11.2 trillion will be used to cover shortfalls in tax revenue. The supplementary budget will be funded mainly through the sale of government bonds.

Extension of Currency Swap Arrangement with US Federal Reserve

BOK and the US Federal Reserve have agreed to extend their currency swap arrangement until 1 February 2010. Originally, the agreement was scheduled to end on 30 October 2009. BOK expects the extension of the swap arrangement to contribute to the continuing stability of foreign currency and financial markets in Korea.

Foreign Investors Exempt from Withholding Taxes on Treasury Bonds and Monetary Stabilization Bonds

Foreign investors are now exempt from withholding taxes on interest income and capital gains taxes when investing in treasury bonds and monetary stabilization bonds. The exemption will be granted provided that an application and required documents are submitted to and approved by fiscal authorities.

Korean Firms Are Now Allowed to Purchase Foreign Currency Bonds

The Financial Services Commission (FSC) has allowed institutional investors to purchase a limited amount of foreign currency–denominated bonds issued abroad by Korean companies. The rule, however, does not include convertible bonds, bonds with a warrant, and exchangeable bonds. There is also a 20% limit on the amount of foreign currency (FCY) bonds that can be purchased by domestic institutions as well as a holding period of 1 year. According to the FSC, the new rule will lower the interest rates that companies have to pay when issuing FCY-denominated bonds abroad. The rule came into effect in July.