Republic of Korea—Update

Yield Movements

The Republic of Korea's (Korea) government bond yield curve widened at the end of September 2009 from its end-June level as yields rose for all maturities **(Figure 1)**. The increase in yields was most significant over the short end of the curve, with yields climbing by 36 basis points for 2-year maturities and 15 basis points for 10-year maturities, which narrowed the spread between 2- and 10-year maturities to 21 basis points.

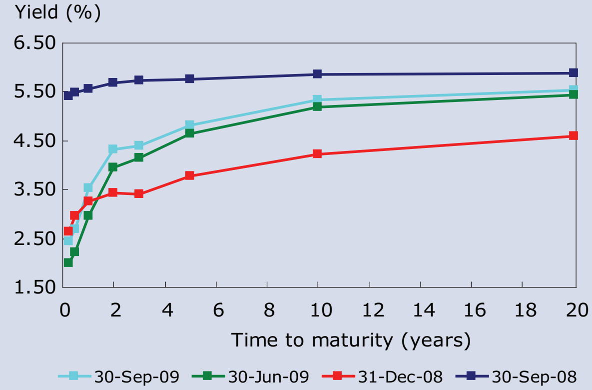
The rise in government bond yields in Korea can be attributed to expectations of an economic recovery. Gross domestic product (GDP) for 3Q09 posted 3.2% growth from the previous quarter, following 2.6% quarter-on-quarter (q-o-q) growth in 2Q09. GDP also grew 0.9% year-on-year (y-o-y) in 3Q09. In addition, consumer price inflation has been rising in recent months, reaching 2.2% y-o-y in September after registering 2.0% in June.

In October, the Bank of Korea (BOK) maintained its base rate at the historically-low level of 2.0%, which has been in place since February 2009. BOK is continuing its accommodative monetary policy stance in order to sustain recent improvements in the domestic growth outlook and the stabilization of financial markets. However, the recent improvement in GDP has raised questions over when BOK will begin to raise the policy rate and phase-out its accommodative monetary policy.

Size and Composition

Total local currency (LCY) bonds outstanding in September 2009 grew by 16.0% y-o-y and 2.6% q-o-q to about KRW1,177 trillion (USD1 trillion) **(Table 1)**.

Figure 1: Benchmark Yield Curve—Local Currency Government Bonds



Source: Bloomberg LP.

In September, government bonds rose by 17.1% y-o-y to KRW540.4 trillion as central government bonds, central bank bonds, and industrial finance debentures climbed 19.0%, 15.9%, and 9.1%, respectively. On a quarterly basis, government bonds rose by 2.4% in 3Q09, led by growth of 7.3% in central government bonds, which more than offset the 6.2% decline in central bank bonds. Meanwhile, industrial finance debentures climbed by only 0.6% q-o-q.

The size of the corporate bond market in Korea also expanded in September as the total amount outstanding grew by 15.1% y-o-y and 2.9% q-o-q to KRW636.6 trillion. Private non-financial corporates accounted for 37% of total corporate bonds, followed by banks and special public corporates with shares of 34% and 29%, respectively **(Table 2)**.

Table 1: Size and Composition of the Local Currency Bond Market in the Republic of Korea

	Amount (billion)								Growth Rate (%)						
	Jun-09		Jul-09		Aug-09		Sep-09		Jun-09		Jul-09	Aug-09	Sep-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	1,146,610	901	1,150,594	941	1,157,799	927	1,176,962	1,001	13.1	5.3	0.3	0.6	16.0	2.6	1.7
Government	527,678	415	531,150	434	537,235	430	540,357	460	10.7	5.9	0.7	1.1	17.1	2.4	0.6
Central Govt Bonds	311,405	245	319,254	261	326,532	261	334,130	284	7.0	2.6	2.5	2.3	19.0	7.3	2.3
Central Bank Bonds	165,677	130	162,197	133	160,587	129	155,327	132	16.3	14.5	(2.1)	(1.0)	15.9	(6.2)	(3.3)
Industrial Finance Debentures	50,596	40	49,698	41	50,116	40	50,900	43	16.7	0.5	(1.8)	0.8	9.1	0.6	1.6
Corporate	618,931	486	619,444	507	620,564	497	636,605	542	15.2	4.8	0.1	0.2	15.1	2.9	2.6

y-o-y = year-on-year, q-o-q = quarter-on-quarter, m-o-m = month-on-month.

Notes:

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	**636,605**
Special Public Corps	**186,956**
of which:	
KDIC	28,091
KHFC	26,667
Korea Land	19,666
KEPCO	14,733
Korea Highway	15,715
SBC	13,613
Korea Gas	8,628
Korea Train Express	8,525
Banks	**216,507**
of which:	
Kookmin Bank	36,880
IBK	33,474
Private Non Financial Corporates	**233,142**

Source: *KoreaBondWeb*.

Rating Changes

In September, Fitch Ratings affirmed Korea's long-term issuer default rating at A+, the short-term issuer default rating at F1, the local currency long-term issuer default rating at AA, and the country ceiling at AA **(Table 3)**. Also, Fitch revised Korea's ratings outlook from negative to stable.

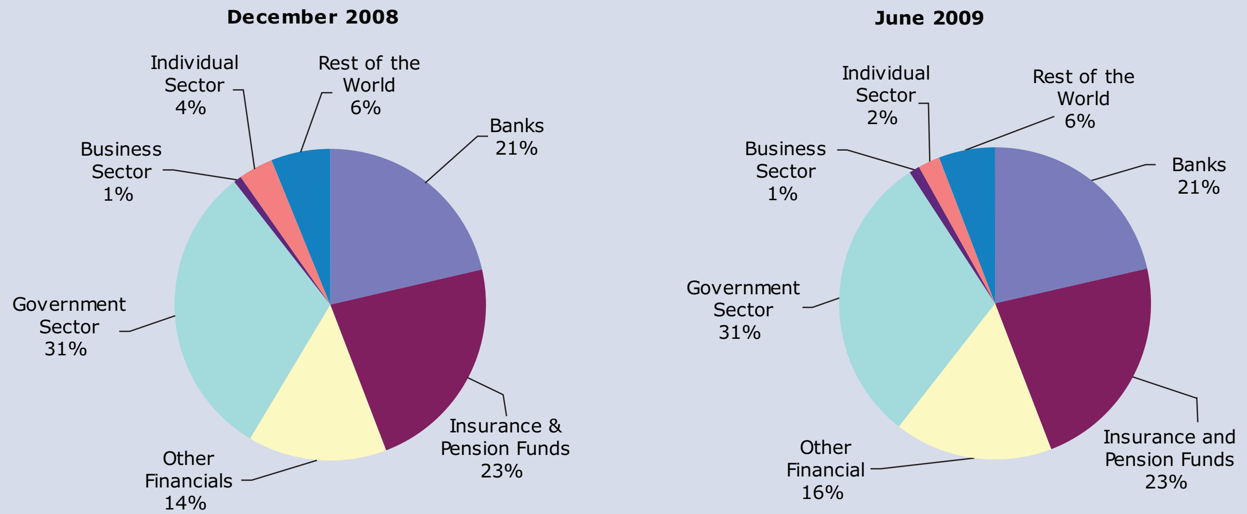
Table 3: Selected Sovereign Ratings and Outlook for Korea

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

FCY = foreign currency and LT = long-term.

Source: Rating agencies.

Figure 2: Investor Profile for Local Currency Government Bonds



Source: Bank of Korea.

Investor Profile

As of June 2009, the financial sector held about 60% of LCY government bonds in Korea, led by insurance and pension funds with a 23% share, and followed by banks and other financial institutions with shares of 21% and 16%, respectively **(Figure 2)**. The government owned 31% of LCY government bonds, while businesses, individuals, and the rest of the world registered shares of 1%, 2%, and 6%, respectively. Compared to end-December 2008, other financial institutions saw their share climb by 2 percentage points, while the share for individuals declined by the same amount.

Policy, Institutional, and Regulatory Developments

2009–2013 Budget Plan

In October, Korea released its 2009–2013 Budget Plan, which aims to develop the country's growth potential, improve fiscal health, and support economic recovery. The Plan projected, among other things, an annual rise in government revenue of 5.6% and that the country's fiscal deficit would fall each year to reach fiscal balance in either 2013 or 2014.

Tax Incentives to Encourage Islamic Bonds

Korea announced in September that it will provide tax incentives on investment proceeds of Islamic bonds starting in 2010. The incentives are designed to attract more investment in Islamic bonds, broaden the investment sources of firms to improve corporate financing decisions, and lessen dependence on the United States (US) and Europe.

Suspension of Currency Stabilization Bonds

In October, Korea temporarily stopped the issuance of currency stabilization bonds in order to limit US dollar inflows and mitigate the rapid appreciation of the local currency (Korean won).

Extension of Currency Swap Facility with Japan

In October, Korea announced an extension of its USD20 billion currency swap facility with Japan for 3 months until 1 February 2010 in order to support the stabilization of domestic financial markets.