Republic of Korea—Update

Yield Movements

The Republic of Korea’s (Korea) government bond yields fell for all maturities in mid-February from their end-December 2009 levels (Figure 1). The drop in yields was largest in the short-end through the belly of the curve, as yields for 1-, 2-, 3-, and 5-year tenors declined 42, 46, 29, and 20 basis points, respectively. At the longer-end of the curve, yields for 10- and 20-year tenors decreased by 10 and 17 basis points, respectively. The larger decline in Korea’s short-term yields compared to long-term yields has resulted in a steepened yield curve.

In March, the Bank of Korea (BOK) held its base rate steady at 2.0%, maintaining an accommodative monetary policy stance in order to help sustain Korea’s economic recovery. Expectations of the policy interest rate remaining unchanged in the coming months are seen to have contributed to the decline in yields.

Korea’s 4Q09 real gross domestic product (GDP) increased 0.2% quarter-on-quarter (q-o-q), down from 3Q09 growth of 3.2%. On a year-on-year (y-o-y) basis, real GDP expanded 6.0% in 4Q09, following 0.9% growth in 3Q09. Consumer price inflation was 2.7% y-o-y in February, compared to 3.1% in January.

Size and Composition

Korea’s total local currency (LCY) bonds outstanding as of December 2009 stood at KRW1,183 trillion (USD1 trillion), representing increases of 15.0% y-o-y and 0.5% q-o-q. However, Korea’s bonds outstanding at the end of December were 0.7% less than end-November levels (Table 1). On a y-o-y basis, total government bonds climbed 11.4% to KRW516.9 trillion (USD446 billion) as central government bonds and central bank bonds increased 15.7% and 17.6%, respectively, more than offsetting the 29.2% drop in industrial finance debentures. Compared to September, however, the amount of total government bonds fell 4.3% due to declines in central government bonds, central bank bonds, and industrial finance debentures. Total government bonds also dropped on a month-on-month (m-o-m) basis, by 2.4%, with central government bonds and central bank bonds falling 2.3% and 3.0%, respectively.

As of December 2009, corporate bonds outstanding reached KRW666 trillion (USD575 billion) for increases of 18.0% y-o-y, 4.6% q-o-q, and 0.7% m-o-m. About 35% of total corporate bonds were private non-financial corporate bonds, while private financial corporate bonds and special public corporate bonds comprised 33% and 32%, respectively, of the total corporate bond market (Table 2).

In 4Q09, Korea’s top LCY corporate bond issues involved banks, special purpose entities (SPEs), and an energy firm. In the banking sector, the largest LCY corporate bond issue was Hana Bank’s 2-year bonds of KRW550 billion (USD475 million) at a 4.95% coupon. The largest SPE issue was made by Dream Hub, which raised KRW850 billion (USD734 million) of 3-year, asset-backed securities (ABS) at a 5.97% coupon. Korea Electric Power issued KRW330 billion (USD285 million) of 5-year bonds at a 5.28% coupon, making it the largest corporate issue in the energy sector.
The size of Korea’s outstanding commercial paper market, as of September 2009, was KRW78.96 trillion (USD67.2 billion), which was down 9.9% y-o-y and 5.6% q-o-q.

### Rating Changes

In January 2010, Standard & Poor’s (S&P) affirmed its foreign currency (FCY) and LCY sovereign credit ratings for Korea at A/A-1 and A+/A-1, respectively. S&P also retained its stable outlook for the country (Table 3). The rating agency reported that Korea’s dynamic economy, sizeable foreign exchange reserves, and healthy fiscal position were helping to support its ratings. Furthermore, S&P noted that these strengths tend to balance the country’s weaknesses, which stem from large contingent liabilities and limited monetary flexibility due to banks’ significant short-term foreign borrowing.
Investor Profile

As of September 2009, the financial sector in Korea owned about three-fifths of the country’s total LCY government bonds, with insurance and pension funds, banks, and other financial institutions holding 22%, 21%, and 17% of government bonds, respectively (Figure 2). The remaining bondholders included the government, individuals, non-financial corporations (i.e., business sector), and the rest of the world with shares of 31%, 2%, 1%, and 6%, respectively. Compared to end-December 2008, individuals’ bond holdings fell by 2 percentage points, while the share of other financial institutions rose by 3 percentage points.

As of September 2009, banks, insurance firms/pension funds, and other financial institutions were the top bondholders of LCY corporate bonds in Korea, with shares of 31%, 29%, and 27%, respectively (Figure 3). Other bondholders included the government (12%) and business sector (1%). Compared to end-2008, the shares of other financial institutions and the government climbed by 7 percentage points and 1 percentage point, respectively, while the share of banks fell by 6 percentage points. The shares of insurance firms/pension funds and individuals registered a drop of one 1 percentage point apiece.

As of September 2009, financial institutions, other than banks and insurance firms/pension funds, held the largest share of commercial paper at 72%, which is 5 percentage points higher than in December 2008 (Figure 4). The share of the business sector stood at 14% in both periods, while the share of banks fell to 8% in September 2009 from 13% in December 2008. Individuals and insurance firms/pension funds held shares of 5% and 1%, respectively, in both periods.

### Table 3: Selected Sovereign Ratings and Outlook for the Republic of Korea

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FCY = foreign currency, LT = long-term.

Source: Rating agencies.

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![Figure 2: Investor Profile for Local Currency Government Bonds in Korea](source: Bank of Korea)
Figure 3: Investor Profile for Local Currency Corporate Bonds

December 2008
- Business Sector: 1%
- Government Sector: 11%
- Other Financials: 20%
- Insurance & Pension Funds: 30%
- Banks: 37%
- Rest of the World: 0%

September 2009
- Business Sector: 1%
- Government Sector: 12%
- Other Financials: 27%
- Insurance & Pension Funds: 29%
- Banks: 31%
- Rest of the World: 0%

Source: Bank of Korea.

Figure 4: Investor Profile for Commercial Paper

December 2008
- Business Sector: 14%
- Government Sector: 0%
- Other Financials: 67%
- Insurance & Pension Funds: 1%
- Banks: 13%
- Rest of the World: 0%

September 2009
- Business Sector: 14%
- Government Sector: 0%
- Other Financials: 72%
- Insurance & Pension Funds: 1%
- Banks: 8%
- Rest of the World: 0%

Source: Bank of Korea.
Policy, Institutional, and Regulatory Developments

Bank of Korea and Bank of Japan Agree to Extend Measure to Increase Size of the KRW–JPY Swap Arrangement

In January, BOK and the Bank of Japan (BOJ) extended an agreement increasing the size of their bilateral KRW–JPY swap arrangement—from USD3 billion to USD20 billion—until 30 April 2010. The increase in the size of the bilateral swap arrangement was originally valid from 12 December 2008 to 30 April 2009.

Amendments to the Enforcement Decree of the Financial Investment Services and Capital Markets Act

In December 2009, amendments to the Enforcement Decree of the Financial Investment Services and Capital Markets Act (FSCMA) took effect with the aim of promoting corporate restructuring and mergers and acquisitions. These amendments include provisions on (i) incorporation of special purpose acquisition companies, (ii) fund valuation and fund sales commission, (iii) independent third-party valuation on mergers, and (iv) investment of private equity funds in restructuring and social overhead capital enterprises.

Amendments to the Enforcement Decrees of the Banking Act and the Financial Holding Companies Act

In October 2009, amendments to the enforcement decrees of the Banking Act and the Financial Holding Companies Act took effect. These amendments cover (i) management participation by a non-financial entity (NFE), (ii) approval of an NFE’s bank ownership, (iii) approval of a private equity fund’s bank ownership, and (iv) public pension funds’ exemption from NFE restrictions.