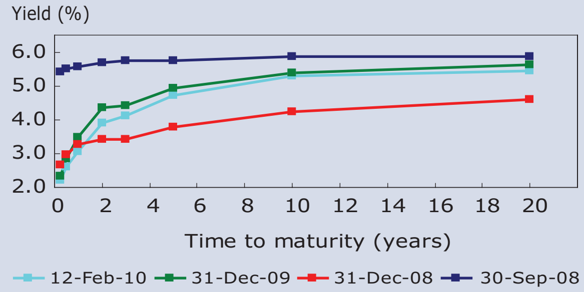
Republic of Korea—Update

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.

Figure 1: Republic of Korea's Benchmark Yield Curve—Local Currency Government Bonds



Source: Bloomberg, LP.

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.

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

	Amount (billion)								Growth Rate (%)						
	Sep-09		Oct-09		Nov-09		Dec-09		Sep-09		Oct-09	Nov-09	Dec-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	1,176,962	1,001	1,180,580	993	1,191,088	1,021	1,182,917	1,021	16.0	2.6	0.3	0.9	15.0	0.5	(0.7)
Total Government	540,357	460	521,680	439	529,480	454	516,935	446	17.1	2.4	(3.5)	1.5	11.4	(4.3)	(2.4)
Central Bank Bonds	155,327	132	149,357	126	153,897	132	149,237	129	15.9	(6.2)	(3.8)	3.0	17.6	(3.9)	(3.0)
Central Government Bonds	334,130	284	337,674	284	340,603	292	332,637	287	19.0	7.3	1.1	0.9	15.7	(0.4)	(2.3)
Industrial Finance Debentures	50,900	43	34,649	29	34,980	30	35,061	30	9.1	0.6	(31.9)	1.0	(29.2)	(31.1)	0.2
Corporate	636,605	542	658,901	554	661,608	567	665,982	575	15.1	2.9	3.5	0.4	18.0	4.6	0.7

m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Note:
1. Calculated using data from national sources.
2. Central government bonds include treasury bonds, National Housing Bonds, and Seoul Metropolitan Subway bonds.
3. Bloomberg end-of-period LCY–USD rates are used.
4. 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 as of end-December 2009 (KRW billion)

Total Corporate Bonds	**665,982**
Special Public Corporations	**212,657**
of which:	
Korea Housing Finance Corporation (KHFC)	28,207
Korea Deposit Insurance Corporation (KDIC)	27,691
Korea Land	19,408
Korea Electric Power Corporation (KEPCO)	16,103
Korea Highway	15,435
Small & Medium Business Corporation (SBC)	13,943
Korea Train Express	8,795
Korea Gas	8,728
Financial Debentures	**217,502**
of which:	
Kookmin Bank	36,309
Industrial Bank of Korea (IBK)	34,930
Private Non-Financial Corporations	**235,823**

Source: *KoreaBondWeb.*

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.

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

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

FCY = foreign currency, LT = long-term.
Source: Rating agencies.

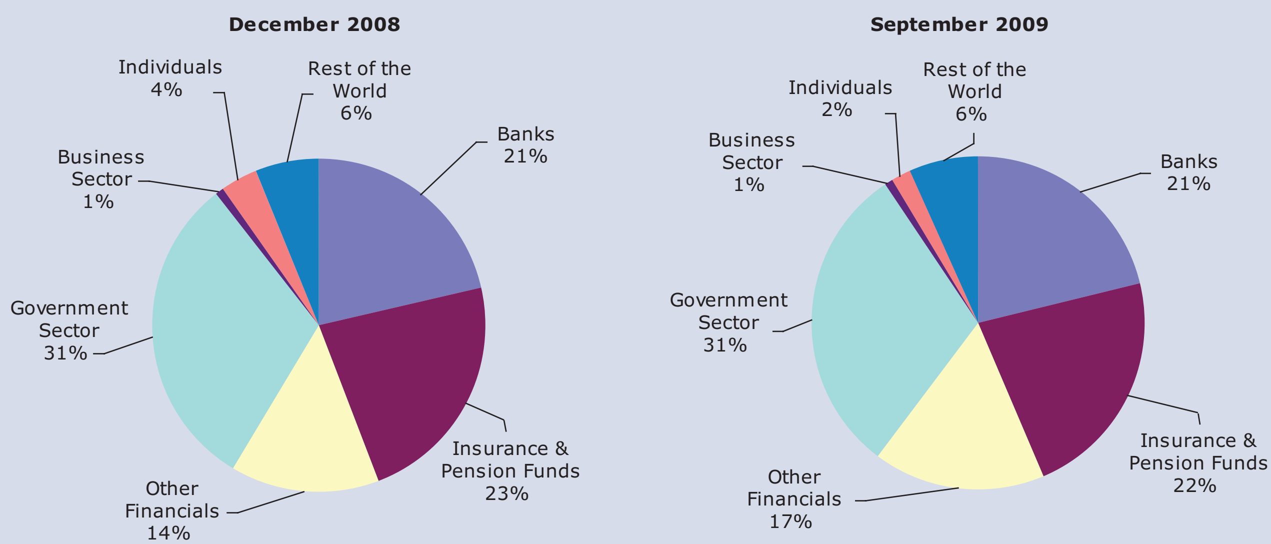
Investor Profile

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.

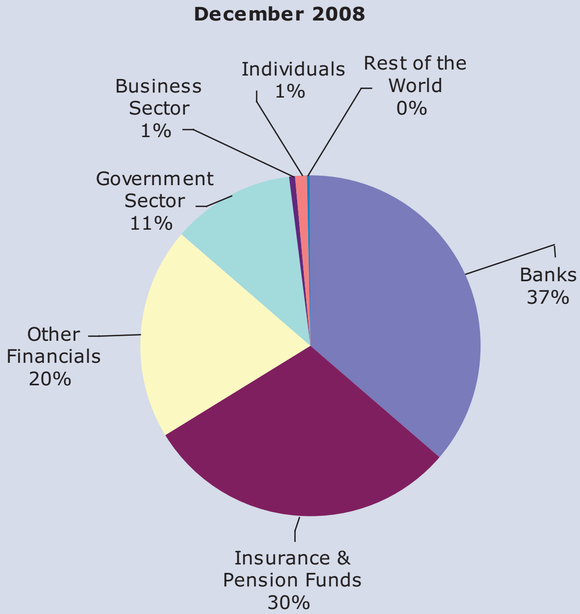
As of September 2009, financial institutions, other than banks and insurance firms/pension funds, held the largest share of commercial paper at 72%, which is 5 percentage points higher than in December 2008 **(Figure 4)**. The share of the business sector stood at 14% in both periods, while the share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

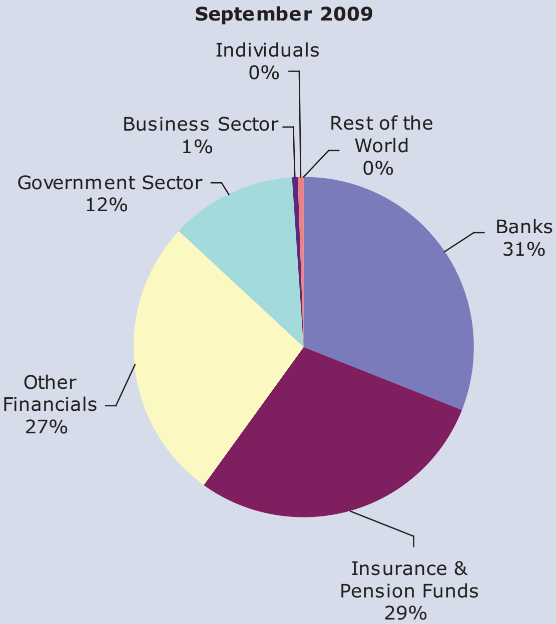
Figure 2: Investor Profile for Local Currency Government Bonds in Korea



Source: Bank of Korea

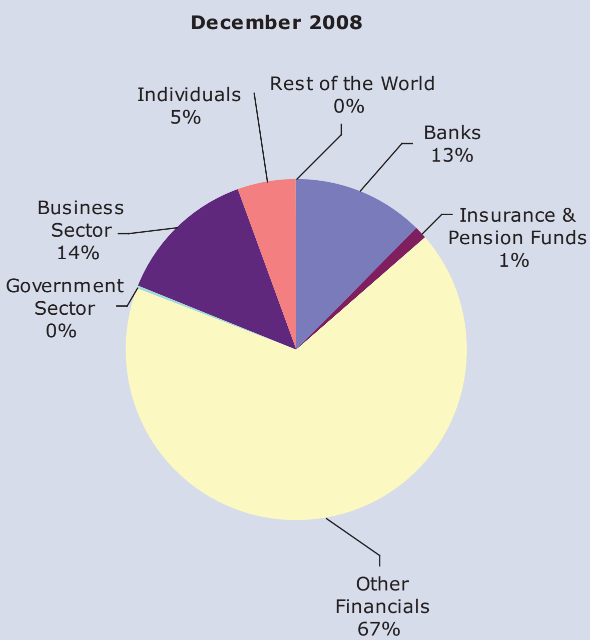
Figure 3: Investor Profile for Local Currency Corporate Bonds

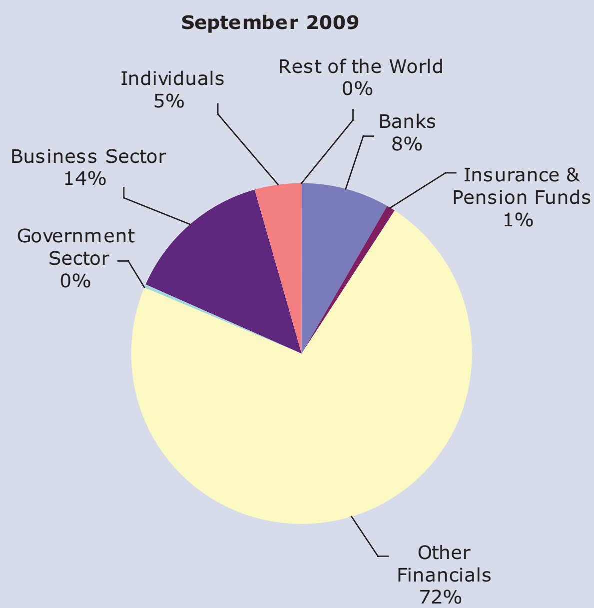




Source: Bank of Korea.

Figure 4: Investor Profile for Commercial Paper





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.