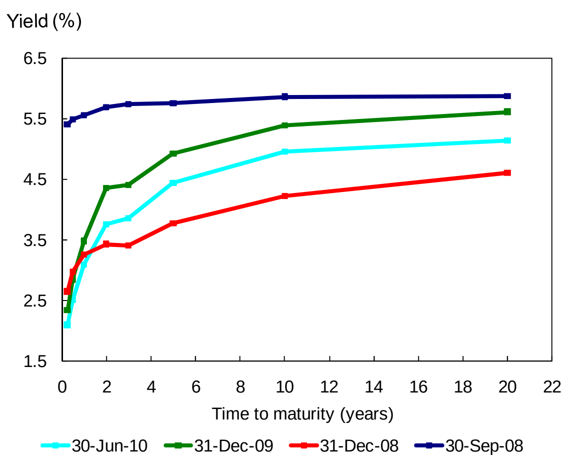
Republic of Korea—Update

Yield Movements

The Republic of Korea's (Korea) government bond yields were down for all maturities at end-June from their end-December 2009 levels **(Figure 1)**. Government bonds with maturities of less than 1 year registered lower yields. Also, yields for 1-, 2-, 3- and 5-year maturities plunged 39, 61, 55, and 48 basis points, respectively. At the longer end of the curve, yields for 10-year maturities fell 44 basis points, while yields for 20-year maturities declined 47 basis points. Meanwhile, yield spreads between 2- and 10-year maturities widened by 17 basis points at end-June from end-December.

Figure 1: Republic of Korea's Government Bond Yield Curves
(as of end-June 2010)



Source: Bloomberg LP.

The drop in Korean government bond yields in the first half of 2010 has been attributed to (i) expectations of a continuing accommodative monetary policy coupled with low interest rates, (ii) lingering fiscal problems in Europe, and (iii) continued foreign investment in Korean bonds. Based on Financial Supervisory Service data, as of end-June, foreigners held KRW38.6 trillion of Korean treasury bonds, compared with KRW27.5 trillion at end-December 2009.

In July, the Bank of Korea (BOK) raised its base rate by 0.25 percentage points to 2.25%, still maintaining an accommodative monetary policy stance in order to help sustain Korea's economic growth. In 1Q10, Korea's GDP growth accelerated to 8.1% year-on-year (y-o-y) from 6.0% in 4Q09, led by buoyant manufacturing activity as well as strong growth in domestic fixed investments and exports. Consumer price inflation eased slightly to 2.6% y-o-y in June from 2.7% in May.

Size and Composition

Korea's total local currency (LCY) bonds outstanding as of March 2010 stood at KRW1,238.4 trillion (USD1.1 trillion), up 13.7% y-o-y, and 4.7% quarter-on-quarter (q-o-q) **(Table 1)**. The annual increase in the size of Korea's LCY bond market was led by a relatively huge expansion in the government bond market as well as in the corporate bond market.

Korea's LCY government bond market expanded 11.2% y-o-y and 7.2% q-o-q to KRW554.4 trillion (USD490 billion) in 1Q10 on the back of increases in the size of central government bonds and central bank bonds. Central government bonds outstanding climbed 17.6% y-o-y and 7.3% q-o-q to KRW356.9 trillion (USD316 billion), while the size of central bank bonds increased 12.1% y-o-y and 8.6% q-o-q to KRW162.1 trillion (USD143 billion). The amount of outstanding industrial finance debentures fell 29.8% y-o-y, but rose marginally 0.9% q-o-q to reach KRW35.4 trillion (USD31 billion). Among the largest LCY government bond issues in Korea during 1Q10 were KRW12 trillion of 2-year monetary stabilization bonds—issued by the BOK—with a coupon rate of 4.12%, followed by KRW10.7 trillion of 5-year treasury bonds with a 4.50% coupon.

Korea's LCY corporate bonds outstanding amounted to KRW684.0 trillion (USD605 billion) as of end-March. The size of the LCY corporate bond market grew 15.8% y-o-y and 2.7% q-o-q. The largest LCY corporate bond issues for Korea in 1Q10 included (i) Lotte Shopping's KRW400 billion of 5-year bonds with a coupon rate of 4.82%, (ii) Dongkuk Steel's KRW350 billion of 3-year bonds at a 5.38% coupon, and (iii) Industrial Bank of Korea's KRW350 billion of 6-year bonds at a 4.95% coupon. Meanwhile, the size of Korea's LCY commercial paper market stood at KRW73.7 trillion in end-March.

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

	Amount								Growth Rate (%)						
	Dec-09		Jan-10		Feb-10		Mar-10		Dec-09		Jan-10	Feb-10	Mar-10		
	KRW Billion	USD Billion	KRW Billion	USD Billion	KRW Billion	USD Billion	KRW Billion	USD Billion	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	1,182,917	1,021	1,181,727	1,019	1,195,920	1,035	1,238,390	1,095	15.0	0.5	(0.1)	1.2	13.7	4.7	3.6
Total Government	516,935	446	527,678	455	538,513	466	554,368	490	11.4	(4.3)	2.1	2.1	11.2	7.2	2.9
Central Bank Bonds	149,237	129	150,737	130	152,447	132	162,120	143	17.6	(3.9)	1.0	1.1	12.1	8.6	6.3
Central Government Bonds	332,637	287	342,700	296	350,967	304	356,875	316	15.7	(0.4)	3.0	2.4	17.6	7.3	1.7
Industrial Finance Debentures	35,061	30	34,241	30	35,098	30	35,372	31	(29.2)	(31.1)	(2.3)	2.5	(29.8)	0.9	0.8
Corporate	665,982	575	654,050	564	657,408	569	684,022	605	18.0	4.6	(1.8)	0.5	15.8	2.7	4.0

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

Notes:

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: The Bank of Korea and *KoreaBondWeb*.

Private non-financial corporate bonds constituted the largest bulk of Korea's LCY corporate bonds outstanding as of end-March at KRW249.2 trillion, followed by special public corporate bonds (KRW226 trillion) and financial debentures (KRW208.9 trillion) **(Table 2)**. The share of private non-financial corporate bonds rose to 36% at end-March from 35% at end-December, while the share of special public corporate bonds also increased to 33% at end-March from 32% at end-December. Meanwhile, the share of financial debentures went down to 31% at end-March from 33% at end-December.

Table 2: Structure of the Korean LCY Corporate Bond Market as of March 2010 (KRW billion)

Total Corporate Bonds	**684,022**
Special Public Corporations	**225,976**
of which:	
Korea Land	48,924
Korea Housing Finance Corporation (KHFC)	29,425
Korea Deposit Insurance Corporation (KDIC)	27,061
Korea Electric Power Corporation (KEPCO)	17,713
Korea Highway	15,545
Small & Medium Business Corporation (SBC)	14,293
Korea Train Express	9,455
Korea Gas	9,358
Financial Debentures	**208,886**
of which:	
Kookmin Bank	34,943
Industrial Bank of Korea (IBK)	32,646
Private Non-Financial Corporations	**249,160**

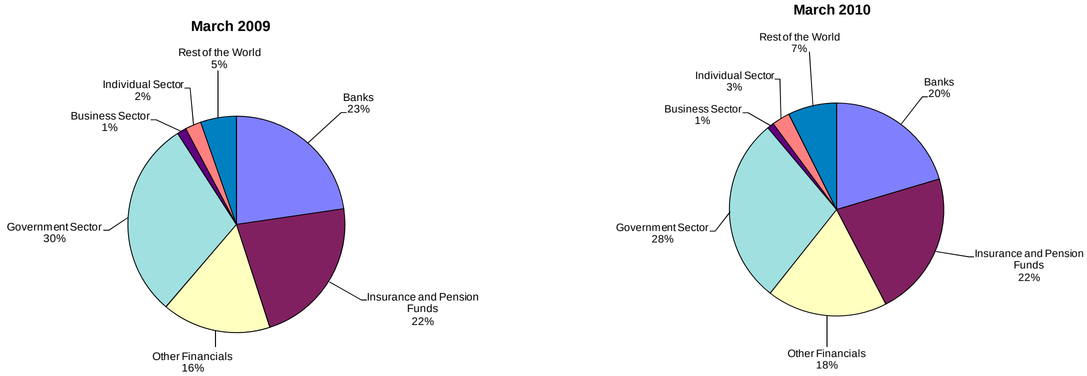
Source: *KoreaBondWeb*.

Investor Profile

As of end-March, the central government of Korea owned 28% of Korean LCY government bonds, followed by Korean insurance and pension funds, banks, and other financial companies with shares of 22%, 20%, and 18%, respectively **(Figure 2)**. Korea's financial sector, as a whole, held 60% of all LCY government bonds. Other Korean government bondholders included individual investors (3%) and non-financial firms (1%). In addition, foreign investors held 7% of the country's LCY government bonds. Compared with March 2009, the shares of LCY government bonds held by the Korean central government and banks fell by 2 and 3 percentage points, respectively; the share of other financial companies and foreign investors each rose by 2 percentage points; and the share of individuals climbed by 1 percentage point.

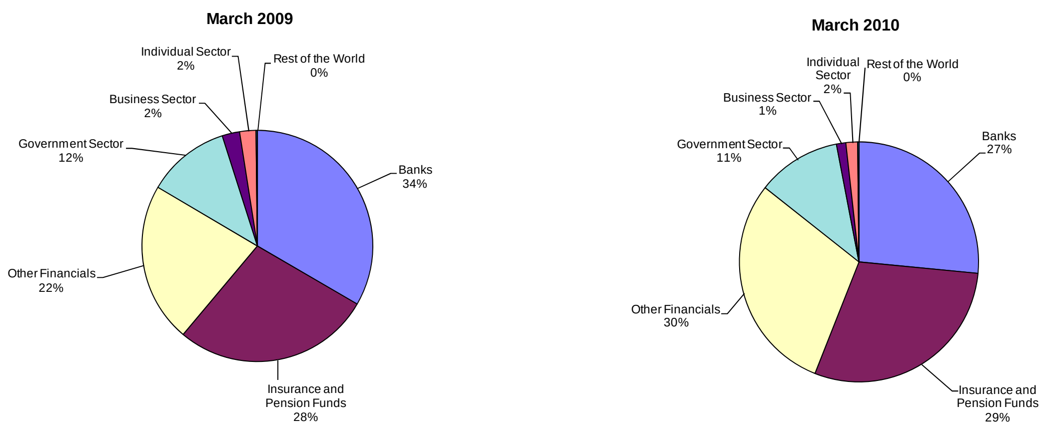
At end-March, financial companies other than banks and insurance firms/pension funds owned 30% of Korea's LCY corporate bonds, while insurance firms/pension funds and banks held 29% and 27%, respectively **(Figure 3)**. Other holders of corporate bonds included the central government (11%), individuals (2%), and the non-financial business sector (1%). On a y-o-y basis, the share of other financial companies holdings of total LCY corporate bonds soared by 8 percentage points, while the share of insurance firms/pension funds rose by 1 percentage point. On the other hand, the share of banks plunged by 7 percentage points and the share of non-financial firms and the government declined by 1 percentage point each.

Figure 2: Investor Profile for Local Currency Government Bonds in the Republic of Korea
(March 2010 and March 2009)



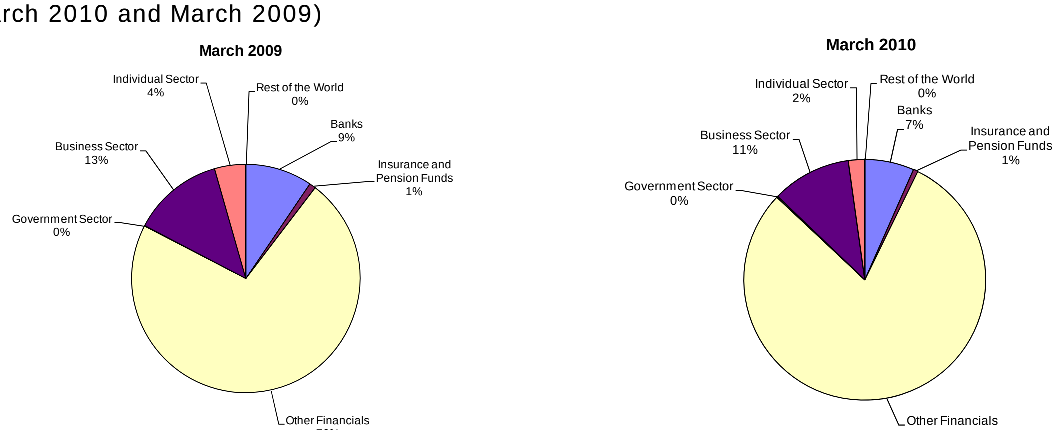
Source: The Bank of Korea.

Figure 3: Investor Profile for Local Currency Corporate Bonds in the Republic of Korea
(March 2010 and March 2009)



Source: The Bank of Korea.

Figure 4: Investor Profile for Local Currency Commercial Paper in the Republic of Korea
(March 2010 and March 2009)



Source: The Bank of Korea.

Financial companies other than banks, insurance firms, and pension funds were the largest holders of Korean LCY commercial paper as of end-March **(Figure 4)**. These other financial companies held 80% of total commercial paper, followed by non-financial firms (11%), banks (7%), individual investors (2%), and insurance firms/pension funds (1%). The share of other financial companies' holdings of total commercial paper surged by 8 percentage points y-o-y, while the share of banks, individual investors, and non-financial firms each fell by 2 percentage points.

Rating Changes

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

	Moody's	Standard & Poor's	Fitch
Sovereign FCY LT Ratings	A1	A	A+
Outlook	stable	stable	stable

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

In April 2010, Moody's Investors Service upgraded its sovereign credit rating for Korea to A1 from A2, and maintained its stable outlook for the country. The rating upgrade was based on the resilience of the Korean economy to the global economic crisis and the government's ability to contain its budget deficit. In January 2010, Standard & Poor's (S&P) affirmed its sovereign credit rating for Korea at A/A-1 and A+/A-1 for foreign currency (FCY) and LCY, respectively, as well as its long-term stable outlook. S&P noted that its ratings were supported by Korea's dynamic economy, sound fiscal position, and sizeable foreign exchange reserves **(Table 3)**.

Policy, Institutional, and Regulatory Developments

Macro-Prudential Measures to Mitigate Capital Flow Volatility

In June, Korea announced macro-prudential measures to curb the volatility of capital flows, including (i) establishing limits on the foreign exchange derivatives contracts of domestic banks and foreign bank branches, (ii) tightening prudential regulations on the FCY liquidity of banks, and (iii) formulating stringent regulations on the use of FCY-denominated bank loans. In addition, the Korean government plans to establish global financial safety nets and an office that will monitor capital flows.

Amendments to the Enforcement Decree of the FSCMA

Amendments to the enforcement decree of the Financial Investment Services and Capital Markets Act (FSCMA) were passed at the Vice-Ministerial Meeting held on 3 June. These amendments include (i) raising the upper limit on bond funds to reinvest their assets into government exchange traded funds from 40% to 100%, (ii) prohibiting executives and employees who are engaged in collective investment businesses to have concurrent job positions in domestic financial institutions, and (iii) specifying the level of punitive measures that affect the authorization of financial investment institutions.

Amendments to the Enforcement Decree of the Mutual Savings Bank Act

Amendments to the Enforcement Decree of the Mutual Savings Bank Act were passed at the Cabinet Meeting held on 22 June. One major amendment requires mutual savings banks to follow the Bank for International Settlement's (BIS) definition of equity capital—comprising Tier 1 capital, Tier 2 capital, and deductible items—and to forego their previous practice of computing equity capital based on a balance sheet definition.

FSC Amends Financial Investment Regulation on Risk Management of Foreign FCY Derivatives

The Financial Services Commission (FSC) amended its financial investment regulation by requiring financial and universal investment companies to formulate and implement risk management guidelines for FCY derivative products effective 12 April. The guidelines require financial investment companies to (i) verify whether their trade of FCY derivative products with professional investors is for risk-hedging purposes, and (ii) establish party dealing limits.