

Republic of Korea—Update

Yield Movements

Government bond yields for the Republic of Korea (Korea) for most maturities were down as of mid-August 2010 from their end-December 2009 levels (**Figure 1**). Yield movements were marginal and mixed for tenors of less than 1 year, while yields for 1-, 2-, 3-, and 5-year maturities dropped 36, 75, 68, and 60 basis points, respectively. Yields for longer-term tenors also fell, by 64 basis points for 10-year maturities and 71 basis points for 20-year maturities. Meanwhile, Korea's yield spreads between 2- and 10-year tenors widened 11 basis points between end-December and mid-August.

The accommodative monetary policy stance of the Bank of Korea (BOK), relatively low interest rates, and increasing foreign investor interest in Korean bonds have all contributed to the decline in government bond yields. Based on Financial Supervisory Service (FSS) data, as of August, foreigners held KRW44.0 trillion of Korean Treasury bonds (KTBs), compared with KRW27.5 trillion in December, and KRW30.0 trillion of monetary stabilization bonds (MSBs), compared with KRW28.2 trillion in December. There was a huge increase in the People's Republic of China's (PRC) holdings of KTBs in 1H10, with holdings

surging 111% to KRW4.0 trillion in June from KRW1.9 trillion in December.

In September, the BOK kept its base rate—the 7-day repurchase rate—steady at 2.25%. The BOK noted that it continues to maintain an accommodative monetary policy to ensure price stability and sustain Korea's sound growth. In 2Q10, Korea's gross domestic product (GDP) expanded 7.2% year-on-year (y-o-y) and 1.4% quarter-on-quarter (q-o-q) on the back of buoyant export growth, rising domestic demand, and a solid performance in the manufacturing sector. Consumer price inflation in August remained the same as in the previous 2 months at 2.6% y-o-y.

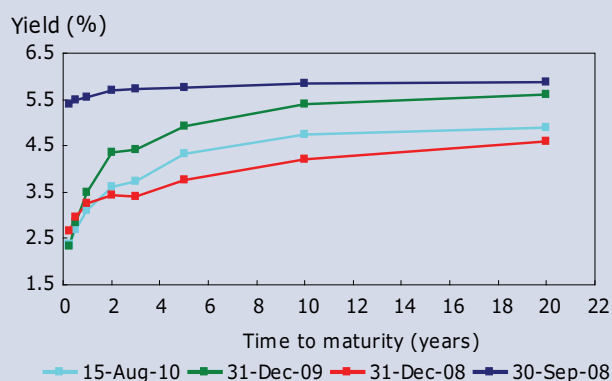
Size and Composition

Korea's total local currency (LCY) bonds outstanding rose 9.6% y-o-y and 1.5% q-o-q to KRW1,256.6 trillion (USD1,029 billion) in June (**Table 1**). The expansion in the size of Korea's LCY bond market was led by positive growth in both government bonds and corporate bonds.

The total amount of LCY government bonds in Korea reached KRW558.9 trillion (USD458 billion) at the end of June, a 5.9% increase from June 2009. This increase was driven by central government bonds, which climbed 14.8% y-o-y to KRW357.5 trillion (USD293 billion), mainly led by a 16.5% y-o-y increase in KTBs. MSBs, which are issued by the BOK, rose 1.2% y-o-y and 3.4% q-o-q to KRW167.6 trillion (USD137 billion). The largest government bond issues in 2Q10 included KRW12.0 trillion of 2-year MSBs with a coupon of 3.62%, and KRW3.5 trillion of 10-year KTBs with a 5.0% coupon.

Korea's LCY corporate bonds outstanding expanded 12.7% y-o-y and 2.0% q-o-q to KRW697.7 trillion (USD571 billion) in June. This expansion stemmed from 36.7% y-o-y growth in special public bonds as well as 8.0% y-o-y growth in private corporate bonds, more than offsetting the 1.4% y-o-y decline in financial debentures. As of June, private corporate bonds remained the largest type of

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



LCY = local currency.
Source: Bloomberg LP.

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

	Amount (billion)						Growth Rate (%)										
	Mar-10		Apr-10		May-10		Jun-10		Mar-10		Apr-10		May-10		Jun-10		
	KRW	USD	KRW	USD	KRW	USD	KRW	USD	Y-o-y	Q-o-Q	m-o-m	Y-o-y	Q-o-Q	m-o-m	Y-o-y	Q-o-Q	m-o-m
Total	1,238,390	1,095	1,243,126	1,119	1,255,894	1,043	1,256,605	1,029	1,029	13.7	4.7	0.4	1.0	9.6	1.5	0.1	0.1
Total Government	554,368	490	559,651	504	562,349	467	558,900	458	458	11.2	7.2	1.0	0.5	5.9	0.8	(0.6)	(0.6)
Central Bank Bonds	162,120	143	165,050	149	162,440	135	167,610	137	137	12.1	8.6	1.8	(1.6)	1.2	3.4	3.2	3.2
Central Government Bonds	356,875	316	361,785	326	367,118	305	357,475	293	293	17.6	7.3	1.4	1.5	14.8	0.2	(2.6)	(2.6)
Industrial Finance Debentures	35,372	31	32,816	30	32,791	27	33,815	28	28	(29.8)	0.9	(7.2)	(0.1)	(33.2)	(4.4)	3.1	3.1
Corporate	684,022	605	683,475	615	693,545	576	697,705	571	571	15.8	2.7	(0.1)	1.5	12.7	2.0	0.6	0.6

LCY = local currency, 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.

corporate bonds in Korea at KRW252.1 trillion (USD206 billion), followed by special public bonds at KRW235.1 trillion (USD193 billion), and financial debentures at KRW210.5 trillion (USD172 billion).

The top 10 issuers of LCY special public bonds as of end-June had a combined KRW208.5 trillion (USD171 billion) of bonds outstanding and accounted for about 89% of total LCY special public bonds outstanding (**Table 2**). Among the largest issuers of LCY special public bonds were Korea Land Housing Corp., Korea Housing Finance Corp., and Korea Deposit Insurance Corp. Eight of the top 10 LCY special public bond issuers also had foreign currency (FCY) bonds outstanding, with the largest amount of FCY bonds being issued by Korea Electric Power Corp.

The outstanding amount of LCY financial debentures of the top 10 Korean issuers (excluding Korea Development Bank) as of June amounted to KRW174.7 trillion (USD143 billion), which comprised 83% of the country's total financial debentures (**Table 3**). The largest three issuers of LCY financial

Table 2: Top 10 Issuers of LCY Special Public Bonds in Korea, June 2010

Issuer	Outstanding Amount		
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)	FCY Bonds (USD billion)
1. Korea Land & Housing Corp.	51,385	42.1	2.4
2. Korea Housing Finance Corp.	31,001	25.4	0.0
3. Korea Deposit Insurance Corp.	27,381	22.4	0.0
4. Korea Finance Corp.	20,780	17.0	0.1
5. Korea Electric Power Corp.	20,150	16.5	3.2
6. Korea Highway	16,440	13.5	0.8
7. Small & Medium Business Corp.	14,723	12.1	0.4
8. Korea Gas Corp.	10,220	8.4	2.0
9. Korea Rail Network Authority	9,905	8.1	0.3
10. Korea Railroad Corp.	6,560	5.4	0.8
Total Top 10	208,545	170.7	
Total LCY Special Public Bonds	235,082	192.5	
Top 10 as % of Total LCY Special Public Bonds	88.7%	88.7%	

FCY = foreign currency, LCY = local currency.

Source: AsianBondsOnline, Bloomberg LP, and KoreaBondWeb.

Table 3: Top 10 Issuers of LCY Financial Debentures in Korea (as of June 2010)

Issuer	Outstanding Amount		
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)	FCY Bonds (USD billion)
1. Industrial Bank of Korea	38,056	31.2	5.3
2. Kookmin Bank	35,484	29.1	3.2
3. Woori Bank	22,322	18.3	6.1
4. Shinhan Bank	19,817	16.2	2.8
5. Nonghyup	15,924	13.0	2.9
6. Hana Bank	15,486	12.7	2.8
7. Shinhan Card	9,019	7.4	0.7
8. Export–Import Bank of Korea	6,270	5.1	92.3
9. Hyundai Capital Services	6,190	5.1	3.1
10. Korea Exchange Bank	6,140	5.0	0.6
Total Top 10	174,708	143.0	
Total LCY Financial Debentures	210,476	172.3	
Top 10 as % of Total LCY Financial Debentures	83.0%	83.0%	

FCY = foreign currency, LCY = local currency.

Note: Financial debentures exclude Korea Development Bank.

Source: *AsianBondsOnline*, Bloomberg LP, and *KoreaBondWeb*.

debentures were the Industrial Bank of Korea, Kookmin Bank, and Woori Bank. Each of the top 10 issuers of LCY financial debentures also had FCY bonds outstanding, with the largest amount issued by the Export–Import Bank of Korea.

The combined amount of bonds outstanding of the top 10 issuers of LCY private corporate bonds in Korea as of June totaled KRW89.3 trillion (USD73.1 billion), which represented about 35% of the total LCY private corporate bonds in the country (**Table 4**). Eight out of the top 10 issuers were securities companies, with the largest being Daewoo Securities, Woori Investment and Securities, and Korea Investment and Securities. Only three of the top 10 issuers had FCY bonds outstanding, with the largest being issued by KT Corporation.

Liquidity

Trading volumes and turnover ratios fell on a quarterly basis in 2Q10 for both Korean government and corporate LCY bonds (**Figure 2**). Trading volume

Table 4: Top 10 Issuers of LCY Private Corporate Bonds in Korea (as of June 2010)

Issuer	Outstanding Amount		
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)	FCY Bonds (USD billion)
1. Daewoo Securities	20,869	17.1	0.0
2. Woori Investment and Securities	16,148	13.2	0.0
3. Korea Investment and Securities	10,102	8.3	0.2
4. Hyundai Securities	8,812	7.2	0.0
5. Mirae Asset Securities	6,719	5.5	0.0
6. Tong Yang Securities	6,303	5.2	0.0
7. Shinhan Financial Group	5,680	4.7	0.2
8. Samsung Securities	5,260	4.3	0.0
9. KT Corporation	5,020	4.1	2.4
10. Hana Daetoo Securities	4,404	3.6	0.0
Total Top 10	89,315	73.1	
Total LCY Private Corporate Bonds	252,147	206.4	
Top 10 as % of Total LCY Private Corporate Bonds	35.4%	35.4%	

FCY = foreign currency, LCY = local currency.

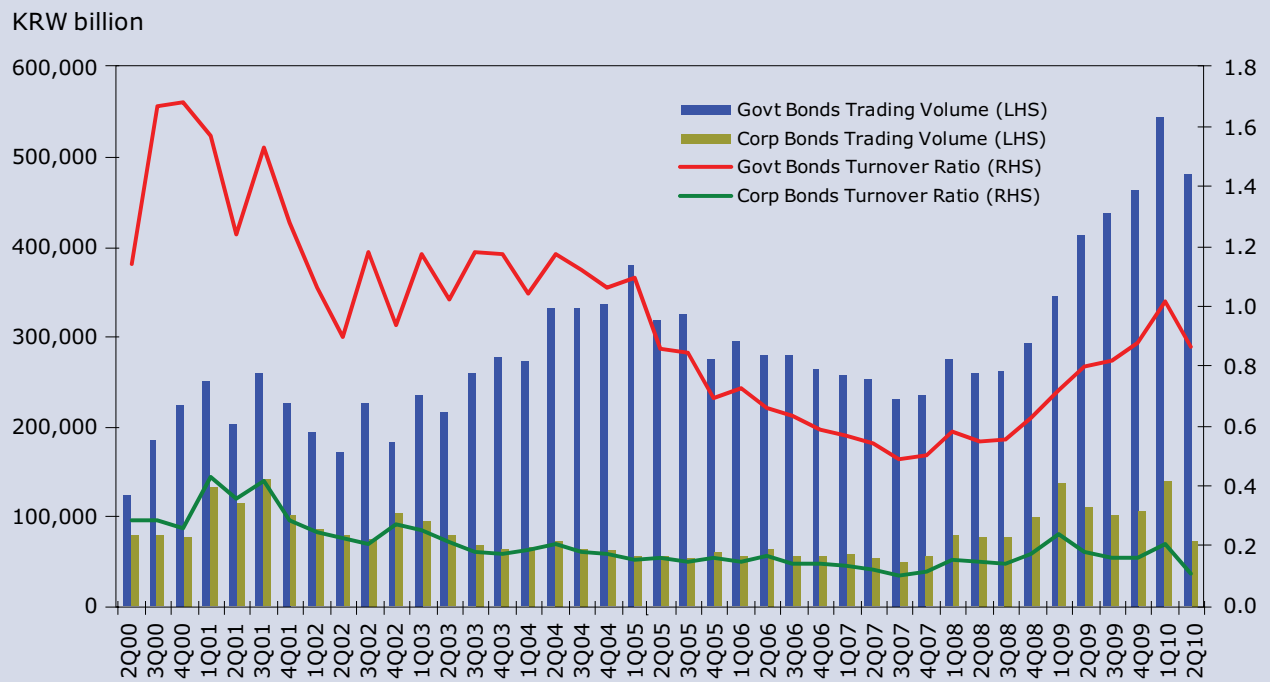
Source: *AsianBondsOnline*, Bloomberg LP, and *KoreaBondWeb*.

in 2Q10 for government bonds fell 11.8% q-o-q to KRW479.3 billion. For corporate bonds, trading volume decreased 47.9% q-o-q to KRW71.9 trillion. Similarly, the turnover ratio for government bonds declined to 0.86 in 2Q10 from 1.02 in 1Q10. For corporate bonds, the turnover ratio dropped to 0.10 in 2Q10 from 0.20 in 1Q10. On a y-o-y basis, however, trading volume for government bonds rose 16.6% in 2Q10, while the turnover ratio of government bonds also increased to 0.86 from 0.80 in 2Q09. Trading volume for corporate bonds plunged 34.7% y-o-y in 2Q10, while the turnover ratio also decreased to 0.10 from 0.18 in 2Q09.

KTBs were the most traded type of government bonds in Korea as of June 2010, with the top 30 traded KTBs amounting to KRW299.4 trillion, which comprised 98% of total KTBs (**Figure 3**). In terms of tenor, the top 30 traded KTBs consisted of four 20-year KTBs, ten 10-year KTBs, ten 5-year KTBs, and six 3-year KTBs (**Figure 4**).

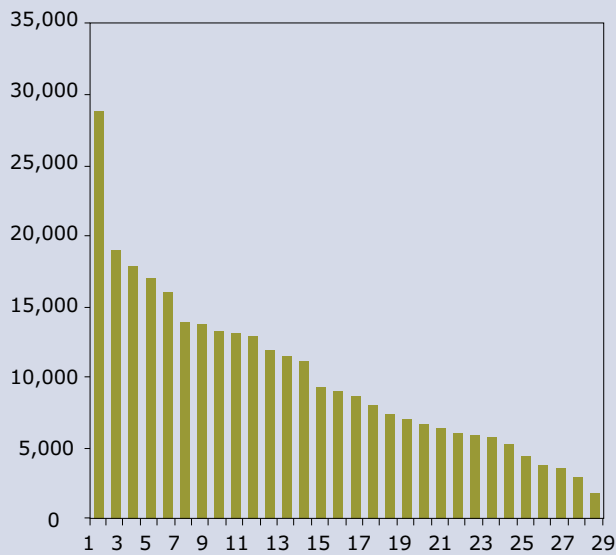
The KTB futures market includes 3-, 5-, and 10-year KTB futures contracts, but only 3-year

Figure 2: Trading Volumes and Turnover Ratios of Korean Government and Corporate Bonds, 2Q00–2Q10



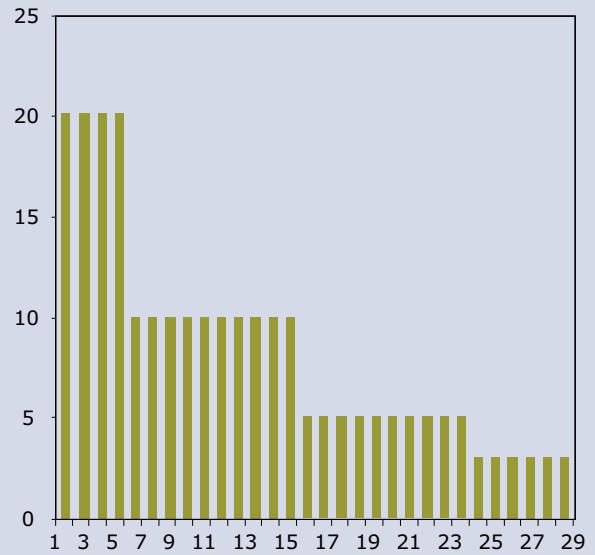
LHS = Left-hand side, RHS = Right-hand side.
 Source: AsianBondsOnline, Bloomberg LP, and KoreaBondWeb.

Figure 3: Top 30 KTBs by Size, June 2010
 (KRW billion)



Source: Bloomberg LP.

Figure 4: Top 30 KTBs by Tenor, June 2010
 (Years)



Source: Bloomberg LP.

KTB futures are widely traded. Recently, there has been an increase in the trading volume of 3-year KTB futures. In 2Q10, the number of 3-year KTB futures contracts traded reached 6.4 million, up 15.9% q-o-q and 33.9% y-o-y (**Figure 5**).

Policy, Institutional, and Regulatory Developments

FSC Approves Regulation to Improve Trading of Long-Term KTB Futures

In September, the Financial Services Commission (FSC) of Korea approved the Korea Exchange's amended version of its Derivatives Market Business Regulation, which aims to enhance the trading of long-term KTB futures. The revised version calls for harmonizing regulations on short-term and long-term KTB futures to improve the accessibility of KTB futures and facilitate the trading of these derivative instruments. Part of this provision is to change the final settlement method for 10-year KTB futures to cash settlement (from physical delivery) in order for primary dealers to actively trade 10-year KTB futures. The amended version, which is expected to be implemented in October, aims to stabilize price movements and enhance market-making functions in the KTB futures market.

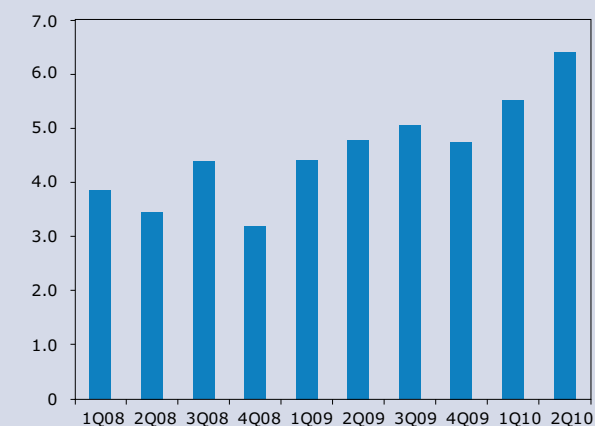
Korea To Introduce Short-Term KTBs

In July, Korea publicized its plan to issue KTBs with maturities of less than 1 year in order to form a short-term benchmark bond rate. The issuance of short-term KTBs will take place following revisions to the National Finance Act to be made in 2011/12.

Korea Sets Ceiling on Call Money Borrowings

The Korean government revealed in July that it will establish a cap in call money borrowings equivalent to 100% of a securities firm's equity capital in order to reduce the potential systemic risk associated with firms' heavy reliance on call money loans. The new rule is intended to be implemented in the third quarter of this year.

Figure 5: Trading Volume of 3-Year KTB Futures, 1Q08–2Q10 (number of contracts traded, million)



KTB = Korea Treasury bonds.
Source: Korea Exchange.