

Republic of Korea—Update

Yield Movements

The Republic of Korea's government bond yields fell for most maturities between end-December 2009 and end-October 2010 (**Figure 1**). Yield movements were mixed for maturities of less than 1 year, while yields for 1-, 2-, and 3-year tenors decreased 70, 121, and 116 basis points, respectively. Yields for 5-, 10-, and 20-year maturities fell 106, 103, and 102 basis points, respectively. Meanwhile, the yield spread between 2- and 10-year tenors widened by 18 basis points between end-December and end-October.

The Bank of Korea's (BOK) accommodative monetary policy stance, relatively low interest rates, and buoyant foreign investment in local currency (LCY) bonds all appear to have induced the decline in government bond yields. Based on data from the Financial Supervisory Service (FSS), foreign investor holdings of Korea Treasury Bonds (KTBs) rose sharply to KRW47.6 trillion in October from KRW27.5 trillion in December last year. The FSS also reported that the People's Republic of China's (PRC) net investments in the Republic of Korea bonds during the first 10 months of the year stood at KRW3.7 trillion, which trailed only Luxembourg's KRW5.7 trillion.

The Republic of Korea's gross domestic product (GDP) growth in 3Q10 stood at 4.5% year-on-year (y-o-y), compared with 7.2% in 2Q10, and 0.7% quarter-on-quarter (q-o-q), compared with 1.4% in 2Q10. Consumer price inflation accelerated to 4.1% y-o-y in October from 3.6% in September. On 16 November, the BOK raised its 7-day repurchase rate for the second time in 2010 by 25 basis points to 2.50%.

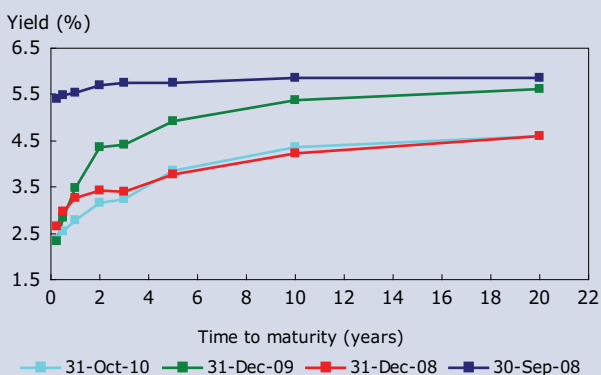
Size and Composition

The size of the Republic of Korea's LCY bond market grew 8.7% y-o-y and 1.8% q-o-q to reach KRW1,278.9 trillion (USD1,126 billion) as of end-September (**Table 1**). The expansion in the size of the Republic of Korea's bond market was brought about by positive growth in both government and corporate bonds.

As of end-September, LCY government bonds climbed 4.6% y-o-y and 1.2% q-o-q to KRW565.4 trillion (USD498 billion). The growth stemmed from an expansion in central government bonds, which increased 10.9% y-o-y and 3.7% q-o-q to KRW370.6 trillion (USD326 billion), driven mainly by 12.3% y-o-y growth (4.3% q-o-q) in KTBs. The size of BOK bonds, or Monetary Stabilization Bonds (MSBs), also increased 5.9% y-o-y, but declined 1.9% q-o-q, to KRW164.5 trillion (USD145 billion).

The Republic of Korea's LCY corporate bond market grew 12.1% y-o-y and 2.3% q-o-q to KRW713.5 trillion (USD628 billion) as of end-September. The growth in the corporate bond market came from an expansion in both private corporate bonds and special public bonds. Private corporate bonds increased 9.6% y-o-y and 1.3% q-o-q to reach KRW255.4 trillion (USD225 billion), while special public bonds rose 34.0% y-o-y and 6.6% q-o-q to reach KRW250.6 trillion (USD221 billion). In contrast, the outstanding size of financial debentures (excluding Korea Development Bank [KDB]) fell 4.1% y-o-y and 1.4% q-o-q to KRW207.5 trillion (USD183 billion).

Figure 1: The 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 (%)										
	Jun-10		Jul-10		Aug-10		Sep-10		Jun-10		Jul-10		Aug-10		Sep-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	1,256,605	1,029	1,258,771	1,064	1,269,076	1,060	1,278,906	1,126	1,126	10.1	4.6	0.2	8.7	1.8	8.7	1.8	0.8
Total Government	558,900	458	557,784	472	560,998	469	565,376	498	498	5.9	8.1	(0.2)	4.6	1.2	4.6	1.2	0.8
Central Bank Bonds	167,610	137	162,870	138	163,140	136	164,470	145	145	1.2	3.4	(2.8)	5.9	(1.9)	5.9	(1.9)	0.8
Central Government Bonds	357,475	293	362,550	307	366,375	306	370,643	326	326	14.8	0.2	1.4	10.9	3.7	10.9	3.7	1.2
Industrial Finance Debentures	33,815	28	32,364	27	31,482	26	30,263	27	(33.2)	(4.4)	(4.3)	(2.7)	(40.5)	(10.5)	(40.5)	(10.5)	(3.9)
Corporate	697,705	571	700,987	593	708,078	591	713,530	628	628	13.7	2.0	0.5	12.1	2.3	12.1	2.3	0.8

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 LP 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.

The top 10 issuers of LCY special public bonds had a combined KRW216.4 trillion (USD191 billion) of bonds outstanding as of end-September—compared with KRW208.5 trillion (USD171 billion) at end-June—and comprised 86.3% of total LCY special public bonds outstanding (**Table 2**). Korea Land Housing Corp., Korea Housing Finance Corp., and Korea Deposit Insurance Corp. are the three largest issuers of special public bonds.

Table 2: Top 10 Issuers of LCY Special Public Bonds in the Republic of Korea, September 2010

Issuer	Outstanding Amount	
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)
1. Korea Land & Housing Corp	54,421	47.9
2. Korea Housing Finance Corp	32,229	28.4
3. Korea Deposit Insurance Corp	26,381	23.2
4. Korea Finance Corp	23,980	21.1
5. Korea Electric Power Corp	20,730	18.3
6. Korea Highway	16,760	14.8
7. Small & Medium Business Corp	14,633	12.9
8. Korea Gas Corp	10,430	9.2
9. Korea Rail Network Authority	10,385	9.1
10. Korea Railroad Corp	6,410	5.6
Total Top 10	216,359	190.6
Total LCY Special Public Bonds	250,562	220.7
Top 10 as % of Total LCY Special Public Bonds	86.3%	86.3%

LCY = local currency.

Source: AsianBondsOnline, Bloomberg LP, and KoreaBondWeb.

The top 10 issuers of LCY financial debentures (excluding KDB) had an aggregate outstanding amount of KRW163.7 trillion (USD144 billion) as of end-September, which was lower than the end-June level of KRW174.7 trillion (USD143 billion), and comprised 79% of total LCY financial debentures (**Table 3**). The largest three issuers of financial debentures were the Industrial Bank of Korea, Kookmin Bank, and Woori Bank.

The top 10 issuers of LCY private corporate bonds in the Republic of Korea had a total of KRW90.0 trillion (USD79 billion) of bonds outstanding as of end-September, up from KRW89.3 trillion (USD73 billion) at end-June, which represented about 35% of total LCY private

Table 3: Top 10 Issuers of LCY Financial Debentures in the Republic Korea, September 2010

Issuer	Outstanding Amount	
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)
1. Industrial Bank of Korea	35,681	31.4
2. Kookmin Bank	31,244	27.5
3. Woori Bank	20,702	18.2
4. Shinhan Bank	19,737	17.4
5. Hana Bank	14,631	12.9
6. Nonghyup	14,442	12.7
7. Shinhan Card	9,142	8.1
8. Hyundai Capital Services	6,460	5.7
9. Export-Import Bank of Korea	5,950	5.2
10. Standard Chartered First Bank Korea	5,743	5.1
Total Top 10	163,732	144.2
Total LCY Financial Debentures	207,530	182.8
Top 10 as % of Total LCY Financial Debentures	78.9%	78.9%

LCY = local currency.

Note: Financial debentures exclude Korea Development Bank.

Source: *AsianBondsOnline*, Bloomberg LP, and *KoreaBondWeb*.**Table 4: Top 10 Issuers of LCY Private Corporate Bonds in the Republic of Korea, September 2010**

Issuer	Outstanding Amount	
	LCY Bonds (KRW billion)	LCY Bonds (USD billion)
1. Daewoo Securities	19,539	17.2
2. Woori Investment and Securities	14,046	12.4
3. Korea Investment and Securities	11,103	9.8
4. Hyundai Securities	10,985	9.7
5. Tong Yang Securities	6,722	5.9
6. Mirae Asset Securities	6,405	5.6
7. Shinhan Financial Group	6,020	5.3
8. Hana Daetoo Securities	5,136	4.5
9. Samsung Securities	5,056	4.5
10. KT Corporation	5,020	4.4
Total Top 10	90,032	79.3
Total LCY Private Corporate Bonds	255,438	225.0
Top 10 as % of Total LCY Private Corporate Bonds	35.2%	35.2%

LCY = local currency.

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

corporate bonds outstanding (**Table 4**). The largest three issuers were Daewoo Securities, Woori Investment and Securities, and Korea Investment and Securities.

Issuance

The issuance of major types of LCY government and corporate bonds slowed in 3Q10 (**Figure 2**). Issuance of KTBs dropped 10.2% q-o-q and 23.0% y-o-y to KRW19.1 trillion (USD17 billion), while BOK issuance of MSBs also decreased 23.1% q-o-q and 50.5% y-o-y to KRW57.2 trillion (USD50 billion). Corporate bond issuance in 3Q10 stood at KRW81.4 trillion (USD72 billion), which was 3.5% lower than the previous quarter, but 22.3% higher on a y-o-y basis. On a q-o-q basis, the slight drop in corporate bond issuance was mainly due to declines of 19.7% and 11.0% in financial debentures and private corporate bonds, respectively, more than offsetting the 37.5% rise in the issuance of special public bonds.

The sector with the largest corporate bond issuance in the Republic of Korea in 3Q10 was the financial sector, comprising about 56% of the total (**Figure 3**). On a q-o-q basis, corporate bond issuance fell for most sectors in 3Q10, including the basic materials/industrial, energy, financial, and utilities sectors. On the other hand, the consumer, special public, and other sectors

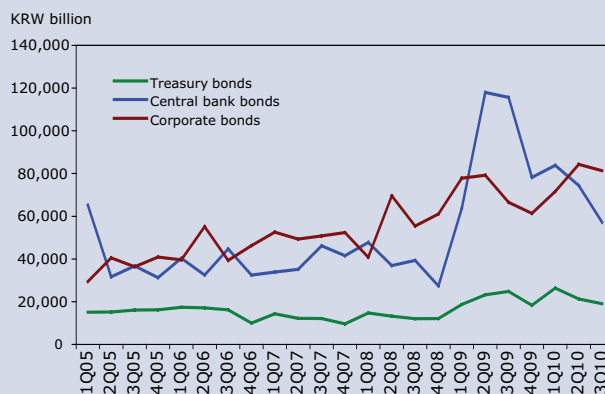
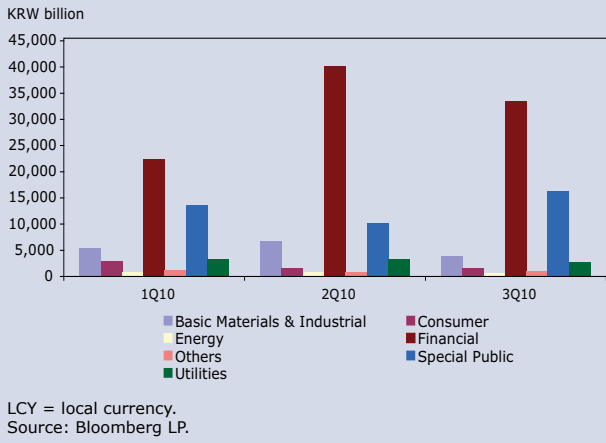
Figure 2: Local Currency Bond Issuance in the Republic of Korea, 1Q05–3Q10Source: *AsianBondsOnline*, The Bank of Korea, and *KoreaBondWeb*.

Figure 3: The Republic of Korea’s LCY Corporate Bond Issuance by Sector, 1Q10–3Q10



recorded higher corporate bond issuance in 3Q10 than in the previous quarter. About 51% of the issuance in special public bonds during 3Q10 were made by public finance companies.

Investor Profile

The Republic of Korea’s public sector remained the largest owner of government bonds in June 2010, with a 27% share of the total (Figure 4). Insurance firms/pension funds were the second-largest holder of government bonds with a 22% share, while banks and other financial institutions held 19% each. Foreign investors held 9% of

government bonds. Compared with June 2009, the shares of financial institutions (other than banks and insurance firms/pension funds) and foreign investors climbed by 3 percentage points each. Conversely, the share of the government sector fell 3 percentage points, the share of banks dropped 2 percentage points, and the share of insurance firms/pension funds decreased 1 percentage point.

Liquidity

Liquidity improved for both LCY government and corporate bonds in 3Q10 (Figure 5). The trading volume for government bonds rose 39.4% q-o-q and 53.3% y-o-y, while the turnover ratio for these bonds increased to 1.19 in 3Q10 from 0.86 in 2Q10. Similarly, the trading volume for corporate bonds surged 141.1% q-o-q and 80.0% y-o-y, and the turnover ratio for corporate bonds climbed to 0.25 in 3Q10 from 0.10 in the previous quarter.

The increased liquidity of the LCY government bonds in 3Q10 may be attributed to a quarterly rise in trading volumes and turnover ratios for both central government and central bank bonds (Figure 6). The trading volume for central government bonds climbed 7.2% q-o-q and 51.2% y-o-y, while the turnover ratio increased to 1.16 in 3Q10 from 1.10 in 2Q10. For central bank bonds, the trading volume soared 181.8% q-o-q

Figure 4: Investor Profile for LCY Government Bonds in the Republic of Korea

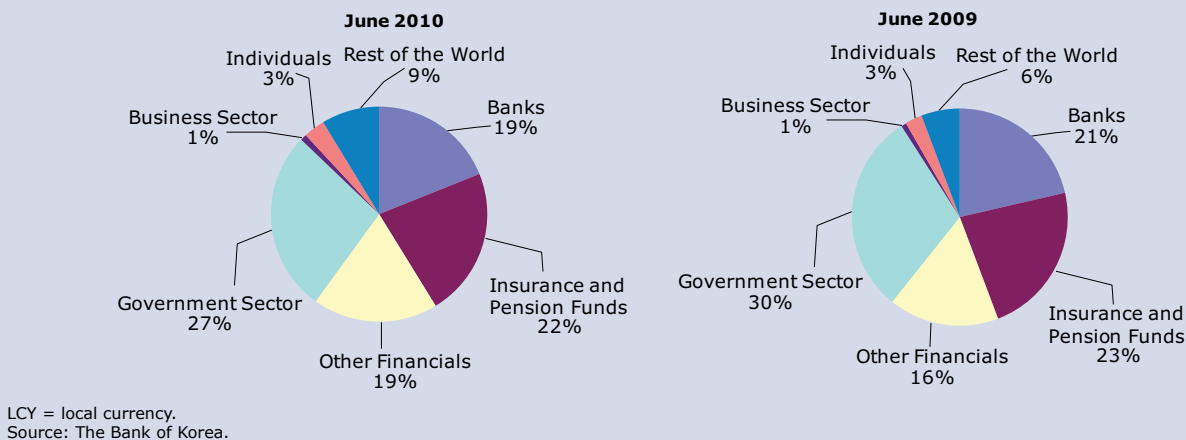
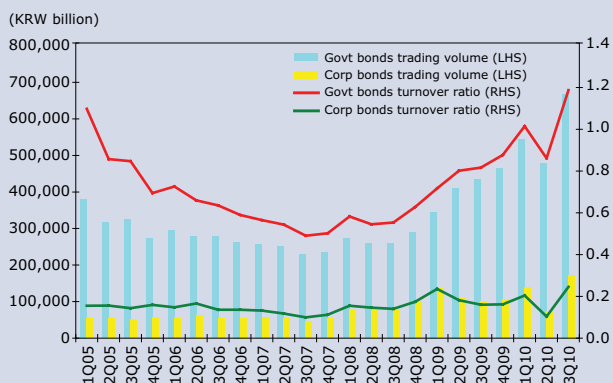


Figure 5: Trading Volumes and Turnover Ratios of the LCY Government and Corporate Bonds in the Republic of Korea, 1Q05-3Q10

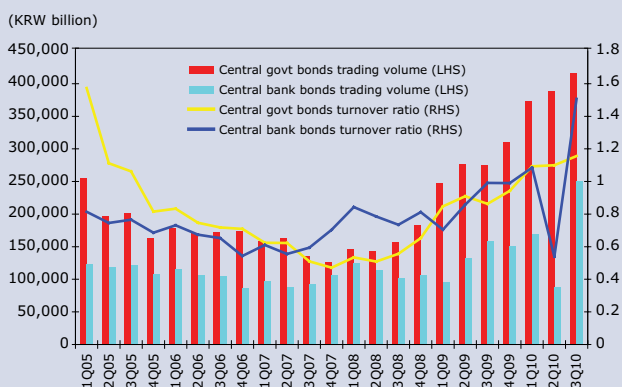


Notes:
 1. LHS = left-hand side, RHS = right-hand side, LCY = local currency.
 2. Trading volume is the average of sales and purchases of bonds traded.
 Source: *AsianBondsOnline*, Bloomberg LP, and *KoreaBondWeb*.

spread for BOK bonds (excluding BOK bills) was 1.11 basis points, which was slightly lower than 1.14 basis points for KTBs.

Across the major types of LCY corporate bonds in the Republic of Korea, the turnover ratio for financial debentures increased to 0.60 in 3Q10 from 0.1 in the previous quarter, but the turnover ratios for special public bonds and private corporate bonds fell marginally in 3Q10 to 0.12 (from 0.13 in 2Q10) and 0.07 (from 0.09 in 2Q10), respectively (**Figure 7**). This also appears to be consistent with the 2010 *AsianBondsOnline* liquidity survey results, which revealed that financial debentures were relatively more liquid than the other types of corporate bonds as evident by having the lowest average on-the-run bid-ask spread at 2.17 basis

Figure 6: Turnover Ratios for LCY Government Bonds in the Republic of Korea, 1Q05-3Q10

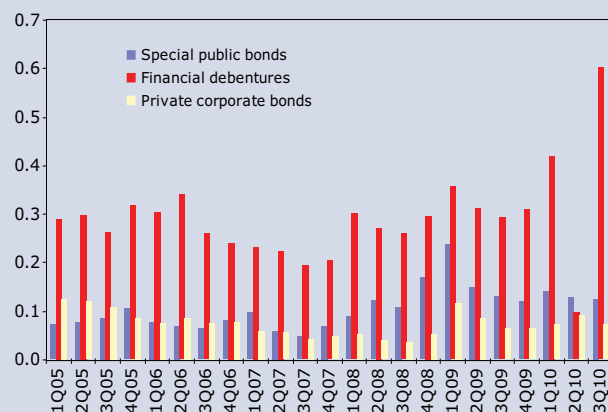


Notes:
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 2. Trading volume is the average of sales and purchases of bonds traded.
 Source: *AsianBondsOnline*, Bloomberg LP, and *KoreaBondWeb*.

and 57.2% y-o-y in 3Q10, while the turnover ratio rose to 1.51 from 0.54.

In 3Q10, the turnover ratio for central bank bonds was higher than that for central government bonds, suggesting that central bank bonds were relatively more liquid than central government bonds. This appears to be consistent with the 2010 *AsianBondsOnline* liquidity survey results, which showed that the average on-the-run bid-ask

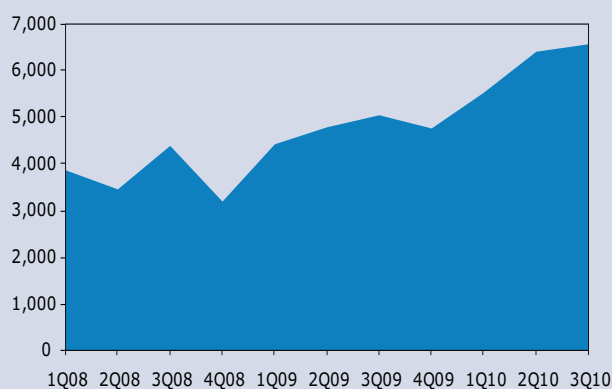
Figure 7: Turnover Ratios for Types of the Republic of Korea Local Currency Corporate Bonds, 1Q05-3Q10



Source: *AsianBondsOnline*, The Bank of Korea, *KoreaBondWeb*.

points, followed by special public bonds and private corporate bonds with average bid-ask spreads of 2.58 and 3.58 basis points, respectively.

In the KTB futures market, there was an improvement in the liquidity of 3-year KTB futures in 3Q10. In particular, the number of 3-year KTB futures contracts traded rose 2.5% q-o-q and 30.2% y-o-y to 6.6 million (**Figure 8**).

Figure 8: Trading Volume of 3-Year KTB Futures, 1Q08–3Q10 (number of contracts traded, thousands)

KTB = Korea Treasury Bonds.
Source: Korea Exchange (KRX).

Rating Changes

On 11 November, Fitch Ratings affirmed the sovereign credit ratings of the Republic of Korea at A+ for its long-term foreign currency (FCY) issuer default rating, AA for its long-term LCY issuer default rating, F1 for its short-term issuer default rating, and AA for its country ceiling (**Table 5**). It has also maintained its stable outlook for the Republic of Korea. Fitch Ratings reported that the Republic of Korea's credit strengths, including its fiscal prudence, improved external finances, and strong balance sheet, have continued to balance against the country's fiscal and geopolitical risks.

Table 5: Selected Sovereign Ratings and Outlook for the Republic of Korea

	Moody's	S&P	Fitch
Sovereign FCY LT Ratings	A1	A	A+
Outlook	stable	stable	stable

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

Policy, Institutional, and Regulatory Developments

Short-Term KTBs to be Introduced

In July, the Republic of Korea announced 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.

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

In September, the Financial Services Commission 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 their accessibility and facilitate the trading of these derivative instruments. This provision includes a change of 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 aims to stabilize price movements and enhance market-making functions in the KTB futures market.