

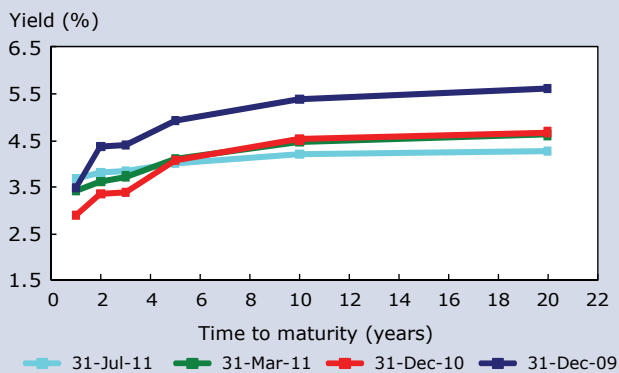
## Republic of Korea—Update

### Yield Movements

The Republic of Korea's government bond yield curve flattened between end-March and end-July (**Figure 1**). Yields for 1-, 2-, and 3-year tenors rose during this period, with the 1-year tenor increasing the most at 26 basis points (bps). Yields for 5-, 10-, and 20-year tenors fell 9 bps, 28 bps, and 34 bps, respectively. The yield spread between 2- and 10-year tenors narrowed by 46 bps between end-March and end-July. The flattening of the yield curve appeared to reflect market expectations of further policy rate hikes amid inflationary pressures.

The Bank of Korea raised its base rate—the 7-day repurchase rate—25 bps in January, March, and June for a total increase of 75 bps in the first half of the year. The policy rate hikes were made to counter inflationary pressures and ensure overall price stability. On 11 August, the Bank of Korea decided to hold steady the base rate at 3.25%, noting both the domestic economy's upward growth trend and heightened inflation risk, as well as global downside risks—such as slowing economic growth in the United States (US) and Europe's sovereign debt problems.

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



LCY = local currency.  
Source: Bloomberg LP.

In the first 3 months of the year, consumer price inflation climbed steadily from 4.1% year-on-year (y-o-y) in January to 4.5% in February and 4.7% in March. At the start of 2Q11, however, the inflation rate dipped to 4.2% y-o-y in April and declined further to 4.1% in May, after which it rose to 4.4% in June. In July, consumer price inflation increased further to 4.7% y-o-y mainly due to a 10.0% spike in the price index for food and non-alcoholic beverages.

Advance estimates for the country's real gross domestic product (GDP) released in July showed that economic growth eased to 0.8% quarter-on-quarter (q-o-q) in 2Q11 from 1.3% in 1Q11, as export growth slowed to 1.8% from 3.3% in the previous quarter. On a y-o-y basis, the real GDP growth rate fell to 3.4% in 2Q11 from 4.2% in 1Q11.

### Size and Composition

The local currency (LCY) bond market in the Republic of Korea had grown 8.1% y-o-y and 2.3% q-o-q as of end-June, with total bonds outstanding amounting to KRW1,358.9 trillion (US\$1.3 trillion) (**Table 1**). The outstanding amount of LCY government bonds reached KRW582.4 trillion at end-June, up 4.2% from June 2010 and 1.3% from the previous quarter. Central government bonds—largely consisting of Korea Treasury Bonds (KTBs)—increased 8.2% y-o-y and 2.2% q-o-q to KRW386.9 trillion. In contrast, Monetary Stabilization Bonds (MSBs)—bonds issued by the Bank of Korea—decreased 1.0% y-o-y and 1.5% q-o-q to KRW166.0 trillion. Meanwhile, the outstanding size of industrial finance debentures—bonds issued by the Korea Development Bank (KDB)—fell 12.7% y-o-y, but rose 5.2% q-o-q.

Total LCY government bond issuance in 2Q11 stood at KRW88.1 trillion, which was 16.3% higher than in the previous quarter. The increase was bolstered by a 26.9% q-o-q rise in MSB issuance in 2Q11, which totaled KRW60.8 trillion. On the other hand, issuance of central government bonds declined

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

	Amount (billion)						Growth Rate (%)										
	Mar-11		Apr-11		May-11		Jun-11		Mar-11		Apr-11		May-11		Jun-11		
	KRW	US\$	KRW	US\$	KRW	US\$	KRW	US\$	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	1,328,907	1,211	1,339,038	1,250	1,352,823	1,254	1,358,854	1,273	7.3	2.7	0.8	8.1	2.3	1.0	8.1	2.3	0.4
Government	575,093	524	577,252	539	585,980	543	582,414	546	3.7	3.8	0.4	4.2	1.3	1.5	4.2	1.3	(0.6)
Central Bank Bonds	168,470	154	165,550	154	169,620	157	165,960	155	3.9	3.0	(1.7)	2.5	(1.5)	2.5	(1.0)	(1.5)	(2.2)
Central Government Bonds	378,557	345	382,579	357	386,481	358	386,942	362	6.1	4.4	1.1	8.2	2.2	1.0	8.2	2.2	0.1
Industrial Finance Debentures	28,066	26	29,123	27	29,879	28	29,512	28	(20.7)	0.2	3.8	(12.7)	5.2	2.6	(12.7)	5.2	(1.2)
Corporate	753,814	687	761,786	711	766,843	711	776,440	727	10.2	1.9	1.1	11.3	3.0	0.7	11.3	3.0	1.3

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 Korea Treasury Bonds, National Housing Bonds, and Seoul Metropolitan Subway Bonds.
  3. Bloomberg LP end-of-period LCY-US\$ rates are used.
  4. Growth rates are calculated from LCY base and do not include currency effects.
- Source: The Bank of Korea, EDAILY BondWeb, and Bloomberg LP.

3.6% from the previous quarter to KRW23.8 trillion in 2Q11.

Two of the largest government bond issues in 1H11 were a KRW12.7 trillion 2-year MSB issued in April at a 3.83% coupon and a KRW10.7 trillion 5-year KTB issued in March with a coupon rate of 4.0%.

The government started auctioning 28-day treasury bills in March and had sold a total of KRW9.7 trillion worth by end-June. In addition, the government sold a 10-year inflation-linked bond in June worth KRW244 billion with a coupon rate of 1.5%. At end-June, the outstanding size of inflation-linked bonds was KRW3.6 trillion.

The LCY corporate bond market at end-June amounted to KRW776.4 trillion, having expanded 11.3% y-o-y and 3.0% q-o-q (Table 1). The growth was spearheaded by private corporate bonds that grew 25.9% y-o-y and 5.2% q-o-q to reach KRW317.5 trillion. In 2Q11, the amount of outstanding special public bonds climbed 7.7% y-o-y and 2.8% q-o-q, totaling KRW253.2 trillion. Meanwhile, financial debentures (excluding KDB bonds) slipped 2.2% y-o-y and 0.1% q-o-q to KRW205.8 trillion.

The top 50 issuers of LCY corporate bonds had a cumulative outstanding balance at end-June of KRW577.8 trillion, or 74% of total corporate bonds outstanding (Table 2). Of the top 50 issuers of LCY bonds in the Republic of Korea at end-June, 70% were financial institutions and 56% were privately owned entities. Meanwhile, 44% were listed on the Korea Exchange. Korea Land & Housing Corp. remained the largest issuer of corporate bonds with total outstanding bonds of KRW55.3 trillion at end-June.

In 2Q11, total LCY corporate bond issuance was KRW84.1 trillion, of which 54% were private corporate bonds, 27% were financial debentures, and the remaining 19% were special public bonds. Corporate bond issuance in 2Q11 was up 14.8% q-o-q, but down 0.3% y-o-y. On a q-o-q basis, issuance increased for all three types of corporate bonds—financial debentures, private

**Table 2: Top 50 Issuers of LCY Corporate Bonds in the Republic of Korea** (as of June 2011)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed In		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US\$ billion)			KOSPI	KOSDAQ	
1. Korea Land & Housing Corp.	55,277	51.8	Yes	No	No	No	Real Estate
2. Korea Housing Finance Corp.	36,190	33.9	Yes	No	No	No	Financial
3. Industrial Bank of Korea	30,715	28.8	Yes	No	Yes	No	Bank
4. Korea Finance Corp.	29,430	27.6	Yes	No	No	No	Financial
5. Korea Highway	24,580	23.0	Yes	No	No	No	Infrastructure
6. Korea Deposit Insurance Corp.	24,520	23.0	Yes	No	No	No	Insurance
7. Kookmin Bank	22,508	21.1	No	Yes	No	No	Bank
8. Korea Electric Power Corp.	22,200	20.8	Yes	No	Yes	No	Utility
9. Daewoo Securities	20,515	19.2	Yes	No	Yes	No	Securities
10. Shinhan Bank	19,677	18.4	No	Yes	No	No	Bank
11. Woori Bank	17,732	16.6	Yes	No	No	No	Bank
12. Woori Investment and Securities	16,666	15.6	Yes	No	Yes	No	Securities
13. Hana Bank	14,819	13.9	No	Yes	No	No	Bank
14. Small & Medium Business Corp.	14,603	13.7	Yes	No	No	No	Financial
15. Korea Investment and Securities	13,732	12.9	No	Yes	No	No	Securities
16. Nonghyup (National Agricultural Cooperative Federation)	12,850	12.0	Yes	No	No	No	Bank
17. Korea Rail Network Authority	12,325	11.5	Yes	No	No	No	Infrastructure
18. Tong Yang Securities	10,861	10.2	No	Yes	Yes	No	Securities
19. Korea Gas Corp.	10,580	9.9	Yes	No	Yes	No	Utility
20. Mirae Asset Securities	9,842	9.2	No	Yes	Yes	No	Securities
21. Hyundai Securities	9,470	8.9	No	Yes	Yes	No	Securities
22. Shinhan Card	9,329	8.7	No	Yes	No	No	Financial
23. Hyundai Capital Services	7,400	6.9	No	Yes	No	No	Securities
24. Standard Chartered First Bank Korea	7,060	6.6	No	Yes	No	No	Bank
25. Shinhan Financial Group	7,050	6.6	No	Yes	Yes	No	Financial
26. Hana Daetoo Securities	6,849	6.4	No	Yes	No	No	Securities
27. Korea Railroad Corp.	6,840	6.4	Yes	No	No	No	Infrastructure
28. Korea Water Resources	6,814	6.4	Yes	No	Yes	No	Utility
29. Korea Eximbank	6,430	6.0	Yes	No	No	No	Bank
30. KB Kookmin Card	6,190	5.8	No	Yes	No	No	Financial
31. SH Corp.	6,058	5.7	No	Yes	No	No	Manufacturing
32. Hyundai Card	5,640	5.3	No	Yes	No	No	Financial
33. Samsung Securities	5,421	5.1	No	Yes	Yes	No	Securities
34. Kiwoom Securities	5,316	5.0	No	Yes	Yes	No	Securities
35. Shinhan Investment Corp.	5,227	4.9	No	Yes	No	No	Securities
36. Korea Student Aid Foundation	4,870	4.6	Yes	No	No	No	Education
37. KT Corp.	4,740	4.4	No	Yes	Yes	No	Telecoms
38. Dongbu Securities	4,532	4.2	No	Yes	Yes	No	Securities
39. Samsung Card	4,280	4.0	No	Yes	Yes	No	Financial
40. Incheon Urban Development Corp.	4,258	4.0	Yes	No	No	No	Infrastructure
41. Korea Exchange Bank	3,950	3.7	No	Yes	Yes	No	Bank
42. Korea Hydro & Nuclear Power	3,730	3.5	Yes	No	No	No	Utility
43. Woori Financial Group	3,660	3.4	Yes	No	Yes	No	Financial
44. Hana Financial Group	3,640	3.4	No	Yes	Yes	No	Financial
45. GS Caltex Corp.	3,460	3.2	No	Yes	No	No	Utility
46. Posco	3,300	3.1	No	Yes	Yes	No	Manufacturing
47. Korean Air Lines	3,270	3.1	No	Yes	Yes	No	Air transport

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Table 2 continued

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed In		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US\$ billion)			KOSPI	KOSDAQ	
	48. National Federation of Fisheries Cooperatives	3,195					
49. Kyobo Securities	3,181	3.0	No	Yes	Yes	No	Securities
50. Shinyoung Securities	3,049	2.9	No	Yes	Yes	No	Securities
<b>Total Top 50 LCY Corporate Issuers</b>	<b>577,831</b>	<b>541.2</b>					
<b>Total LCY Corporate Bonds</b>	<b>776,440</b>	<b>727.2</b>					
<b>Top 50 as % of Total LCY Corporate Bonds</b>	<b>74.4%</b>	<b>74.4%</b>					

KOSPI = Korea Composite Stock Price Index, KOSDAQ = Korean Securities Dealers Automated Quotations, LCY = local currency.  
Source: AsianBondsOnline, EDAILY BondWeb, and Bloomberg LP.

corporate bonds, and special public bonds—by 10.8%, 22.9%, and 1.5%, respectively. On a y-o-y basis, private corporate bond issuance surged 33.8%, whereas issuance of financial debentures and special public bonds fell 28.2% and 14.3%, respectively.

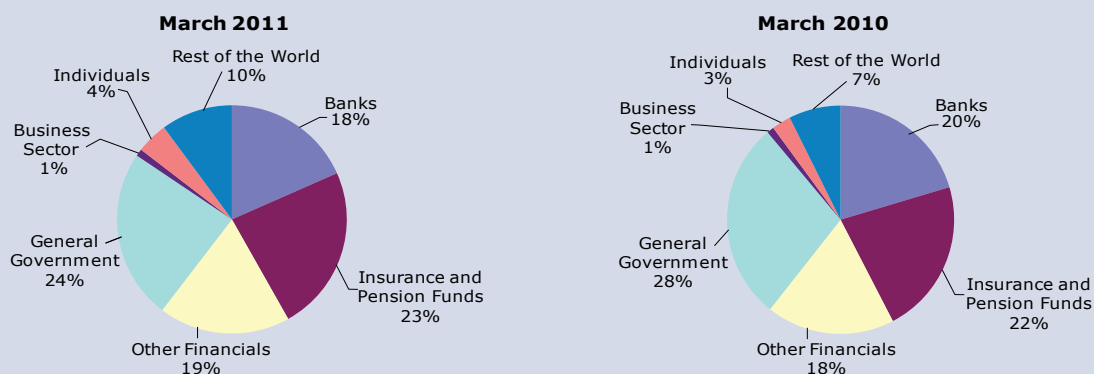
Two of the largest individual LCY corporate bond issues in 1H11 were the Industrial Bank of Korea's KRW550 billion 6-month zero-coupon bond issued in May and Hana Financial Group's KRW520 billion 5-year bond issued in January. The latter bond has a coupon rate of 4.78%.

## Investor Profile

As of end-March, the Republic of Korea's general government—which comprises the central government, local government, and social security

funds—remained the largest investor in LCY government bonds with a 24% share (**Figure 2**). The general government was closely followed by insurance companies and pension funds, which held 23% of the total. Between March 2010 and March 2011, the share of the general government's holdings declined 4 percentage points, while the share of insurance companies and pension funds increased 1 percentage point. The largest share increase during this period came from foreign investors, which held 10% of total government bonds at end-March, a y-o-y increase of 3 percentage points. Between March 2010 and March 2011, the shares of local individual investors and other financial institutions (financial institutions other than banks, insurance firms, and pension funds) rose 1 percentage point each, whereas the share of banks dropped 2 percentage points.

Figure 2: LCY Government Bonds Investor Profile



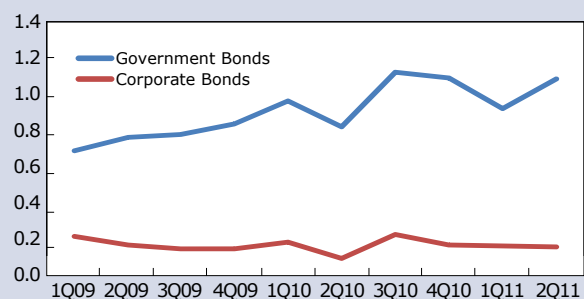
LCY = local currency.  
Source: The Bank of Korea.

Insurance firms and pension funds surpassed other financial institutions as the largest holder of LCY corporate bonds at the end of March (**Figure 3**). Between March 2010 and March 2011, the share of corporate bonds held by insurance firms and pension funds climbed from 29% to 32%, while that of other financial institutions remained steady at 30%. Also, the respective shares of the general government and local individual investors increased 1 percentage point each, whereas the share of banks fell 5 percentage points over the same period.

### Liquidity

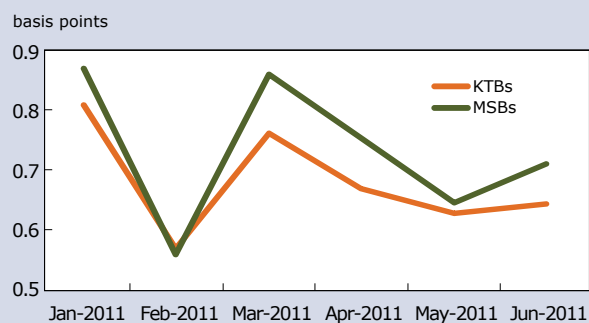
Liquidity in the LCY government bond market improved in recent quarters, but it has remained stagnant in the LCY corporate bond market (**Figure 4**). The turnover ratio for government bonds rose sharply to 1.15 in 2Q11 from 0.97 in 1Q11 as the trading of MSBs and central government bonds—particularly KTBs—increased during this period. For example, the turnover ratio for central government bonds climbed from 0.98 in the previous quarter to 1.21 in 2Q11, reflecting a rebound in central government bond market liquidity following a downward trend in 4Q10 and 1Q11. Similarly, the bid-ask spreads for both KTBs and MSBs narrowed in January–June (**Figure 5**), highlighting improved liquidity for both of these government bond instruments.

**Figure 4: Turnover Ratio for Government and Corporate Bonds, 1Q09–2Q11**



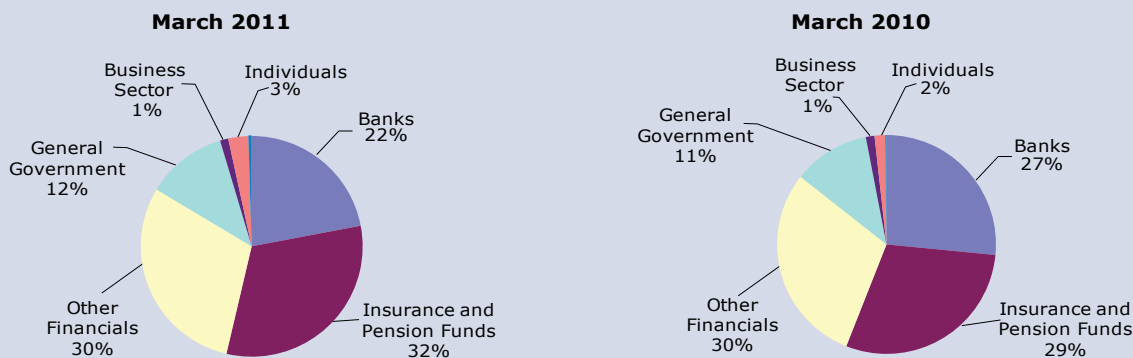
LCY = local currency.  
Source: The Bank of Korea and EDAILY BondWeb.

**Figure 5: Bid-Ask Spreads for Government Bonds, January–June 2011**



LCY = local currency, KTBS = Korea Treasury Bonds, MSBs = Monetary Stabilization Bonds.  
Source: EDAILY BondWeb.

**Figure 3: LCY Corporate Bonds Investor Profile**



LCY = local currency.  
Source: AsianBondsOnline, The Bank of Korea.

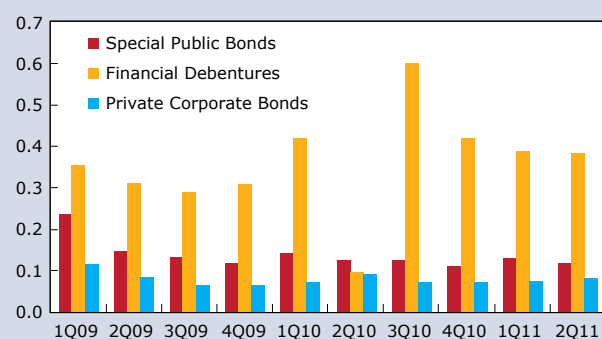
On the other hand, the turnover ratio for corporate bonds remained flat at 0.18 between 4Q10 and the end of 2Q11. Financial debentures were still the most liquid of all types of corporate bonds with a turnover ratio of 0.38 in 2Q11, followed by special public bonds (0.12) and private corporate bonds (0.08) (**Figure 6**). In 2Q11, the turnover trends for corporate bonds were marginal and mixed—rising 0.01 point for private corporate bonds and falling 0.01 point for both financial debentures and special public bonds.

The trading activity of 3-year KTB futures was relatively buoyant in 1Q11, as the number of traded contracts for this type of derivative totaled 8.1 million, which is slightly lower than the record-high of 8.4 million in 1Q11 (**Figure 7**). In the first 5 months of the year, the number of 3-year KTB futures contracts traded reached 12.8 million, up 24.0% y-o-y. The largest investor group in 3-year KTB futures was securities and futures companies, which sold 55.3% of all contracts during the first 5 months of the year, while the second largest was banks, which sold 24.3% of the total in the same period.

## Rating Changes

In May, Rating and Investment Information (R&I) affirmed its foreign currency issuer rating and LCY issuer rating for the Republic of Korea

**Figure 6: Turnover Ratio for Major Types of LCY Corporate Bonds, 1Q09–2Q11**

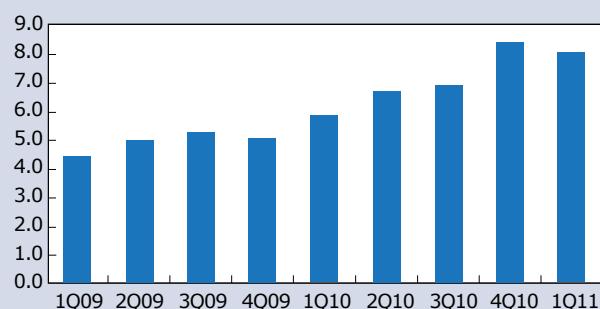


LCY = local currency.

Note: Financial debentures exclude Korea Development Bank.

Source: EDAILY BondWeb.

**Figure 7: Trading Volume of 3-Year KTB Futures, 1Q09–1Q11** (millions of contracts traded)



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

at A+ and AA-, respectively, and maintained its stable outlook for the country (**Table 3**). In affirming its ratings, R&I noted the country's "economic strength" on the back of more than 6% growth in 2010 and expected growth of more than 4% in 2011. It also attributed its ratings to the country's "prudent fiscal management" and current account surplus.

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

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

FCY = foreign currency, LT = long-term.

Source: Rating agencies.

## Policy, Institutional, and Regulatory Developments

### Investment of Foreign Exchange Agencies in Domestic Foreign Currency-Denominated Bonds Restricted

The Bank of Korea restricted foreign exchange agencies' investments in foreign currency-denominated bonds issued domestically for Korean won financing, effective 25 July. This change was made in light of the Bank of Korea's

new measures to enhance regulations on foreign currency-denominated loans implemented in July 2010, requiring these loans to be used for overseas purposes only. The Bank of Korea has noted that domestic foreign currency-denominated bond issuance by local enterprises has increased recently, with issuers converting 70% of their proceeds into the Korean won.

### **Measures on Household Debt Announced**

The Financial Services Commission (FSC) and the Financial Supervisory Service (FSS) announced a set of comprehensive measures in June to improve the growth and soundness of household debt, provide better credit access to low-income households, and enhance consumer protection. The household debt measures, which are intended for implementation in the second half of the year, include (i) applying higher Bank for International Settlements (BIS) risk weights on banks' high-risk mortgage loans, (ii) introducing leverage regulations covering credit companies, (iii) widening the accessibility of microcredit programs, and (iv) promoting banks' issuance of covered bonds and mortgage-backed securities (MBSs).

### **Guidelines on Covered Bond Issuance Released**

In June, the FSC and the FSS jointly released guidelines on covered bond issuance, including the definition of covered bonds as well as the requirements for their issuance and cover assets. The guidelines specify that the eligible issuers of covered bonds are banks with more than a 10% BIS ratio, or securitization entities established by such banks. Furthermore, the issuance amount must not be greater than 4% of the issuer's total liabilities and the maturity profile must be between 1 and 30 years. Finally, the cover assets must comprise certain mortgage loans and MBSs issued by the Korea Housing Finance Corporation.

### **Revision on Loan-Loss Requirements for Credit Card Assets**

The FSC revised its regulations on loan-loss requirements for credit card assets in June with the aim of strengthening the ability of credit card companies to absorb losses and mitigate excessive competition in the credit card debt market. Specifically, the FSC raised the loan-loss provisioning ratio for sales on credit and credit card debt for most loan classification types—particularly precautionary, substandard, and doubtful loans.

### **Preliminary Primary Dealer System Launched**

The government launched its preliminary primary dealer (PPD) system in March in order to enhance the market-making primary dealer system and help further the development of the KTB market. In April, the government appointed two foreign banks—ING CB Seoul and Credit Agricole CIB Seoul—as PPDs in the domestic bond market. PPDs can participate in KTB auctions and conduct market-making obligations, but receive fewer incentives than primary dealers.