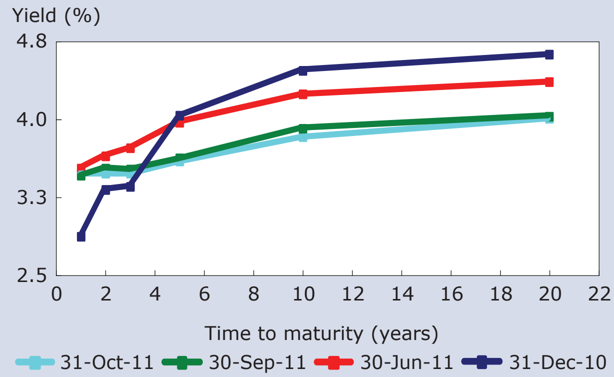
Republic of Korea—Update

Yield Movements

Government bond yields in the Republic of Korea dropped for all tenors between end-June and end-September, and fell further for most tenors in October **(Figure 1)**. Between end-June and end-September, the decline in yields ranged from 7 basis points (bps) in the 1-year tenor to 35 bps in the 5-year tenor. In October, yields fell for tenors longer than 1 year, with the 10-year tenor recording the largest monthly drop.

The government bond yield curve continued to flatten as the spread between 2- and 10-year tenors narrowed 22 bps between end-June and end-September, and tightened further by 3 bps in October.

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



LCY = local currency.
Source: Bloomberg LP.

The Bank of Korea kept its base rate—the 7-day repurchase rate—steady at 3.25% for the fifth consecutive month in November, after increases totaling 75 bps in the first half of the year. In its monetary policy decision dated 11 November, the central bank's Monetary Policy Committee cited expectations of a moderate global economic recovery—amid uncertainty in international financial markets—and a sustained long-term growth trend in the domestic economy.

Consumer price inflation in October stood at 3.9% year-on-year (y-o-y), down from 4.3% in September, 5.3% in August, and 4.7% in July. On a month-on-month (m-o-m) basis, consumer prices fell 0.2% in October.

Advance estimates of real gross domestic product (GDP) for 3Q11 showed a quarter-on-quarter (q-o-q) growth rate of 0.7%, compared with the previous quarter's growth rate of 0.9%. This was due to an easing in the growth of private consumption and gross fixed capital formation in 3Q11, and in spite of increases in the growth of government consumption and the export of goods and services. On the supply side, the agriculture–forestry–fishing and electricity–gas–water supply sectors contracted in 3Q11, while manufacturing growth eased slightly. On a y-o-y basis, real GDP growth in 3Q11 remained unchanged from the previous quarter at 3.4%.

Size and Composition

The local currency (LCY) bond market in the Republic of Korea expanded 8.6% y-o-y and 2.1% q-o-q to reach KRW1,389 trillion (US$1,179 billion) at end-September **(Table 1)**. Government bonds outstanding stood at KRW590.4 trillion, up 4.4% y-o-y and 1.2% q-o-q. Central government bonds—largely consisting of Korea Treasury Bonds (KTBs)—climbed 5.5% y-o-y and 1.1% q-o-q, leveling off at KRW391.2 trillion. The Bank of Korea's Monetary Stabilization Bonds (MSBs) rose 3.0% y-o-y and 1.4% q-o-q to reach KRW169.4 trillion. On the other hand, industrial financial debentures—bonds issued by the Korea Development Bank (KDB)—declined 1.5% y-o-y but rose 1.0% q-o-q to KRW29.8 trillion.

The LCY corporate bond market grew 11.9% y-o-y and 2.9% q-o-q to reach KRW798.6 trillion at end-September. Private corporate bonds again boosted the market's expansion, as the outstanding amount surged 29.9% y-o-y and 4.5% q-o-q to reach KRW331.9 trillion. Special public bonds outstanding were valued at KRW261.6 trillion, recording steady growth rates of 4.4% y-o-y and 3.3% q-o-q. On the other hand, financial debentures (excluding KDB bonds) declined 0.3% q-o-q and 1.1% y-o-y, leveling off at KRW205.1 trillion.

As of end-September, the top 30 issuers of LCY corporate bonds had a cumulative outstanding balance of KRW495.7 trillion, comprising 62% of total corporate bonds outstanding **(Table 2)**. Korea Land & Housing Corp. was still the largest corporate issuer at KRW57.6 trillion. About 77% of the top 30 issuers were banks, insurance companies, securities houses, or other financial firms.

LCY corporate bond issuance for 3Q11 amounted to KRW77.6 trillion, of which 46% were private corporate bonds, 30% financial debentures, and 24% special public bonds. Issuance of corporate bonds in 3Q11 was down 7.8% from 2Q11 largely due to a 21.4% quarterly drop in private corporate bond issuance. Compared with the previous year, corporate bond issuance fell 4.7% due to annual declines in the issuance of special public bonds and financial debentures.

The two largest LCY corporate bond issuances in the Republic of Korea in 3Q11 were made by Korea Land & Housing Corp: a 10-year bond worth KRW1,150 billion with a coupon rate of 3.25% and a 3-year bond worth KRW520 billion at a 4.21% coupon.

Investor Profile

As of end-June, the general government—comprising the central government, local government, and social security funds—and insurance companies and pension funds were the two largest investor groups in LCY government bonds with 23% shares each **(Figure 2)**. The next largest investor groups were banks and other financial institutions with 18% shares

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

	Amount (billion)								**Growth Rate** (%)						
	Jun-11		**Jul-11**		**Aug-11**		**Sep-11**		**Jun-11**		**Jul-11**	**Aug-11**	**Sep-11**		
	KRW	**US$**	**KRW**	**US$**	**KRW**	**US$**	**KRW**	**US$**	**y-o-y**	**q-o-q**	**m-o-m**	**m-o-m**	**y-o-y**	**q-o-q**	**m-o-m**
Total	1,359,924	1,274	1,367,933	1,298	1,381,012	1,295	1,389,038	1,179	8.2	2.3	0.6	1.0	8.6	2.1	0.6
Government	583,484	547	586,553	556	590,027	553	590,429	501	4.4	1.5	0.5	0.6	4.4	1.2	0.1
Central Bank Bonds	167,030	156	168,740	160	169,920	159	169,420	144	(0.3)	(0.9)	1.0	0.7	3.0	1.4	(0.3)
Central Government Bonds	386,942	362	389,662	370	392,690	368	391,213	332	8.2	2.2	0.7	0.8	5.5	1.1	(0.4)
Industrial Finance Debentures	29,512	28	28,151	27	27,417	26	29,796	25	(12.7)	5.2	(4.6)	(2.6)	(1.5)	1.0	8.7
Corporate	776,440	727	781,380	741	790,985	741	798,609	678	11.3	3.0	0.6	1.2	11.9	2.9	1.0

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. Bloomberg LP end-of-period LCY–US$ rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
Source: EDAILY *BondWeb* and The Bank of Korea.

Table 2: Top 30 Issuers of LCY Corporate Bonds in the Republic of Korea (as of September 2011)

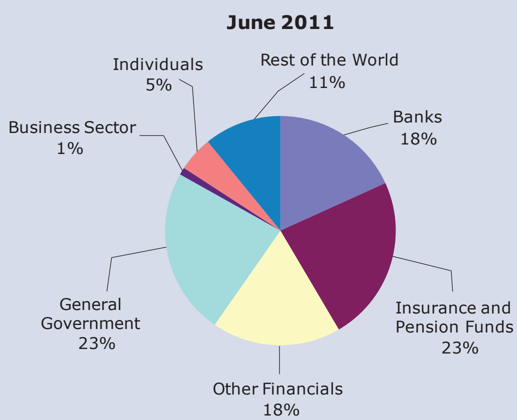
Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed on		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US$ billion)			KOSPI	KOSDAQ	
1. Korea Land & Housing Corp.	57,645	48.9	Yes	No	No	No	Real Estate
2. Korea Housing Finance Corp.	36,968	31.4	Yes	No	No	No	Financial
3. Korea Finance Corp.	31,050	26.4	Yes	No	No	No	Financial
4. Industrial Bank of Korea	30,634	26.0	Yes	No	Yes	No	Bank
5. Korea Deposit Insurance Corp.	23,290	19.8	Yes	No	No	No	Insurance
6. Korea Electric Power Corp.	23,230	19.7	Yes	No	Yes	No	Utility
7. Daewoo Securities	21,745	18.5	Yes	No	Yes	No	Securities
8. Kookmin Bank	21,527	18.3	No	Yes	No	No	Bank
9. Shinhan Bank	18,597	15.8	No	Yes	No	No	Bank
10. Korea Highway	18,130	15.4	Yes	No	No	No	Infrastructure
11. Woori Bank	18,052	15.3	Yes	No	No	No	Bank
12. Woori Investment and Securities	18,031	15.3	Yes	No	Yes	No	Securities
13. Korea Investment and Securities	14,814	12.6	No	Yes	No	No	Securities
14. Small & Medium Business Corp.	14,563	12.4	Yes	No	No	No	Financial
15. Hana Bank	14,314	12.2	No	Yes	No	No	Bank
16. Korea Rail Network Authority	12,745	10.8	Yes	No	No	No	Infrastructure
17. Tong Yang Securities	11,981	9.2	No	Yes	Yes	No	Securities
18. Korea Gas Corp.	11,490	9.8	Yes	No	Yes	No	Utility
19. Nonghyup (National Agricultural Cooperative Federation)	10,870	9.2	Yes	No	No	No	Bank
20. Mirae Asset Securities	10,587	9.0	No	Yes	Yes	No	Securities
21. Hyundai Securities	9,438	8.0	No	Yes	Yes	No	Securities
22. Shinhan Card	9,364	7.9	No	Yes	No	No	Financial
23. Korea Water Resources	7,790	6.6	Yes	No	Yes	No	Utility
24. Shinhan Financial Group	7,530	6.4	No	Yes	Yes	No	Financial
25. Hyundai Capital Services	7,282	6.2	No	Yes	No	No	Securities
26. Hana Daetoo Securities	7,238	6.1	No	Yes	No	No	Securities
27. Korea Railroad Corp.	7,190	6.1	Yes	No	No	No	Infrastructure
28. Standard Chartered First Bank Korea	6,910	5.9	No	Yes	No	No	Bank
29. Korea Eximbank	6,800	5.8	Yes	No	No	No	Bank
30. KB Kookmin Card	5,940	5.0	No	Yes	No	No	Financial
Total Top 30 LCY Corporate Issuers	**495,747**	**420.8**					
Total LCY Corporate Bonds	**798,609**	**677.9**					
Top 30 as % of Total LCY Corporate Bonds	**62.1%**	**62.1%**					

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

each, followed by foreign investors with an 11% share. Between June 2010 and June 2011, the share held by the general government declined 4 percentage points, while the shares for banks and other financial institutions fell 1 percentage point each. Meanwhile, the shares of foreign investors and individual investors saw gains of 2 percentage points each, while the share for insurance firms and pension funds rose 1 percentage point.

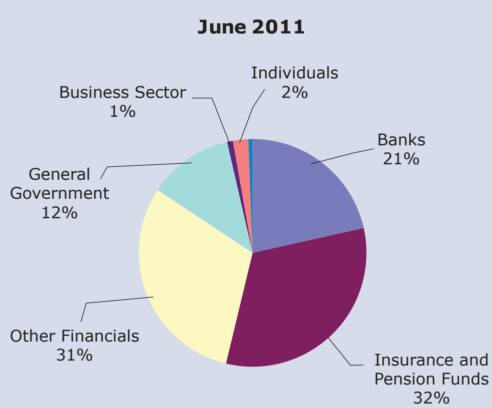
Insurance firms and pension funds remained the largest investor group in LCY corporate bonds at end-June, holding 32% of the total, followed closely by other financial institutions at 31% **(Figure 3)**. Between June 2010 and June 2011, the share for insurance firms and pension funds climbed 2 percentage points, while shares for the general government and individual investors rose 1 percentage point each. In contrast, shares for banks plunged 5 percentage points.

Figure 2: LCY Government Bonds Investor Profile



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

Figure 3: LCY Corporate Bonds Investor Profile



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

Rating Changes

In November Fitch Ratings affirmed the Republic of Korea's foreign currency (FCY) long-term issuer default rating at A+ and revised its outlook from stable to positive **(Table 3)**. It also affirmed its LCY long-term issuer default rating at AA with a stable outlook. According to Fitch, the Republic of Korea's sovereign creditworthiness is strengthening amid improvements in its sovereign and external balance sheets. It noted that the country's fiscal prudence and moderate public debt are its key rating strengths, and that its external liquidity has been improving thanks to increasing foreign reserves and declining reliance on short-term external debt. The ratings agency, however, mentioned that the country faces certain risks such as the volatile global economic and financial environment and its heavy external debt refinancing burden in 2012.

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

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

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

Policy, Institutional, and Regulatory Developments

Tax Revision Bill for 2011 Introduced

In September the Ministry of Strategy and Finance introduced its tax revision bill for 2011. The bill aims to facilitate sustainable growth and promote employment, improve fiscal conditions, and foster fair competition. One of the key aspects of the bill is fair taxation: yields derived from issuing FCY bonds domestically will be taxed just like LCY bonds, and capital gains taxes coming from financial products, including derivatives, will be legislated.

The Bank of Korea and People's Bank of China Expand Bilateral Swap Arrangement

In October the Bank of Korea announced the renewal of its bilateral swap arrangement with the People's Bank of China for 3 years. The size of the swap arrangement was expanded from KRW38 trillion–CNY180 billion to KRW64 trillion–CNY360 billion.

FSCMA Revision to Allow Hedge Funds

The Financial Services Commission (FSC) reported that the government approved on 27 September the proposed revision of the Enforcement Decree of the Financial Investment Services and Capital Markets Act (FSCMA), which will allow for the entry of locally based hedge funds into the Republic of Korea's capital market. The revision also allows hedge funds to invest in a wider range of asset classes, eases the restrictions on derivatives trading and leverage, and increases the diversity of hedge fund investors.

Macroprudential Stability Levy Imposed

The government imposed a macroprudential levy on the non-deposit FCY liabilities of banks effective 1 August. The levy applies to 56 financial institutions including 13 commercial banks, 37 foreign bank branches, Korea Eximbank, Industrial Bank of Korea, Korea Development Bank, Korea Finance Corporation, Bank of National Agricultural Cooperative Federation, and the National Federation of Fisheries Cooperatives. The levy was introduced in order to help mitigate capital flow volatility, including sudden outflows. The levy is 0.5% or less of face value depending on debt maturity.