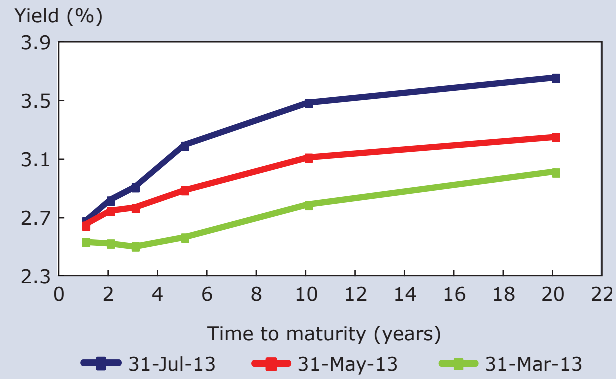
Republic of Korea

Yield Movements

Local currency (LCY) government bond yields in the Republic of Korea rose for all tenors between end-March and end-July, with the yield hikes ranging from 14 basis points (bps) for the 1-year tenor to 69 bps for the 10-year tenor **(Figure 1)**. Yields for all tenors initially climbed between end-March and end-May, and further rose through end-July amid concerns that the United States (US) Federal Reserve could start tapering its asset purchase program later this year. Meanwhile, the yield spread between 2- and 10-year tenors widened 40 bps between end-March and end-July.

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



LCY = local currency.
Source: Bloomberg LP.

The Bank of Korea's Monetary Policy Committee decided on 8 August to keep the base rate—the 7-day repurchase rate—steady at 2.50%. In its monetary policy decision, the committee took note of external events—such as the sustained moderate recovery in the US, the ongoing sluggishness in the euro area, and the economic slowdown in emerging markets, particularly the PRC—as well as domestic events including the country's moderate economic growth, an uptick in inflationary pressures, the stabilization of domestic financial markets, and the appreciation of the Korean won. Consumer price inflation moderated in August to 1.3% year-on-year (y-o-y) from 1.4% in July.

The Republic of Korea's real gross domestic product (GDP) growth stood at 1.1% quarter-on-quarter (q-o-q) and 2.3% y-o-y in 2Q13, based on preliminary estimates of The Bank of Korea. On a q-o-q basis, GDP expansion was bolstered by positive growth in final consumption expenditure, gross fixed capital formation, and exports of goods and services on the demand side, and the agriculture/forestry/fishing, construction, manufacturing, and services sectors on the production side. A supplementary budget of KRW17.3 trillion was announced in April to be utilized through the remainder of 2013 to help stimulate the domestic economy.

The Bank of Korea in July revised upward its GDP growth outlook for 2013 to 2.8% from its previous forecast of 2.6% made in April. The revised GDP growth rate projections for 1H13 and 2H13 stood at 1.9% and 3.7% y-o-y, respectively. By expenditure type, the central bank reported that its revised 2013 growth rates for private consumption, facilities investment, exports, and imports were lower compared with the earlier forecasts made in April. On the other hand, the revised 2013 growth rate for construction investment was higher than the April forecast. The central bank also stated in the same report that the headline inflation rate for 2013 would average 1.7%, compared with an April forecast of 2.3%.

Manufacturing production in the Republic of Korea posted a 0.2% month-on-month (m-o-m) decrease in July following a 0.5% increase in June, according to Statistics Korea data. However, on a y-o-y basis, manufacturing production grew 0.8% in July following a 2.6% decrease in June.

The country's current account surplus shrank to US$6.8 billion in July from US$7.2 billion in June, according to data culled from The Bank of Korea, despite a 13.0% m-o-m rise in the trade surplus in goods; exports of goods climbed 6.7% m-o-m, which was more significant than the 5.9% increase in merchandise imports. The narrowing of the current account surplus mainly stemmed from a 67.4% m-o-m fall in the service account surplus. The merchandise trade surplus for the month of August stood at US$4.9 billion, higher than July's US$2.5 billion, based on figures from the Ministry of Trade, Industry, and Energy, as merchandise exports rose to US$46.4 billion in August from July's US$45.8 billion, and merchandise imports fell to US$41.4 billion from US$43.3 billion. On a y-o-y basis, merchandise exports expanded 7.7% in August and imports of goods increased 0.8%.

Total external debt rose to US$411.8 billion at end-June from US$410.3 billion at end-March, based on data from The Bank of Korea. The quarterly uptick can be largely attributed to an increase in long-term external debt. Between end-March and end-June, the country's short-term external debt decreased from US$122.2 billion to US$119.6 billion, while long-term external debt rose from US$288.0 billion to US$292.1 billion. Meanwhile, banks' external debt fell to US$183.1 billion at end-June from US$184.3 billion at end-March.

The domestic stock market has exhibited volatility in recent months. The Korea Stock Price Composite Index (KOSPI) fell from 2,001 in May to 1,863 in June, before climbing to 1,914 in July. According to The Bank of Korea, the rebound in July resulted from diminished concerns over the US Federal Reserve's quantitative easing exit strategy, the reduced possibility of a hard landing in the PRC, and favorable earnings reports from listed companies.

The banking sector posted lower earnings in 2Q13 compared with the previous quarter. According to the Financial Supervisory Service (FSS), the net income of domestic banks stood at KRW1.1 trillion in 2Q13, down 35.3% on a q-o-q basis and 48.0% on a y-o-y basis. The drop mainly came from a decline in interest income, amid falling interest rates, and losses in the valuation of securities. Meanwhile, the FSS also reported that the delinquency rate of domestic banks' LCY-denominated loans fell 0.3 percentage points in June to 1.0% as newly delinquent loans declined and the status of a number of existing delinquent loans improved.

Size and Composition

Total LCY bonds outstanding in the Republic of Korea grew 10.6% y-o-y and 2.2% q-o-q to reach KRW1,650 trillion (US$1.4 trillion) at the end of 2Q13 **(Table 1)**. Growth for the quarter was higher compared with 2Q12. Outstanding LCY government bonds amounted to KRW637.3 trillion at end-June, growing 6.0% y-o-y and 2.3% q-o-q. This growth can be attributed to the government's supplementary budget to stimulate economic activity that required additional issuance of Korea

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

	Outstanding Amount (billion)						**Growth Rate** (%)			
	2Q12		**1Q13**		**2Q13**		**2Q12**		**2Q13**	
	KRW	**US$**	**KRW**	**US$**	**KRW**	**US$**	**q-o-q**	**y-o-y**	**q-o-q**	**y-o-y**
Total	1,491,463	1,302	1,614,631	1,453	1,650,267	1,445	2.1	9.7	2.2	10.6
Government	601,162	525	622,659	560	637,277	558	(0.05)	3.0	2.3	6.0
Central Bank Bonds	164,580	144	167,830	151	165,420	145	(2.0)	(1.5)	(1.4)	0.5
Central Government Bonds	408,361	357	426,699	384	439,059	384	1.1	5.5	2.9	7.5
Industrial Finance Debentures	28,221	25	28,130	25	32,798	29	(5.0)	(4.4)	16.6	16.2
Corporate	890,301	777	991,972	893	1,012,990	887	3.6	14.7	2.1	13.8

( ) = negative, LCY = local currency, 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.
Sources: EDAILY *BondWeb* and The Bank of Korea.

Treasury Bonds (KTBs). LCY central government bonds rose 7.5% y-o-y and 2.9% q-o-q to KRW439.1 trillion, led by increases in KTBs. Industrial finance debentures also expanded 16.2% y-o-y and 16.6% q-o-q, leveling off at KRW32.8 trillion. Meanwhile, outstanding central bank bonds, or Monetary Stabilization Bonds (MSBs), increased 0.5% on a y-o-y basis, but contracted 1.4% on a q-o-q basis, and stood at KRW165.4 trillion at end-June.

Issuance of LCY government bonds quickened at a double-digit pace in 2Q13, growing 14.2% y-o-y and 15.1% q-o-q to reach KRW76.3 trillion at end-June. Issuance of central government bonds rose 8.2% y-o-y and 8.7% q-o-q to KRW24.4 trillion, central bank bonds increased 5.3% y-o-y and 3.8% q-o-q to KRW44.7 trillion, and industrial finance debentures issued by the Korea Development Bank (KDB) surged 321.7% y-o-y and 952.4% q-o-q to KRW7.1 trillion.

Corporate LCY bonds outstanding reached KRW1,013 trillion at end-June, growing 13.8% y-o-y and 2.1% q-o-q. Private sector corporate bonds accounted for 46% of the corporate bond market in 2Q13, expanding 20.1% y-o-y and 3.2% q-o-q in nominal terms. Special public bonds, which are issued by government-owned corporations, accounted for one-third of total corporate bonds and increased 13.3% y-o-y and 1.9% q-o-q. Financial debentures (excluding KDB bonds) accounted for 21% of total corporate bonds and had the smallest increase in 2Q13 compared with other types of corporate bonds, rising 2.4% y-o-y and 0.2% q-o-q.

Issuance of LCY corporate bonds was down 7.4% y-o-y and 6.9% q-o-q during 2Q13 amid less bond issuance from private corporations (down 10.4% y-o-y and 9.9% q-o-q) and special public companies (down 13.5% y-o-y and 12.2% q-o-q). On the other hand, issuance of financial debentures (excluding KDB bonds) rose 9.1% y-o-y and 8.1% q-o-q.

As of end-June, the top 30 LCY corporate bond issuers had outstanding bonds of KRW635.0 trillion, accounting for 63% of total LCY corporate bonds **(Table 2)**. Korea Land & Housing Corporation was the largest issuer of corporate bonds with bonds outstanding of KRW58.7 trillion.

In 2Q13, the five largest LCY corporate bond issues included Posco's KRW800 billion 30-year bond offering a coupon of 4.3%, Woori Bank's KRW500 billion 30-year bond at 4.4%, Korea Land & Housing Corporation's KRW400 billion 3-year bond at 2.83%, SK Telecom's KRW400 billion 60-year bond at 4.21%, and Woori Bank's KRW350 billion 10-year bond at 3.9% **(Table 3)**.

Liquidity

Liquidity in the LCY government bond market appears to have improved in 2Q13, as the turnover ratio for government bonds climbed to 1.27 from 1.09 in 1Q13 and 1.01 in 4Q12. By type of government bond, the turnover ratio for central government bonds, mostly KTBs, increased to 1.32 in 2Q13 from 1.20 in 1Q13, while the turnover ratio for MSBs rose to 1.39 in 2Q13 from 1.04 in 1Q13 **(Figure 2)**.

Liquidity also appears to have improved in 2Q13 in the KTB futures market, with the total number of contracts traded rising to 13.2 million from 9.8 million in 1Q13 and 9.3 million in 4Q12, led by greater trading of 3-year KTB futures **(Figure 3)**. In 2Q13, about 73% of the total KTB futures contracts traded were for the 3-year tenor, an increase of about 11 percentage points from the previous quarter, while the remainder were for the 10-year tenor.

Liquidity in the LCY corporate bond market was unchanged in 2Q13, as the turnover ratio for corporate bonds remained at 0.14. Between 1Q13 and 2Q13, the turnover ratio for financial debentures inched up from 0.29 to 0.33, while it fell for special public bonds from 0.16 to 0.13, and for private corporate bonds from 0.07 to 0.06 **(Figure 4).**

Investor Profile

Insurance companies and pension funds were the largest investor group in LCY government

Table 2: Top 30 Issuers of LCY Corporate Bonds in the Republic of Korea

Issuers	Outstanding Amount		State-Owned	Listed on		Type of Industry
	LCY Bonds (KRW billion)	LCY Bonds (US$ billion)		KOSPI	KOSDAQ	
1. Korea Land & Housing	58,735.0	51.4	Yes	No	No	Real Estate
2. Korea Housing Finance	57,307.6	50.2	Yes	No	No	Financial
3. Korea Finance	45,590.0	39.9	Yes	No	No	Financial
4. Korea Deposit Insurance	43,960.0	38.5	Yes	No	No	Insurance
5. Industrial Bank of Korea	32,524.7	28.5	Yes	Yes	No	Bank
6. KDB Daewoo Securities	31,623.6	27.7	Yes	Yes	No	Securities
7. Korea Electric Power	30,270.0	26.5	Yes	Yes	No	Utillity
8. Korea Investment and Securities	27,698.2	24.3	No	No	No	Securities
9. Woori Investment and Securities	27,625.9	24.2	Yes	Yes	No	Securities
10. Mirae Asset Securities	23,487.2	20.6	No	Yes	No	Securities
11. Korea Expressway	20,090.0	17.6	Yes	No	No	Infrastructure
12. Kookmin Bank	18,905.2	16.6	No	No	No	Bank
13. Tong Yang Securities	18,740.8	16.4	No	Yes	No	Securities
14. Shinhan Bank	18,258.2	16.0	No	No	No	Bank
15. Korea Rail Network Authority	15,490.0	13.6	Yes	No	No	Infrastructure
16. Small & Medium Business	15,005.0	13.1	Yes	No	No	Financial
17. Hana Daetoo Securities	14,169.4	12.4	No	No	No	Securities
18. Korea Gas	13,665.0	12.0	Yes	Yes	No	Utility
19. Woori Bank	13,462.5	11.8	Yes	No	No	Bank
20. Hana Bank	12,315.0	10.8	No	No	No	Bank
21. Hyundai Securities	11,755.1	10.3	No	Yes	No	Securities
22. Shinhan Investment	11,223.2	9.8	No	No	No	Securities
23. Samsung Securities	10,098.3	8.8	No	Yes	No	Securities
24. Standard Chartered First Bank Korea	9,990.0	8.7	No	No	No	Bank
25. Korea Water Resources	9,987.0	8.7	Yes	Yes	No	Utility
26. Shinhan Card	9,350.3	8.2	No	No	No	Financial
27. Korea Eximbank	9,110.0	8.0	Yes	No	No	Bank
28. Hyundai Capital Services	8,295.0	7.3	No	No	No	Securities
29. Korea Student Aid Foundation	8,270.0	7.2	Yes	No	No	Financial
30. Korea Railroad	7,960.0	7.0	Yes	No	No	Infrastructure
Total Top 30 LCY Corporate Issuers	**634,962.3**	**556.0**				
Total LCY Corporate Bonds	**1,012,990.0**	**887.0**				
Top 30 as % of Total LCY Corporate Bonds	**62.7%**	**62.7%**				

KOSDAQ = Korean Securities Dealers Automated Quotations, KOSPI = Korea Composite Stock Price Index, LCY = local currency.
Notes:
1. Data as of end-June 2013.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg and EDAILY *BondWeb* data.

Table 3: Notable LCY Corporate Bond Issuance in 2Q13

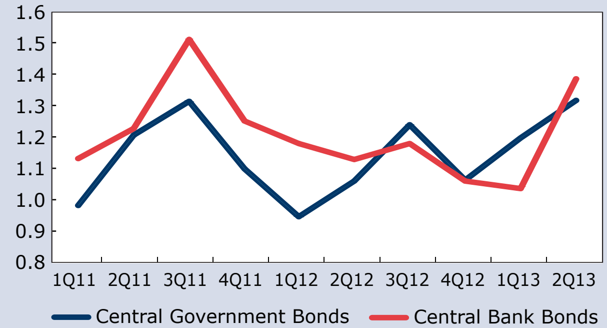
Corporate Issuers	Coupon Rate (%)	Issued Amount (KRW billion)
Kookmin Bank		
7-year bond	3.61	300.0
Korea Land & Housing Corp.		
3-year bond	2.83	400.0
Posco		
30-year bond	4.30	800.0
SK Telecom		
60-year bond	4.21	400.0
Woori Bank		
10-year bond	3.90	350.0
30-year bond	4.40	500.0

LCY = local currency.
Source: Bloomberg LP.

bonds, holding 26% of the total as of end-March, an increase of 1 percentage point from the same month in the previous year **(Figure 5)**. General government entities—the central government, local governments, and social security funds—held 22% of the total, and stood as the second-largest holder of LCY government bonds at end-March; their share, however, slipped 2 percentage points from March 2012. The share of banks' holdings of LCY government bonds fell 1 percentage point from a year earlier, leveling off at 18% in March 2013. Meanwhile, the share of foreign investors holdings of LCY government bonds fell from 11% to 9% over the same period.

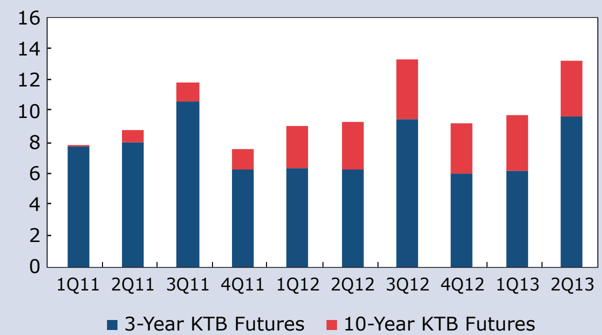
Insurance companies and pension funds remained the largest investor group in LCY corporate bonds, holding 33% of the total at end-March **(Figure 6)**. They were followed by financial companies other than banks, insurance firms, and pension funds, with a share of 28%, banks at 15%, the general government at 12%, households and nonprofit organizations at 8%, non-financial companies at 3%, and foreign investors at 1%. Compared with the same month in the previous year, the shares of households and nonprofit organizations, and non-financial businesses, climbed 3 percentage points and 1 percentage point, respectively, while those of banks and other financial companies fell 3 percentage points and 1 percentage point, respectively.

Figure 2: Turnover Ratios for Central Government and Central Bank Bonds



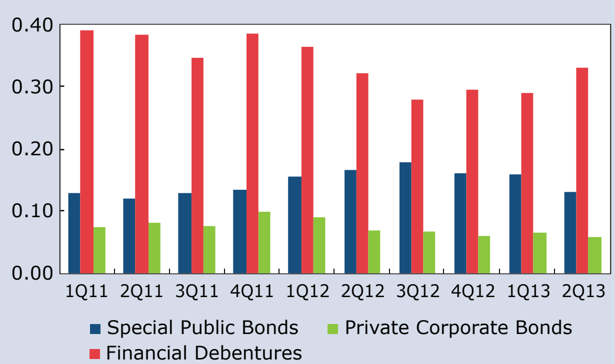
Note: Central government bonds include Korea Treasury Bonds and National Housing Bonds.
Sources: The Bank of Korea and EDAILY *BondWeb*.

Figure 3: Trading Volume for KTB Futures Contracts (millions of contracts)



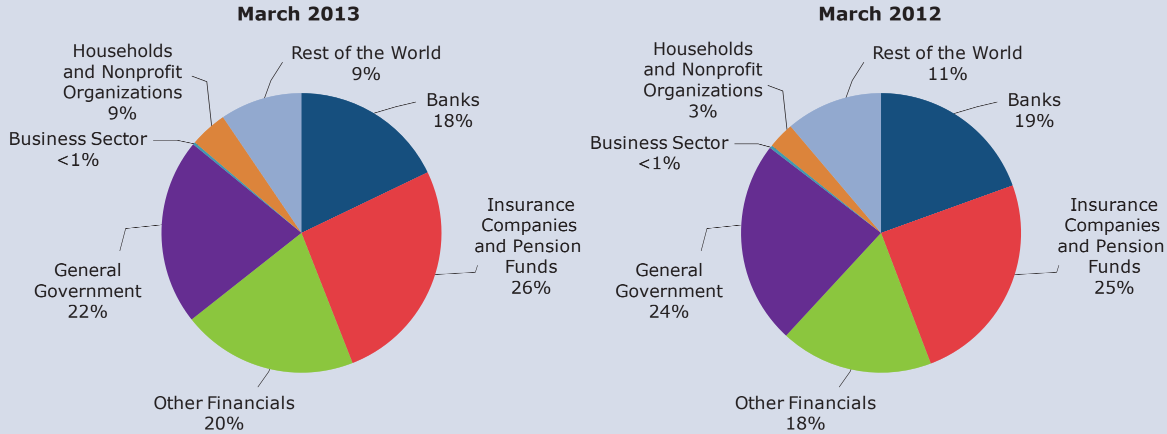
KTB = Korea Treasury Bond.
Source: Korea Exchange.

Figure 4: Turnover Ratios for Special Public Bonds, Financial Debentures, and Private Corporate Bonds



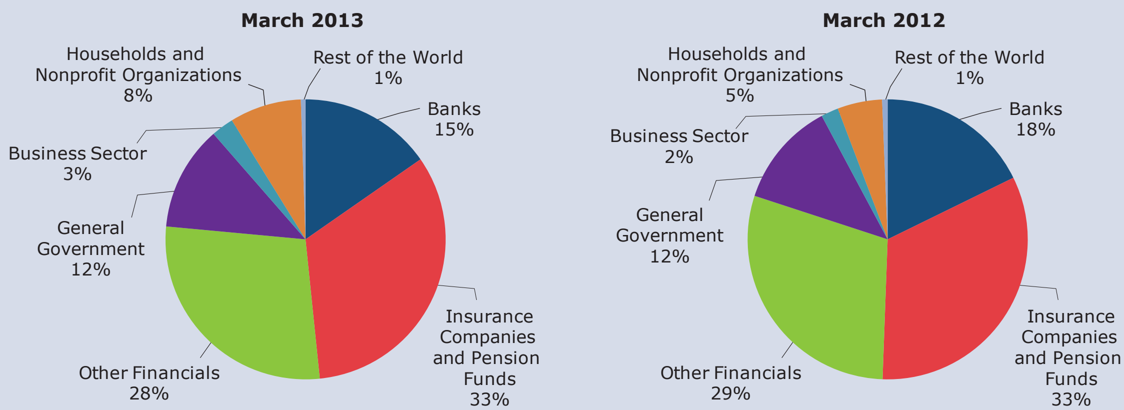
Source: EDAILY *BondWeb*.

Figure 5: LCY Government Bonds Investor Profile



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

Figure 6: LCY Corporate Bonds Investor Profile



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

Rating Changes

On 11 June, Rating and Investment Information (R&I) affirmed the Republic of Korea's LCY and foreign currency (FCY) issuer ratings at AA– and A+, respectively, with the outlook remaining stable for both.

On 22 August, Fitch Ratings affirmed the Republic of Korea's long-term FCY issuer default rating (IDR) at AA–, the long-term LCY IDR at AA, the short-term FCY IDR at F1+, and the country ceiling at AA+, with the outlook remaining stable for both long-term ratings.

Policy, Institutional, and Regulatory Developments

MOSF Announces Amendments to Regulations on KTB Issuance and Primary Dealer System

The Republic of Korea's Ministry of Strategy and Finance (MOSF) announced in July amendments to regulations on KTB issuance and the primary dealer system, with the amendments aimed at attracting greater primary dealer participation in the primary and secondary markets. The amendments extend the (i) differential knock-down rates for 10-, 20-, and 30-year bonds to 3 bps from 2 bps; (ii) threshold of primary dealers' non-competitive purchasing option to 10%; and (iii) quote spreads for long-term bonds given their yield volatility. MOSF stated that the amendments would be implemented sometime between the 10-year KTB auction starting on 15 July and the end of 2013.

FSC Introduces Measures to Invigorate Corporate Bond Market

The Republic of Korea's Financial Services Commission (FSC) announced measures in July to invigorate the country's corporate bond market and prevent the worsening of corporate funding conditions and the possible spillover of "destabilizing factors" from the market to the real economy. Specifically, the FSC measures include (i) a liquidity support program through government issuance of primary collateralized bond obligations, (ii) tax incentives for dividends of corporate bond funds with more than 30% of bonds rated BBB– or below, (iii) improvements in the Qualified Institutional Buyer system, (iv) easing of relevant regulations to boost demand for corporate bonds, (v) revisions to the regulations on asset-backed securities, (vi) reforms in the credit rating system, (vii) enhancements to the system for corporate bond issuance, (viii) improvements in the system for corporate bond management, and (ix) strengthening the effectiveness and transparency of the bond distribution system.

Republic of Korea Introduces 2013 Supplementary Budget, KTB Market Stabilization Measures

MOSF reported in April that a supplementary budget of KRW17.3 trillion will be utilized to help stimulate the domestic economy through the remainder of 2013. Of the amount, KRW12.0 trillion will be used to finance government revenue shortfalls and the remaining KRW5.3 trillion will be spent to supplement the government's budget expenditures. Under the 2013 supplementary budget, government expenditures will amount to KRW349 trillion, which is KRW7 trillion higher than what was specified in the original 2013 budget. Also, government revenues in the 2013 supplementary budget are projected to reach KRW360.8 trillion, which is KRW11.8 trillion less than in the original budget.

MOSF reported that the 2013 supplementary budget calls for an additional net increase in issuance of KTBs amounting to KRW15.8 trillion. Since this will likely trigger upward pressure on interest rates, thereby imposing a burden on the market, MOSF has decided to reduce the issue amount for buy-backs. Against this backdrop, total issuance of KTBs for the year is projected to reach KRW88.5 trillion, which is KRW8.8 trillion higher than the previous estimate of KRW79.7 trillion. In addition, MOSF reported that it intends to continue with the monthly issuance of KTBs at similar levels. It will continue to optimize the proportions of KTBs by maturity (3-, 5-, 10-, 20-, and 30-year tenors), with plans to increase the issuance of "on-the-run" KTBs. MOSF will also conduct flexible application of "partial knock-down rates" and ensure that primary dealers' obligations are strengthened.

Basel III Capital Regulations to Apply to Bank Holding Companies

The FSC announced in August that the Basel III capital regulations will apply to bank holding companies effective 1 December 2013. These regulations establish the minimum capital requirement ratios for bank holding companies at 4.5% for common equity capital, 6.0% for Tier 1 capital, and 8.0% for total capital. A capital conservation buffer will also be introduced to bank holding companies starting in 2016.