SEOUL
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FORUM

KOREA AS AN
INTERNATIONAL FINANCIAL CENTER

Policy Recommendations
for
The Incoming Lee Myung-bak
Government

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CHAIRMAN'S INTRODUCTION

The Seoul Financial Forum (SFF) came into being in the fall of 2001. From the very beginning, the Forum has pursued a single mission: to help Korea emerge as an international financial services center (IFC) in Northeast Asia in a minimum amount of time. All its members are convinced that it is critical for Korea to become an international financial center not only for its own continued social and economic progress, but also for that of the entire Asian region.

Driven by this conviction, the Forum issued its first major policy report, "*Korea as an International Financial Center: Vision and Strategy,*" in the fall of 2002. The report outlined not only the vision for Korea to become a financial center in Northeast Asia, but also the strategy to realize this vision. Influenced in no small measure by this report, the Roh Moo-hyun government, soon after it came into office in 2003, accepted the goal of transforming Korea into an IFC as its official policy. In December 2003, this policy led to the adoption of its first roadmap towards becoming the premier financial center in Northeast Asia. The first roadmap, however, contained a number of conceptual and operational problems. The SFF lost no time in bringing these problems to the attention of the government. In June 2005, the Roh government adopted a second roadmap amending these problems in large measure.

To its credit, the Roh government has implemented many significant reforms needed for Korea to become a world-class financial center, especially since the adoption of the second roadmap. These include the accelerated liberalization of foreign exchange controls on capital account transactions and the enactment of the Capital Market Consolidation Act (CMCA). Such policy changes and reforms are indeed epoch-making in the history of the nation.

However, in view of the enormous benefits that Korea will receive from becoming an IFC and the urgency with which Korea should achieve this goal, the pace of progress made under the Roh government has left much to be desired. Today, many countries in Asia are vying with each other to become an IFC. Moreover, as there are many strategic advantages to be gained from becoming an international financial center ahead of others, Korea should do everything in its power to accelerate the progress it has made. What this means is that the incoming Lee Myung-bak government should not only continue with the initiative started by the Roh government, but, more importantly, achieve the goal of becoming a world-class financial center long before 2015, the target date set by the Roh government.

The primary purpose of this report is to help the Lee government meet this challenge. The report is divided into five chapters. Chapter 1 sets forth the reasons why it is imperative for Korea to become an IFC. Chapter 2 reviews the progress Korea has made to date. Chapter 3 identifies the major issues and challenges Korea has yet to meet before it can become a full-fledged IFC. Chapter 4 recommends a list of major policy reforms that Korea has to undertake to achieve its goal. Chapter 5 concludes the report.

EXECUTIVE SUMMARY

Korea has achieved phenomenal economic success over the past half century. During this period, Korea has emerged from being one of the poorest countries in the world to an OECD member country with a per capita GDP approximating US$20,000. Korea achieved this progress mainly through a development strategy emphasizing manufactured exports.

With the rise of China and other emerging economies, however, today this strategy is no longer feasible. Given its highly educated workforce, Korea needs to move into a high value-added, knowledge-based service economy.

For this transition, it is essential for Korea to become a premier international financial center (IFC) in Northeast Asia. For one, the financial industry itself is a high value-added industry. For another, as Korea tries to become a financial center, its financial industry will become highly competitive. This highly competitive financial industry in turn will greatly facilitate the transformation of the Korean economy from a manufacturing-based to a knowledge-based economy. As Korea makes this transition, both its potential and actual growth rates will be greatly enhanced, thus creating many high value-added employment opportunities.

Fortunately, Korea is well equipped with many strengths it can draw from to become a world-class financial center. Its people are highly educated, its economy is the 13th largest in the world, and it has the world's most advanced IT infrastructure. In addition, it is already home to many world-class companies, including Samsung, LG, POSCO and Hyundai Motors. These global champions have already generated a large volume of cross-border transactions and funding.

To its credit, the outgoing Roh Moo-hyun government readily accepted the idea that Korea should become a world-class IFC. To this end, it has undertaken many significant reforms and laid down the legal foundation for Korea to become a financial center.

However, the progress the Roh government has made in implementing its policy for the IFC initiative has been slow at best. In the meantime, not only have established financial centers in Asia, such as Hong Kong and Singapore, been making great strides in further expanding and upgrading their operations, but also newcomers, such as Shanghai, Tokyo, and Mumbai, are making rapid progress. In view of these developments, there is little question that Korea needs to re-double its efforts to become a financial center or else it will never achieve this goal.

Therefore, it is extremely important for the incoming Lee government to re-launch the IFC initiative with great vigor upon coming into office.

With this imperative in mind, the Seoul Financial Forum (SFF) recommends the following:

- Immediately launch a Presidential-level Program Management Office (PPMO) with the responsibilities of not only designing an overall action program and coordinating all facets of the IFC initiative of the government, but also completing Korea's transition into a world-class IFC within the tenure of the new administration. The PPMO should also be empowered to monitor and evaluate the implementation and progress of the program.

- Eliminate all defacto barriers to market entry and cross-border sharing of utility functions and capital movements.

- Accelerate the current initiatives aimed at transforming the nation's regulatory regime from a positive-list, rule-based approach to a negative-list and principle-based approach.

- Upgrade professional capabilities, particularly of FSS regulators, by expanding overseas on-the-job training programs and injecting more foreign talent into regulatory roles.

- Promulgate all financial regulatory documents in both Korean and English.

- Enhance Korea's participation in important international initiatives and fora aimed at coordinating, harmonizing and strengthening financial supervisory policies pursued by national authorities, and assure a leadership role for Korea within the Asian region with regard to these initiatives.

- Improve Korea's business environment by concentrating on increasing flexibility in the labor market; resolving pending issues, such as the Lone Star case; opening the legal services markets to foreign firms; and undertaking fundamental reform not only in the structure of the nation's tax system, but also its administration.

  Given the utmost importance of reform in both the tax system and its administration, we recommend launching a National Tax Reform Commission. The primary task of this commission is to recommend an optimal tax system that will not only strengthen Korea's competitiveness as a financial center, but also meet the needs of a healthy national economy in this globalizing era.

- Redefine the roles of publicly-owned financial institutions and resume the policy of privatizing those financial institutions, including those that became government-owned in the course of overcoming the 1997-98 financial crisis.

  At this particular point in time, the SFF believes that special attention must be given to the need to restructure the Korea Development Bank (KDB). The SFF recommends privatization of KDB's corporate and investment banking businesses.

- Undertake systematic PR efforts to obtain greater support for the IFC initiative not only from citizens at home but also from the international community.

Indeed, the issues and challenges Korea has yet to address in its efforts to become a world-class financial center are formidable. However, over the past 50 years or more, Korea has demonstrated its capacity to meet challenges, and today's challenges are no more formidable than those of the past. The SFF submits this report with every expectation that the new government will implement all of the recommendations contained in this report.

Chapter 1. WHY SHOULD KOREA BECOME AN INTERNATIONAL FINANCIAL CENTER?

Simply put, an international financial center (IFC) is a place where both foreign and domestic market participants freely and actively trade large volumes of financial assets denominated in any currency. Physically, it is usually a large city of international stature, whose economy relies significantly upon the presence and operation of a broad range of domestic and foreign institutions in banking, securities, insurance, and asset management, as well as treasury operations of non-financial multinational corporations.

In the world today, there are many types of IFCs. At the broadest level, there are global IFCs, such as London and New York. Then there are regional IFCs, such as Frankfurt, Singapore, and Hong Kong. In addition, there is a group of niche players, such as Zurich, focused on private banking and asset management; Dublin, focused on providing infrastructure and back-office services; and Bermuda, serving mostly as an insurance center.

Over the past several years, Korea has chosen first to become a regional financial center, à la Hong Kong and eventually an IFC at the global level. Reasons why Korea should become an IFC in Northeast Asia fall into two categories. On the one hand, there are many economic and non-economic benefits Korea can reap from becoming such a center. On the other hand, Korea has many strengths that it can draw on to become an international financial center. It is the purpose of this chapter to clearly set forth these benefits and strengths.

BENEFITS FROM BECOMING AN IFC

1.1 New Engine for Growth

Over the past 40 years or more, Korea has achieved phenomenal economic progress. As late as the early 1970s, Korea was one of the poorest countries in the world. Today, however, Korea is a member of the OECD with a per capita income of approximately US$20,000.

Korea achieved such rapid economic development thanks in large measure to its development strategy emphasizing manufactured exports. This strategy, however, has now reached its limit. With China and India rising on the strength of their low wages, Korea no longer enjoys competitiveness in manufactured exports. Moreover, the better-educated workforce in Korea demands high value-added employment opportunities. In short, Korea is in need of restructuring its economy from one based on manufacturing to a high value-added, knowledge-based service economy.

The financial sector itself is a high value-added, knowledge-based service industry. More importantly, in any market-oriented economy, it is the role of the financial sector to bring about the structural transformation of an economy by redirecting investments away from low value-added sectors to high value-added sectors. If Korea becomes a world-class financial center, its financial industry will become highly competitive. This competitive financial industry in turn will greatly facilitate Korea’s transformation from a manufacturing-based to a knowledge-based service economy.

If Korea becomes a world-class international financial center ahead of its competitors, it will enjoy many advantages that come from occupying the high ground first. These advantages will not only further strengthen the competitiveness of the locally-based financial industries but also fuel Korea’s economic growth into the future.

1.2 Enhanced Potential Growth Rate

For the past five years, Korea has experienced a slowdown in the growth of its GDP, averaging around 4% per year. In the opinion of many, this slowdown reflects the decline in Korea's potential growth rate. Whether or not the slowdown is due to the decline in potential growth rate, actual growth rate will become higher as more efficient investment takes place thanks to the greater competitiveness of Korea's financial industry. With more efficient investment, Korea's potential growth rate will increase as well.

1.3 Lower Investment Funding Cost

As Korea becomes a financial center, domestic firms will have easier access not only to domestic savings, but also to foreign savings. With more diversified access to savings, the cost of financing investment for Korean firms will decline. This will increase the level of investment in Korea leading to a higher overall growth rate.

1.4 Increased Innovation and Entrepreneurship

In addition, as Korea becomes a financial center supported by well-functioning financial markets, an important qualitative change in the economy will take place. A greater "matching of talent with capital" will ensue, setting a stage conducive not only to "competition-induced creative destruction," but also innovations and entrepreneurship of all kinds. This will not only revitalize small and medium enterprises (SME) in Korea, but also enhance the "mobility of people" resulting in higher productivity and renewed vitality for the economy.

1.5 More High Value-Added Job Creation

As Korea plays the role of an IFC by offering a broad range of domestic and international financial and other related services, opportunities for high value-added employment will increase utilizing Korea's highly-educated workforce to the fullest. This will go far towards resolving many social and political issues currently stemming from widespread unemployment, especially among the younger generation and recent university graduates. According to current statistics released by the Korean government, unemployment among young workers between 16 and 30 years of age is more than twice the 3.5% unemployment rate of the rest of the population.

1.6 Greater Resilience to External Shocks

As Korea becomes an IFC, the nation's businesses and financial institutions will become more transparent not only in governance structures, but also in accounting practices. This will enable Korea to have access to a wider array of sources of capital and diversify its own investments, thus greatly increasing its ability to withstand financial shocks, such as the one encountered in 1997.

1.7 Improvement in Public Welfare

Korea was once a capital-deficit country. With rapid economic development over the past several decades, Korea has become a capital-surplus country. In addition, with the rapid aging of its population, Korea needs to invest its savings overseas for high returns. As Korea continues to free capital controls in its effort to become an IFC, it will be easier for its citizens to invest overseas without leaving the country. Furthermore, domestic savers will have far greater variety of financial instruments and maturities from which to select. Thus, becoming an IFC will greatly enhance the welfare of the Korean people.

1.8 Enhanced International Status

Benefits Korea will receive from becoming an international financial center are not confined to the economic area. In becoming an IFC, Korea will be called on to finance many development projects, especially in Northeast Asia. This will not only give Korea a greater voice in its choice of major development projects in the region, but also higher diplomatic status.

1.9 Peace and Stability on the Korean Peninsula

As Korea makes progress towards becoming the premier financial center for Northeast Asia, more global companies – financial as well as industrial – will set up their Asian regional headquarters in Korea. This will induce their home country governments to pay more attention to the need for maintaining peace and stability on the Korean peninsula. Singapore is currently able to maintain economic prosperity without a big national defense budget because many advanced countries around the world have a vested interest in Singapore's stability. In short, Korea's playing the role of an international financial center in Northeast Asia will not only enhance Korea's international status, but also strengthen peace and stability on the peninsula.

1.10 Contributing to Asia's Continued Growth with Stability

Benefits from Korea's becoming an international financial center are not limited to Korea. As a matter of fact, by becoming an IFC, Korea will greatly strengthen the prospect of Asia's continued growth with financial stability.

The fundamental cause of the 1997-98 Asian financial crisis was the well-known "triple mismatches," i.e., currency mismatch, maturity mismatch, and capital structure mismatch. As Korea begins to function as an effective IFC in Northeast Asia, many firms in the region will be able to raise long-term investment capital in the currencies of the region. This will reduce currency mismatch. Moreover, firms in the region will be better able to secure long-term investment capital at the maturities they seek. This will greatly reduce maturity mismatch. Furthermore, companies in the region will enjoy greater opportunities to finance their long-term investment by issuing stock rather than debt. This will also significantly reduce their capital structure mismatch. All in all, the emergence of Korea as an effective financial center will greatly strengthen the prospect for the region to continue high growth with stability.

KOREA'S STRENGTHS FOR BECOMING A FINANCIAL CENTER

Korea has numerous strengths and advantages it can draw on in becoming a world-class financial center. They range from the large size of the Korean economy to substantial holdings of financial assets, extensive experience in restructuring the economy following the Asian financial crisis, high-quality human resources, extraordinary strength in IT infrastructure, rule of law, democracy, and the growing role of Korea as the most vibrant cultural center in East Asia.

1.11 The World's 13th Largest Economy

Measured in GDP, Korea is the 13th largest economy in the world, placing it far ahead of Singapore and Hong Kong. Although Singapore and Hong Kong currently serve as the most active international financial centers in East Asia, they face limitations in expanding their roles as financial hubs since their domestic economic activities are limited in scale. Thus, they are financial centers focusing on offshore transactions. By contrast, Korea can become a more balanced financial center carrying on both offshore and onshore activities.

1.12 Home to World-Class Companies

Thanks in large measure to Korea's economic success, Korea has already become home to a number of large corporations with global capabilities in fields ranging from electronics and telecommunications to automobiles, shipbuilding and steel. Such names as Samsung, LG, Hynix, Hyundai, and POSCO are becoming household names throughout the world. These global champions have already generated a large volume of cross-border transactions and funding and investment needs.

1.13 Growing Financial Asset Holdings

Another one of Korea's strengths is its large and growing financial asset holdings. This is no doubt a result of Korea's rapid economic growth, but it is also the result of a higher savings ratio with the aging population preferring to hold sizable portions of their wealth in the form of financial assets. According to the Bank of Korea, Korea's gross financial assets at the end of 2006 were KRW6,933 trillion, 8.2 times the size of Korea's GDP for the same year. This large financial asset holding provides adequate liquidity for Korea to play the role of an international financial center.

1.14 Extensive Experience in Economic Restructuring

The Korean financial industry underwent a far-reaching restructuring in the wake of the 1997-98 financial crisis. As a result, financial institutions in Korea today have much stronger balance sheets. The average BIS ratio of Korean banks continues to rise after surpassing 12% in 2006 and bears favorable comparison with premier banks in advanced countries. Korean companies have also made great strides in strengthening managerial capability as well as transparency in corporate governance. These experiences will be useful when it comes to Korean financial firms helping other Asian countries to restructure their corporate sectors.

1.15 High-Quality Human Resources

Korea is home to a vast pool of high-quality human resources. This is a major advantage because an abundant supply of highly-educated and talented human resources is a critical prerequisite for becoming a financial hub. One-third of Korea's work force is already composed of college graduates, and this ratio is rising. Over 85% of Korea's high school graduates go on to college and university, compared to 45% in the U.S. and 70% in Israel.

Today, with its population of 50 million, Korea sends more students to the United States than China or India. In the long term, this will no doubt greatly strengthen the adaptability of Korea's work force, not only to the needs of Korea's becoming a financial center, but also to meeting the challenges brought on by globalization.

1.16 Strong IT Infrastructure

Korea today is one of the most advanced in the world in terms of Information Technology (IT). For competitiveness in the financial industry, the ability to rapidly process an enormous amount of data and information is critical. Thanks to advances in the IT sector, Korea's financial institutions not only offer account remittance, financial settlement, and other transactions more quickly and efficiently than those of other countries, they also enjoy great advantages in data processing and risk evaluations. If leveraged well, these capabilities will increase Korea's competitiveness in many back-office operations.

1.17 Rule of Law and Democracy

There is no question that the rule of law in Korea needs further advancement. However, Korea has made greater progress in this regard than other countries in Asia. Finance is built on rigorous protection of property rights of all kinds by the state and timely and fair resolution of disputes over these rights by the judiciary when they arise. Korea's democracy is not only vibrant, it is far more advanced than those of its neighbors in Asia. With an advanced democracy, Korea can look forward to a stable political outlook and more orderly transition of government than most of its neighbors.

1.18 Korea as a Cultural Center

Financial professionals are highly educated and experience a great deal of stress in their work. As a result, they have a large demand for cultural and artistic performances. It is no coincidence that global financial centers, like London and New York, are also home to world-class art, music, and theater. In recent years, many Koreans have emerged as world-class artists and performers. In addition, Korea has a long history and cultural tradition. With these resources, Korea is rapidly emerging as the most vibrant cultural center in Asia. Many musical performances and art exhibitions in Seoul and other Korean cities attract a growing number of visitors from all over the region, and the so-called “Korean Wave” has been dominating not only pop-culture, but also movies and TV shows throughout Asia. There is little question that these strengths in culture will go far towards making Korea an attractive financial center.

Chapter 2. PROGRESS TO DATE

Over the past five years, the Roh government has made significant progress in transforming Korea into an international financial center. Besides making an unequivocal political commitment to making Korea an IFC, the Roh government has adopted roadmaps and implemented a number of significant policies and institutional reforms.

2.1 Strong Commitment to an IFC

During the 2002 presidential campaign, candidate Roh Moo-hyun enthusiastically embraced the idea of transforming Korea into the premier international business center in Northeast Asia, but nowhere in his campaign could one find any mention of the need for Korea to become a financial center.

The Seoul Financial Forum was convinced, however, that Korea must develop into a financial center before it becomes a comprehensive business center, and thus approached policymakers on the Roh government's transition team to persuade them that it was imperative to incorporate the idea of a financial hub in their policy program for a comprehensive business center. This effort continued even after the Roh government took office in February 2003.

It was remarkable that within a few months in office President Roh came to appreciate the perspective of the SFF. He too agreed that if Korea was to succeed with its ambition of becoming a comprehensive regional business center, it should at the same time aspire to become an IFC. He also appreciated the critical importance for Korea to restructure its economy in the face of a rapidly growing China and other economies in Asia with strong competitiveness in manufacturing. Furthermore, he felt strongly that a competitive financial industry that comes with a financial center would go far towards facilitating this economic restructuring. This thinking led to the adoption of the First Financial Hub Roadmap in December 2003.

2.2 The First Financial Hub Roadmap

The first Roadmap envisaged a three-stage approach: laying down the legal and institutional foundation for an IFC between 2004 and 2007; developing into a "niche financial center" specializing in asset management between 2007 and 2012; and expanding into a regional financial center, with a scope of activities comparable to Hong Kong, between 2012 and 2020.

In the SFF's opinion, this three-stage approach presented a number of problems. The first was its prolonged and slack timeframe. Considering what the rest of the world was going to do, the target date of 2020 was far too unrealistic. Simply put, other countries in Asia were not going to wait around while Korea took its time becoming an IFC. Hong Kong was already making an all-out effort to become a more comprehensive financial center while Shanghai was busying itself to become East Asia's new financial hub. At this time, Tokyo also renewed its efforts to become a financial center for the second time.

In a move to become a financial center, the so-called "first mover's advantage" is very important. Once a particular city or country has made its mark as an established financial hub ahead of other contenders, all others will face greater difficulties in their pursuit of the same. In view of this, the Roh government's three-stage approach, with 2020 as the target date, was ill conceived.

Another shortcoming in the first Roadmap was the idea of Korea's becoming a "niche market" specializing only in asset management during the 2007-2012 period. Becoming a financial center exclusively focusing on asset management assumed that the Korean financial market already offered a wide range of diverse assets and products. This certainly was not the case. In the absence of diverse assets in the domestic financial market, asset managers would look for opportunities for investment overseas. This would have very little impact in terms of developing domestic financial markets. In addition, the government hoped that its policy emphasis on asset management would induce foreign financial institutions to move their operations to Korea. As a matter of fact, operating only as an asset manager would give little incentive for foreign firms to relocate their operations to Korea.

The idea to develop various financial sectors only after 2012 also made no sense. Korea already had strength in a number of financial sub sectors. For example, Korea had the second largest debt and insurance markets in Asia next to Japan. Korea's derivative market, especially those related to equity indices, was the most active in the world, and its private equity market was the envy of other Asian countries. In addition, in the course of overcoming the 1997-98 financial crisis, Korea accumulated much experience in corporate restructuring. In view of these strengths, concentrating on asset management alone until 2012 did not make sense.

Moreover, as a first step to becoming an IFC the government should allow all market participants to freely trade any financial asset denominated in any currency. Hence, liberalizing foreign exchange controls, particularly on capital account transactions, should be the utmost priority. However, the government failed to go beyond the existing commitment to liberalize capital account transactions by 2011.

Lastly, the first Roadmap was defective with regard to the organization responsible for planning and implementing the financial center initiative and reporting the progress to the President. The job of designing the strategy and reporting the progress in implementation was given to the Presidential Committee for the Northeast Asia Initiative, whereas the responsibility for implementation was given to the Ministry of Finance and Economy (MOFE). However, the Presidential Committee had neither expertise nor a professional staff to design the strategy. On the other hand, MOFE, which had both expertise and a professional staff, had no strong incentive to implement the strategy because it had no responsibility to report on the progress to the President.

The Seoul Financial Forum pointed out these conceptual and operational weaknesses in its second major report, *Korea as an International Financial Center: Policy Recommendations for Strengthening and Implementing the Government Roadmap,* September 2004. Due in no small measure to such efforts, the Roh government adopted a Second Financial Hub Roadmap in June 2005.

2.3 The Second Financial Hub Roadmap

Announced in June 2005, the second Roadmap remedied most of the weaknesses of the first Roadmap noted above.

First, the timeframe was tightened significantly. The completion date of the Roadmap was moved up to 2015 from 2020, and the three-stage implementation plan was revised so that most of the separate tasks involved were to be carried out concurrently.

Second, the original Roadmap's idea of focusing just on asset management until 2012 was revised so as to develop and utilize key financial sectors where Korea held comparative advantages, e.g., fixed-income, corporate restructuring, derivatives, and private equity.

Third, the government made a clearer commitment to liberalizing foreign exchange controls on capital accounts by setting the target date for this liberalization at 2009 instead of 2011.

Fourth, the responsibilities for designing and implementing policies for the IFC initiative and reporting the progress were now all placed with the Deputy Prime Minister for Economic Affairs, who is concurrently the Minister of Finance. In terms of the ease in mobilizing requisite manpower and expertise, this new arrangement was definitely an improvement. However, this arrangement also left much to be desired as will be discussed in Chapter 3.

2.4 Specific Policy Reform Measures Taken by the Roh Government

Apart from the revisions to the first Roadmap, over the past three years the Roh government has made a number of significant policy changes and reforms worth noting:

- Creating an Integrated Korea Exchange (KRX)

In January 2005, the Korea Stock Exchange (KSE) was merged with the Korea Futures Exchange (KFE) to create an integrated Korea Exchange (KRX).

- Allowing Foreign Companies to Use KRX as a Platform for Primary Listing

In 2006, the government authorized primary listings of shares by foreign companies on KRX, removing discrimination against foreign companies. However, KRX still requires foreign companies to submit the application for primary listing and related documents in Korean. In addition, unlike its counterparts in advanced countries, KRX still remains a non-profit organization.

- Encouraging the National Pension Fund and Other Pension Funds to Invest in Equities

In a move to not only deepen Korea's capital market, but also to encourage investments for high returns, the government authorized the National Pension Fund to increase its investments in equities in January 2005.

In December 2005, the government also adopted the policy of encouraging private sector firms to set up retirement funds in place of current severance payment accounts, which would encourage investment of funds not only in debt instruments but also in equities.

- Investment Trust Companies (ITCs) Restructuring Completed

In the years immediately following the 1997-98 crisis, government-initiated restructuring efforts of the financial sector were concentrated for the most part in the banking sector, but in May 2005, the government announced that it had completed the restructuring of distressed investment trust companies (ITC) carried over from the 1997-98 financial crisis.

- Deregulation of FX Controls

In July 2005, the government announced that effective January 2006, the system requiring advance permission for capital account FX transactions would be replaced by a system requiring ex-post reports. In November 2007, the government announced that all restrictions on overseas real estate investment and remittance would be removed by 2008. It also reaffirmed that any remaining FX controls on capital account transactions would be removed by 2009.

However, it is important to note that financial institutions still encounter many de facto restrictions on capital account FX transactions in their day-to-day operations. We shall cover this problem in Chapter 3.

- Asset Management Regulations Eased

In June 2005, the government reduced the minimum capital requirements to set up an asset management company specializing in derivatives, real estate, and private equity from KRW10 billion to KRW3 billion. The government also eased requirements to establish small-scale private equity funds specializing in motion picture and other cultural productions.

- Korea Investment Corporation (KIC) Launched

On July 1, 2005, the Korea Investment Corporation (KIC) was launched for effective management of public funds, such as excess foreign exchange reserves and other public funds currently managed by different agencies, including the National Pension Service.

- Capital Market Consolidation Act (CMCA) Enacted

With the aim of removing barriers and fragmentation among various financial markets, the Capital Market Consolidation Act (CMCA) was passed by the National Assembly in July 2007. The CMCA also calls for a change in Korea's regulatory regime from the current positive list system to a negative list one. The CMCA is also function-based, i.e., financial functions of the same nature will be governed by the same regulations irrespective of the type of financial institutions engaged in the transaction. It should be noted that the CMCA will take effect in February 2009.

- A Step to Promote the Long-term Bond Market

In 2006, the government started issuing 20-year bonds to give rise to a "yield curve" for the economy.

- Graduate School of Finance Launched

In order to increase the domestic supply of financial professionals, a graduate school of finance was launched by the Korea Advanced Institute of Science and Technology (KAIST) with help from the government in March 2006, offering a two-year MBA program in finance.

It is worth noting that stimulated by this KAIST initiative, other universities in Korea have also started similar programs, often jointly with their counterparts in the US and UK.

- Established the International Supervisory Support Office

In 2006, an International Supervisory Support Office was established within the Financial Supervisory Service (FSS) to serve as a "help desk" for foreign financial institutions and investors.

- Law on the Promotion and Development of the Financial Center Enacted

In order to provide a statutory basis for promoting and developing an IFC, the government submitted a bill called the Law on the Promotion and Development of the International Financial Center to the National Assembly. The bill was passed in November 2007.

- Foreign Financial Institutions Allowed to Establish Financial Holding Companies

In 2006, the government amended the Financial Holding Company Act to allow foreign institutions to operate as financial holding companies in Korea.

- Roadmap for Advanced Financial Supervision Announced

In October 2007, the FSS announced its Roadmap for Advanced Financial Supervision with the aim of upgrading Korea's financial regulatory regime from a rule-based to a principle-based one. Some 100 tasks were identified to achieve the goal, and the target date for completing these tasks was set at 2010.

2.5 Outcomes of the IFC Initiative to Date

It is by no means easy to assess the progress towards becoming an IFC. First, there must be an agreement as to what precisely constitutes the key contributions to the success of an IFC. For some, this success should be measured in terms of the incremental number of new foreign financial institutions coming to Korea. For others, the progress should be measured in terms of additional job creation that comes from becoming a financial center. The SFF believes that the ultimate criteria should relate to the contribution that the activities in the financial center makes to the growth of GDP, increase in high-value added employment opportunities, and growth in national wealth.

In any case, it is still too early to assess the impact of the various policy changes and reforms undertaken by the Roh government in terms of the criteria just noted. However, there have been a number of significant developments so far:

- Prudential International Investment Set Up Its Asian Head Office in Seoul

In the fall of 2005, Prudential International Investment of the Prudential Financial Group established its Asian head office in Seoul.

- Macquarie Financial Group uses Korea as the Operational Base for Its Asian Business

Over the past five years, Australia's Macquarie Financial Group has found Korea hospitable in increasing its infrastructure funding business. The number of employees for its infrastructure operation increased from less than 10 in 2000 to over 350 by 2005. It is now looking to expand its infrastructure business in other Asian countries jointly with Korean institutions.

- AIG Undertaking Construction of SIFC

AIG, an international insurer, signed a US$1.4 billion contract with the Seoul Metropolitan Government to build the Seoul International Financial Center (SIFC) in Yoido and began construction in 2006. AIG expects to complete the complex in 2009.

- Chinese Companies Begin Listing on KRX

In 2007, two Chinese companies used KRX as the platform for their primary listing, marking the first outcome of KRX's efforts to internationalize its operations.

- Growing International Interest in Korea as an International Financial Center

In April 2006, *The Financial Times* organized and hosted the "Asian Financial Centres Summit" in Seoul and provided an opportunity for evaluating Korea's multi-faceted efforts towards building an international financial center.

- Expanding Financial Markets

Korea’s financial market and activities have grown rapidly over the past 3 to 4 years.

For example,

- The market capitalization of the Korean stock market rose from US$330 billion in 2003 to US$1 trillion by August 2007, a nearly three-fold increase.

- The daily trading volume on the Korean FX market grew from US$12 billion in 2003 to US$40 billion by 2Q 2007, a 3.5-fold increase.

2.6 Korea Still Ranks Low as an IFC

Despite many policy changes and reforms undertaken and the encouraging developments noted above, Korea still remains low in various international surveys evaluating the effectiveness of different cities or countries as financial centers. On the one hand, a 2007 MasterCard survey indicates that Seoul ranks in the top nine out of the fifty international financial centers surveyed. On the other hand, the “Global Financial Centres Index” published by the City of London in March 2007, ranks Seoul 43rd among the 46 financial centers surveyed. One thing these surveys show is that Korea still has many problems and issues it has to resolve before it can be recognized as the premier financial service center in Northeast Asia. These issues and challenges will be the subject of the following chapter.

Chapter 3. ISSUES AND CHALLENGES KOREA HAS YET TO ADDRESS

There is little doubt that the Roh government has done its best to build Korea as the premier IFC in Northeast Asia. To this end, it has implemented a number of important policy reforms as noted in Chapter 2. However, there is no denying that the Roh government could have done more. In any case, there are many issues and challenges that must be addressed before Korea can function as a world-class financial center.

Broadly speaking, these issues and challenges fall into five categories. First, over the past two years the Roh government has lost momentum in implementing the strategy for an IFC. Except for the passing of the Capital Market Consolidation Act (CMCA), it has implemented few major policy changes or reforms. This was due in no small measure to the decline in political power that President Roh experienced towards the last phase of his administration. But this could have been avoided if the Roh government had put in place a powerful coordination mechanism for the IFC initiative at the time the initiative was announced.

Second, the Roh government has made efforts to implement financial regulatory reform, but owing to the absence of a clear overall philosophy as well as lack of cooperation from regulators, the regulatory regime in Korea has not yet been brought up to the levels and standards found in the UK and elsewhere.

Third, for the nation to become a world-class financial center, it is not enough to reform financial regulations. It also has to improve the overall business environment by undertaking fundamental reforms beyond the financial sector.

Fourth, it is worth noting that under the Roh administration, the drive for privatization that had started under previous administrations has been put on hold. In the field of finance, this has caused a great deal of confusion with regard to the identity of principal players, particularly in capital markets.

Lastly, in any drive towards an international financial center, domestic policy reforms should go hand in hand with efforts to publicize the progress the country is making not only to its own people, but to the international community as well. The Roh government's performance in this regard has been lackluster at best. As a result, the Roh government has failed to secure strong support for the financial hub initiative from both its domestic constituency and the international community.

The purpose of this chapter is to analyze and evaluate these issues and challenges.

ABSENCE OF EFFECTIVE POLITICAL LEADERSHIP AND POLICY COORDINATION

3.1 Losing Momentum in Implementing Reforms for the IFC Initiative

As noted in Chapter 1, the Roh government first chose 2020 as the target date for the completion of reforms for the financial center initiative. Then in 2005, it advanced the date to 2015 with the adoption of the second Roadmap. In the months following this adoption, it quickly implemented several policy changes and reforms in succession. However, since the fall of 2006, few notable policy changes have been implemented to this day with the exception of the enactment of the CMCA in July 2007. With the loss of momentum in policy reforms, Korea has been put in danger of losing the race of becoming a world-class financial center ahead of its competitors in Northeast Asia. In this regard, it is particularly noteworthy that on December 21, 2007, the Japanese Financial Services Agency announced an ambitious plan to boost the appeal of Japan's capital markets by undertaking large-scale deregulation of stock exchanges, funds, and financial institutions. In view of such developments, there is a real danger that unless Korea quickens its pace of progress, it will not be able to achieve the goal of becoming a world-class financial center even by 2015 let alone an earlier date.

3.2 Political Dynamics Underlying the IFC Initiative

Transforming a nation into a world-class IFC entails wide-ranging reforms on social, political, and cultural fronts. These reforms give rise to different kinds of benefits and costs to different social groups. As is the case in so many economic and social reforms, most of the benefits from becoming an IFC are of a "public good" nature. As seen in Chapter 1, the benefits include higher economic growth, increases in high value-added employment opportunities, Korea's enhanced diplomatic status, and better prospects for peace and prosperity on the Korean peninsula. For ordinary citizens, these benefits are difficult to appreciate. More importantly, these benefits would be available to them even if they did not make individual contributions to the nation's efforts in becoming an IFC. In other words, the benefits from becoming a financial center would accrue to all, even if they did not make an individual contribution. Because of these peculiar characteristics of the benefits from becoming an IFC, it would be difficult to push ahead with the IFC initiative unless there is strong political leadership at the very top.

However, the costs of becoming an IFC are more immediately perceived by many groups in society. For example, in order to become an international financial center, there is a need to increase competition in financial markets. This would mean greater allocation of investment capital through a competitive market mechanism, which hurts those business groups who have enjoyed privileged access to credit. Similarly, many bankers, who have been used to playing the role of credit allocators following a set of guidelines issued by the government under the closed domestic financial market, would experience a loss in power and prestige if the financial market becomes open and highly competitive. Also, labor unions in the financial sector that have been used to sharing the comfort of the closed domestic financial market with management would be reluctant to accept the consequence of an open and competitive financial market. Policymakers and bureaucrats who have had much influence over the allocation of credit under the closed financial system would have no reason to be enthusiastic about the introduction of an open and competitive financial market environment either because they would not only have less power and influence than before, but also because they would have to deal with more complex markets.

In short, to push ahead with the IFC initiative, the Roh government should have made systematic efforts not only to mobilize public support, but also to overcome resistance from a number of groups, including some policymakers and regulators. In retrospect, this is one thing that the Roh government failed to do. We will see this in more detail in the pages that follow.

3.3 The Roh Government's Failure in Designing a Proper Coordination Mechanism

It was indeed remarkable that President Roh readily understood the enormous benefits the country would receive from becoming an IFC. He also understood the importance of Korea's becoming an international financial center in terms of the value for Korea to become an overall business center in Northeast Asia. In addition, he understood that becoming a financial center was critical to transforming Korea from a manufacture-based to a knowledge-based service economy. Nonetheless, over the two past years, President Roh was not at all effective in providing strong leadership for the financial center initiative. This was due in large measure to his failure to put in place an effective coordination mechanism within the government.

As already noted in Chapter 2, President Roh first assigned the responsibility for designing and implementing the financial center initiative to the Presidential Committee for the Northeast Asia Initiative. This committee, however, had neither sufficient manpower nor expertise to carry out its responsibilities. The subsequent transferring of the responsibility to the Presidential Council for National Economic Policy was no improvement in this regard. Only when he decided to give the assignment to the Deputy Prime Minister for Economic Affairs, concurrently serving as Minster of Finance and Economy, did the situation improve. However, it is worth emphasizing that under both the Roh Moo-hyun and the Kim Dae-jung governments the Deputy Prime Minister (DPM) has not been endowed with sufficient power to coordinate policies among all economic ministries. This is due to the fact that unlike in the past, the DPM no longer has the power to allocate budgetary resources within the government.

3.4 Failure to Launch a Presidential Advisory Council

Implementing the vision of Korea becoming the premier IFC in Northeast Asia requires a great deal of knowledge and expertise. In addition, the task requires drawing on experiences of other countries. For this reason, the SFF recommended establishing a Presidential Advisory Council composed of world-class experts and professionals from home and abroad. But due in no small measure to overly nationalistic sentiments and a lack of familiarity with the world outside the country on the part of President Roh's close aides, commonly referred to as "386ers," this recommendation has never been adopted. In retrospect, this was a serious omission, if not an outright fault.

INSUFFICIENT PROGRESS WITH REGULATORY REFORM

3.5 Little Progress in Implementing a Negative List Approach

Since the adoption of the first Roadmap in December 2003, Korean financial regulatory authorities have indicated many times the overall direction in which the system of regulations ought to be reformed. The key message has been that the approach to Korea's financial regulations will be converted from the current positive list approach to a negative list approach. However, in actuality, the implementation of this change has yet to take place. The CMCA, which was enacted in July 2007, provides the legal basis for this shift, but it will not take effect until February 2009. Before an actual shift to the negative list approach takes place, the nation cannot expect significant innovation in financial products and processes.

Over the past year, the Korean authorities have also discussed the need to adopt principle-based regulation as opposed to rule-based regulation. In October 2007, the FSS announced it would complete the transition from its current rule-based to principle-based regulation by 2010. However, the specific steps by which to implement this transition have yet to be proposed. But what should be noted is that the current Korean approach to regulation falls far short of a rule-based approach let alone a principle-based one. This is the case because, to this day, Korean regulators tend to exercise far too much discretion. Recently this has been particularly true in the area of license applications, as we shall see shortly.

3.6 Excessive Discretion Interfering with Market Principles

Historically, the tendency to exercise too much discretion on the part of policymakers and regulators in Korea stems from two sources. With Korea's culture steeped in Confucianism, civil servants are held in high esteem. Furthermore, many civil servants believe that they know what is good for the people better than the people themselves. Such an orientation of Korean civil servants was reinforced during the period of government-led economic development in the 1960s and '70s.

Such behavioral tendencies often result in actions contrary to market principles. As a matter of fact, Korean policymakers and working-level bureaucrats far too often produce policies that in effect dictate the development of an industry rather than facilitate the evolution of the industry in accordance with market principles.

The propensity on the part of Korean bureaucrats and regulators to exercise excessive discretion takes many forms. Sometimes it takes the form of explicit action, while other times it takes the form of passive resistance, i.e., not taking any action when policies coming from above are not in the interests of bureaucrats. Delays experienced by many foreign institutions in the approval of license applications in recent years are a case in point.

In recent years, the frequency of inaction has stemmed from yet another source. With the advancement of democracy, the Board of Audit and Inspection (BAI) has become powerful. As of late, the BAI has passed ex post judgment not only on whether rules and regulations were followed in pursing a policy, but also on the very merits of the policy itself. Because of such activism by the BAI, many policymakers and working-level bureaucrats would rather do nothing than being held responsible later for what they had done before. As will be seen shortly, a good case in point is the reluctance shown by the FSS to take any action towards an early resolution of the issues surrounding Lone Star's desire to sell its stake in the Korea Exchange Bank.

3.7 Growing Influence of Interest Groups

There is another reason why Korean government agencies, including the financial regulatory authorities, in recent years have taken such a long time to take action on an appeal or application for business licenses. In the days of government-led economic development, any petitions or applications were acted on promptly by bureaucrats. The only criterion they cared about most was whether or not the action was justified in terms of the contribution it made to the economic development of the country.

But, today, under democracy where competing interest groups carry enormous political weight particularly vis-à-vis the national legislature, both policymakers and bureaucrats think twice about how those interest groups would react before they take any action. For the reasons indicated in Section 3.2 above, however, many of those interest groups are not necessarily in favor of globalization or opening domestic markets to foreign players. Indeed these interest groups have been acting as protectionists in the financial sector. Needless to say, resulting delays in action are perfectly understandable in terms of the political dynamics at work, but they are neither in the overall interest of the nation nor in accord with the nation's need for globalization.

3.8 Insufficient Professionalism and International Exposure of Financial Regulators

The present FSS came into being shortly after the financial crisis in 1997-98. The FSS today is an amalgamation of several separate regulatory bodies: the Banking Supervisory Board, which was affiliated with the Bank of Korea; the Securities Supervisory Board; and the Insurance Supervisory Board. The quality of personnel from these different organizations was highly uneven. Furthermore, their orientations, particularly with regard to globalization, were very different. Some people were far too parochial and nationalistic in their outlook and far too few have sufficient international exposure and a willingness to be open-minded. In fairness, it should be noted that the FSS has recently initiated programs to enhance the international exposure of its employees. But it should be emphasized that over the past several years, these people from different backgrounds and with different orientations have been put under one roof and urged to do their jobs in accordance with global standards. So it is no surprise that many problems and difficulties have occurred. Some of these include an inadequate understanding of developments in global financial markets, an inability to effectively communicate with both domestic and foreign institutions and unnecessary friction with "clients."

Ironically, the personnel policy of the regulatory authorities in Korea, particularly the FSC and FSS, has added to these problems. Frequent rotational assignments of personnel in regulatory bodies, insufficient number of regulators who have substantive professional experience in the private sector, and a low number of regulators who have on-the-job training at regulatory agencies overseas have strengthened the tendency to perpetuate outmoded regulations.

3.9 Increasing Tendency to Resort to Window-Guidance by Regulatory Authorities

Many problems and difficulties that have been encountered by foreign financial institutions over the past two years illustrate the bureaucratic behaviors noted above. For example, over the last two years, it has been the practice of the FSS to advise applicants for new business licenses on whether and when the FSS is ready to receive applications. A number of foreign firms have been provided with verbal indications that the FSS is not ready to receive their applications.

3.10 Conflict between the Rise of the Global Economy and Regulations by National Authorities

As far as economic activities are concerned, they are increasingly becoming more globalized, i.e., many interconnected economic activities even within a firm are being carried on in several national jurisdictions, but virtually all financial regulations or for that matter any regulations bearing on economic activities are carried out by national authorities whose primary concerns and capabilities do not extend beyond national borders. This gives rise to many new problems as well as complications in regulations. One such problem occurs in cross-border sharing of back office functions. Whereas it is in the interest of individual financial institutions to make use of back office functions usually located in some large business center outside the country, national regulatory authorities would like to see those functions carried out within national boundaries.

The Business Delegation Act legislated in 2000 regulates the outsourcing/delegation of non-core business functions to affiliates or third parties as well as the sharing of non-core functions between legal entities of the same group operating in Korea. Under this Act, there is a list of core/essential functions that cannot be delegated, i.e., negative list. This negative list covers front office activities but does not cover any back office functions. Nevertheless, the FSS is very reluctant to approve any delegation of back office functions to offshore affiliates. Moreover, particularly for foreign financial institutions in subsidiary status, the FSS appears to take the view that a subsidiary, being a locally incorporated company, should not rely on operating systems residing in offshore servers, which forces foreign financial institutions to treat their subsidiaries in Korea as "stand alone" operations, which runs counter to the global management of groups. However, foreign financial institutions in the form of branch offices are allowed a little more flexibility in this respect. In any case, there is little question that these FSS practices add to the operational costs for foreign players in Korea. In this regard, it is worth noting that the FSS has set a two-year deadline to resolve issues related to the overseas transfer of financial information and data processing under the Korea-US FTA.

However, it should be highlighted that Korea is the only country in the world that insists that foreign firms applying for a new business licenses must not use any of their global operating systems residing in offshore servers. As a result, the processing time for new licenses is currently prolonged to 9 to 12 months. This also amounts to an entry barrier to foreign players.

3.11 De Facto FX Restrictions on Capital Account Transactions

It goes without saying that for Korea to become a world-class IFC there should be no foreign exchange (FX) controls on capital account transactions. Bearing this in mind, the Roh government to its credit advanced the target date for full liberalization on capital account transactions from 2011 to 2009. Recently, the government also announced that it would abide by this commitment.

However, many foreign financial institutions and other investors continue to experience many de facto restrictions at the operational level. First, "prior discussion" is required with MOFE in the case of cross-border loan transactions between residents and non-residents in both local and foreign currency before the loan transactions are reported to one of the "foreign exchange banks" authorized by the government to carry out foreign exchange transactions.

Second, non-bank market participants in the foreign exchange market are also required to provide documentary evidence of underlying FX transactions in the form of "original" transaction records. Partly as a result of these burdensome documentation requirements, many international corporations' global treasury offices have resorted to the NDF market where FX forwards are traded between offshore banks and non-resident counterparties on a non-deliverable basis. It should go without saying that for Korea to stimulate the rapid development of FX markets at home, continued reliance on the NDF market is far from optimal, i.e., it is a second best solution.

Third, Korea experienced a sharp rise in its short-term external debt position over the past two years. Reportedly, short-term offshore borrowings by foreign bank branches were one of the major contributors to this rise. As short-term external debt continued to rise, Korean authorities, including MOFE and BOK, were concerned with financial instabilities that might result. This concern led authorities to take a number of direct measures to curb offshore borrowings in 2007. These efforts were problematic on at least two accounts. First, it undermined the credibility of the earlier policy of liberalizing FX controls on capital account transactions. Second, the measure for all practical purposes failed to achieve what the government wanted. For one thing, as a result of the direct measures to restrict offshore borrowings by foreign bank branches, the onshore-offshore basis swap rate differential has widened and created new offshore arbitrage opportunities for offshore investors. To the extent that offshore investors have purchased short-term KRW bonds, this has translated into an increase in the short-term external debt position of Korea, the very outcome that the government has been trying to avoid.

3.12 Problems in the Debt Market

Before the 1997-98 financial crisis, Korea's bond market was large enough to rank No. 1 in Asia behind Japan. Moreover, the market was well balanced. In 1995, private corporate bonds accounted for 45% of the total bond market. In recent years, the government bond market continued to grow, but the corporate bond market has shrunk. To be sure, the amount of corporate bonds outstanding grew from KRW 119.4 trillion at the end of 1998 to KRW 141.3 trillion at the end of 2002. Since 2002, however, there was a steady decline in the corporate bond market with the total amount of corporate bonds outstanding registering at KRW 101.3 trillion at the end of 2006. As the corporate bonds outstanding continued to shrink, its share of the total bond market fell dramatically. At the end of 2006, this share was only 13.0% of the total. It is also worth noting that during the entire 1998-2006 period, the amount of bonds issued by foreign entities was negligible. Their shares in the total bond market ranged 0.2%-0.3%.

The explanation for the continued shrinking of the corporate debt market is several-fold. Over the past several years, business demand for new investment was rather weak. Hence, corporations had no need to raise money externally. As a matter of fact, many large companies had enough internal funds of their own. As a result, they did not bother to issue new bonds. Some small companies had a need for external funding, but their credit standing was too poor to issue new bonds. From investors' point of view, Korean corporate bonds did not have the quality they wanted. In their opinion, the rating services provided by domestic firms did not meet professional standards. In addition, the data and information they needed to assess the credit ratings of issuers of new bonds were not readily available.

Whatever the causes, the continuing shrinkage of the private bond market has serious consequences for the national economy. For one thing, with other things being equal, the shrinkage of the corporate bond market means a lesser ability for corporations to undertake long-term investment. For another, the corporate sector is compelled to rely more on bank financing. However, commercial banks are not in the best position to price risks associated with long-term investments. Furthermore, limited availability of long-term corporate bonds handicaps the growth of players in other parts of the financial sector, such as insurance companies and pension funds. In the absence of a large and deep domestic debt market, these institutional investors look offshore to riskier markets to invest their assets. So, the question to ask is why should domestic institutional investors with long-term domestic currency liabilities need to invest in foreign currency instruments issued by foreign entities in foreign markets, thereby assuming not only foreign exchange risk, but also less definable risks involved in dealing with unfamiliar markets and issues far from home and without the protection of the Korean legal and regulatory system?

In short, for Korea to become a full-fledged IFC, it should overcome all these problems plaguing the development of private bond markets.

3.13 The Continuing Ban on Hedge Funds

The current ban on hedge fund operations in Korea also illustrates problems with Korea's regulatory system and the orientation of its bureaucracy. In 2004, the "Indirect Investment Asset Management Act" was legislated with the purpose of encouraging indirect investment by households and institutional investors. But, instead of taking the negative list approach, the legislation took a positive list approach. The positive list specified in the legislation failed to include hedge funds on the ground that hedge funds make too much use of high leverage, short positions, and derivatives, which were judged to be detrimental to the protection of investors. Obviously, it did not occur to the overly paternalistic Korean bureaucrats who drafted the legislation that a limited number of high net worth individuals and highly professional investors who run hedge funds do not need protection from the government.

Moreover, one should note that as observed in a recent McKinsey report, hedge funds not only constitute one of the five biggest power brokers in today's international financial markets, but they also represent the most important alternative form of investment for the global community today. Thus, delaying the introduction of this important new financial product to operate in Korea has seriously slowed down the development of its capital markets.

INSUFFICIENT EFFORTS TO IMPROVE THE BUSINESS ENVIRONMENT

It goes without saying that for a nation to become a world-class financial center, it should have a first-rate business environment where all businesses can be conducted expeditiously and at low costs. Although the Roh government has made a great deal of effort precisely for this purpose, the Korean business environment in general still leaves much to be desired. For one thing, the country is still known for the militancy of its labor unions. For another, due to recent developments, including the Lone Star case, confidence in the nation's rule of law has been undermined. Furthermore, Korea's legal services market still remains closed causing higher costs for financial transactions. By way of taxation, the fundamental structure of Korea's tax system is not at all competitive vis-à-vis Hong Kong and Singapore. In addition, many foreign investors in particular experience a great deal of difficulty because Korea's tax administration still lacks transparency. For the financial industry in particular, Korea's tax system is problematic for another reason. Korea imposes a variety of taxes on financial transactions causing a great deal of tax friction without yielding significant tax revenue.

3.14 Militant Labor Unions

Survey after survey shows that problems caused by militant labor unions represent one of the biggest impediments to direct foreign investment in Korea, including investment in the financial sector. The 2006 annual report from Korea's Investment Ombudsman Office showed that problems related to labor unions accounted for approximately 11% of all grievances filed by foreign investors, the second largest category after tax and tax audit grievances.

According to the OECD, Korea ranks 17th out of the 28 OECD member countries in providing employment protection. Actually, this is an understatement. For all practical purposes, foreign and large domestic companies do not have the freedom to dismiss regular full-time employees. They usually have to pay extraordinary amounts of early retirement allowance to induce voluntary resignation. The legislation to protect non-regular workers passed in 2006 has further reduced managerial flexibility in hiring and firing workers. In addition, Korean unions are often very militant and demand a voice in managerial affairs. In this process, they do not mind even physical confrontation with the police. Moreover, some Korean unions exploit anti-foreign sentiment in their dealing with foreign investors, ignoring the immense contributions foreign capital has made to Korean economic development. All of these problems caused by militant labor unions have been particularly troublesome in the financial sector because, being a knowledge-based industry, the financial sector requires labor flexibility more than any other industry.

The militancy of labor unions in Korea stems in large part from the political and ideological orientations of the labor movement. Unlike their Western counterparts, many Korean labor leaders are not satisfied with the goal of only improving the economic welfare of their followers. They want to achieve their political aims based on their left-wing ideology as well. This in part explains the difficulties management experiences in negotiating with union leaders. However, it should be noted that many union members follow their leaders because they are very insecure with the prospects of securing a basic livelihood for their families in the event they are unemployed. By international standards, both the amount and duration of unemployment insurance are very low in Korea.

3.15 The Lone Star Case and Rule of Law in Korea

It was noted in Chapter 1 that the rule of law has made more progress in Korea than many other countries in Asia. However, foreign investors' perception of Korea's rule of law has undergone a dramatic change for the worse over the past two years. This has a lot to do with the manner in which the Lone Star case has been handled.

In 2003, the Korean government sold the Korea Exchange Bank (KEB) to solve a serious capital shortage at KEB brought on in part by the over-extension of credit cards during the 2001-2002 period. At that time, the Korean government was not prepared to inject public funds to rescue KEB, and there were very few buyers domestic or international. Lone Star was one of the few who were willing to put fresh capital into KEB. The Korean government approved Lone Star as the majority shareholder of KEB and, in October 2003, Lone Star successfully acquired a majority stake in KEB.

Some time after the transaction closed and Lone Star's efforts to improve KEB's balance sheets, the value of KEB shot up tremendously. Thereafter some people, including certain politicians, began to make accusations that the transaction was completed at an unfairly low price, raising questions on the legal qualifications of Lone Star as the majority shareholder. These accusations resulted in two National Assembly investigations and demands that the government take action against Lone Star.

The BAI, FSS and the National Tax Service (NTS) commenced investigations and concluded that there was some suspicion surrounding the transaction and referred the matter to the Prosecutor's Office. The Prosecutor's Office concluded that unlawful activities were committed by former officers of KEB and Korean government officials, and the court proceedings continue to this day. During the course of the prosecutor's lengthy investigation, they also concluded that some directors on the KEB board, appointed by Lone Star, engaged in unfair stock price manipulation in order to fully acquire the KEB credit card business, in which KEB owned 40%. While unrelated to the Lone Star acquisition of KEB, this case is also now pending before the court.

In the meantime, Lone Star has attempted to sell its stake in KEB. Lone Star first reached an agreement with Kookmin Bank (KB). However, the FSS refused to approve the sale while the trial against the former KEB President and Ministry of Finance official was pending. Given the prolonged legal proceedings, the agreement with KB expired and was later terminated. Subsequently, another agreement was reached with Hong Kong Shanghai Banking Corporation (HSBC) to sell Lone Star's stake in KEB, and that contract is now pending.

The FSS now takes the position that the sale of KEB can be approved after the pending court cases are concluded. If this policy continues, the sale of KEB and the continuing Lone Star controversy will continue for another five years or so until the litigation surrounding the KEB acquisition is resolved. The problem with this position is that the case pending with respect to the KEB acquisition does not involve Lone Star. Lone Star nor its officers are defendants in this case, and despite numerous investigations by the National Assembly, the BAI, the FSS and the prosecutors, no allegations have been brought against Lone Star that they acted improperly in the acquisition of KEB. The stock price manipulation case does not involve the KEB acquisition.

Legal experts have concluded that even if the case against the former KEB president and the MOFE official results in a guilty verdict, no action can be taken to invalidate the acquisition by Lone Star. A guilty finding in the stock price manipulation case may have impact on the qualification of Lone Star to remain a major shareholder in a financial institution, but the result of that would be an order requiring Lone Star to sell its shares in KEB. Thus, the policy preventing Lone Star from selling its shares of KEB stems more from an emotional reaction of trying to prevent Lone Star from earning any profits on the sale of its shares than enforcing any provisions of Korean law and protecting the interests of financial markets or other shareholders of KEB. Rightly or wrongly, this issue has grown to become a key focus of attention for existing and potential foreign investors in Korea. Any international gathering on investment in Korea immediately is dominated by the Lone Star issue. In the minds of foreign investors, the Lone Star case has created the strong impression that Korea is inconsistent in its policies encouraging foreign investment and enforcing its laws on foreign investors. The perception among most foreign investors has become that foreigners are welcome in Korea as long as they do not make too much money. There is little doubt that one of the most important reasons for the steady decline in the inflow of direct foreign investment since 2004, when the annual inflow peaked at US$12.8 billion, is these sentiments sparked by the Lone Star matter.

3.16 Need to Improve the Legal Services Environment

The SFF has long recognized the critical importance for Korea to open its legal services market as part of its efforts to build an IFC. However, this market still remains closed. As a consequence, many financial institutions in Korea are compelled to secure a great deal of their international legal services from law firms based in Singapore and Hong Kong. In so doing, they unnecessarily incur higher costs than would be the case if those services were directly provided by foreign law firms based in Seoul.

In addition, if Korea's legal services market were opened, far more legal expertise would be available in Korea. This would not only contribute to enhancing the quality of financial regulations in Korea, but also reduce risks in financial transactions.

PROBLEMS IN TAXATION

In the field of taxation, the challenges Korea ought to address as part of its efforts to build an international financial center are fourfold.

3.17 Korea's Complicated Personal and Corporate Income Tax Laws

Korea needs to address the problems caused by its highly progressive personal and corporate income taxes. Korea's highest marginal tax rate of 35% in personal income tax is much higher than that of 17% in Hong Kong and 26% in Singapore. There is little question that such a high marginal tax rate reduces the incentive of many financial professionals to come to Korea. The same is true of corporate income tax. Korea's highest corporate income tax rate applicable to corporate profits in excess of KRW100 million is 25%, while the highest corporate income tax rate in Hong Kong and Singapore are 17.5% and 20%, respectively. Needless to say, these differences in marginal tax rates put Korea at a disadvantage in attracting foreign financial firms.

A point that should be highlighted in this regard is that the highly progressive personal and corporate income tax rate structures in Korea have not contributed much to the improvement of income distribution. On the contrary, if anything, those progressive rate structures have done the very opposite. The high marginal tax rates create added incentives to avoid taxation. Over the years, these incentives have translated into strong pressure on the national legislature and tax authorities to grant more deductions and exemptions. As a result, tax deductions and exemptions have proliferated. This proliferation in turn has not only undermined progressivity in personal and corporate income taxes, but has also made the nation's tax laws extremely complicated. Complicated tax laws in turn constitute a breeding ground for corruption.

In order to deal with incentive problems due to high marginal tax rates in Korea's personal income tax, the Roh government passed an amendment to the Restriction on Tax Deduction and Exemption Act in 2004 that allows foreign executives an alternative way to determine their income tax obligation. Under this amendment, they can deduct 30% of their total gross income as business expenses or apply a flat tax rate of 17% to the gross income. This alternative way of determining tax liabilities for foreign executives who are working in Korea is at best a temporary expediency creating its own problems. For example, there is the question of equity between foreign and Korean executives.

3.18 Inconsistent Interpretations of Tax Laws

Many foreign investors who actually run their businesses in Korea have complained that the Korean tax authority far too often interprets tax laws and regulations very differently from the experts they hire. Actually, given the complexity in Korean tax laws, it would be a surprise if there were no complaints from taxpayers with regard to different interpretations of tax laws and regulations by tax authorities.

Aside from the complexity of tax laws, there is another reason for frequent disputes between tax authorities and payers on the meaning of tax laws. As Korean tax officials are often under great pressure to maximize the amount of tax revenue collected, they frequently tend to overlook niceties in the interpretation of tax laws. What's more, over the past several decades, the National Tax Service (NTS) has evolved into an organization, which for all practical purposes is a law unto itself. Although organizationally the NTS is under the jurisdiction of MOFE, MOFE seldom supervises NTS operations. This has been the case due in part to the fact that the NTS was often used as an instrument of political control under the successive military regimes. Under the outgoing Roh administration, however, the NTS was not used as such a tool. But, over the past year or two, it was used far too frequently as an instrument of implementing its real estate policies. In any case, the oversight of the NTS has been less than sufficient.

In short, the NTS today is somewhat of an anomaly within the overall structure of the government in Korea. This institutional reality goes far towards explaining why the NTS tends to be more arbitrary in interpreting tax laws than its counterparts in western countries. In addition, this same reality helps explain why the NTS has suffered from corruption at the highest level as has been made clear by the recent scandal.

3.19 Tax Frictions

In the eyes of foreign financial market players, there are many unnecessary taxes imposed on financial transactions. Strictly speaking, it is difficult to characterize any taxation as unnecessary in the sense that all governments need certain sources of revenue. However, when certain taxation creates many problems hindering productive transactions between or among market players, that taxation can be characterized as unnecessary. In the Korean context, the education tax of 0.5% is imposed on financial transactions by banks, but not on transactions by securities companies, even though they sometimes deal with the same products, e.g., swaps and CMA deposits. The Securities Transfer Tax of 0.3% on listed stock and 0.5% on unlisted stock transfers is another example. The amount of market friction caused by this tax cannot be justified by the amount of revenue it creates for the government.

3.20 Problems Related to Tax Treaties

There is another area in taxation that has caused a great deal of uneasiness on the part of foreign players in Korean financial markets. Over the past 15 years, many foreign investors have employed certain investment structures to make investments in Korea, including stocks and bonds, foreign direct investments, and offshore bank loans from offshore jurisdictions that have favorable double tax treaties with Korea. These investment structures have been set up taking into account international tax principles, e.g., OECD Guidelines. In the past, the Korean tax authorities did not challenge such foreign investment structures.

However, in May 2006, the Law for the Coordination of International Tax Affairs governing international transactions was enacted to include the codification of the "substance over form" principle and beneficial ownership requirement. MOFE also started renegotiating existing tax treaties with several countries, including Ireland, the Netherlands, and Belgium, with the aim of limiting tax benefits in such treaties. MOFE further introduced a "Special Withholding Procedure," effective July 1, 2006, applicable to certain designated jurisdictions considered to be tax havens, whereby the treaty benefits will only be available to the offshore investor who can prove beneficial ownership of the relevant income. For the moment, only Labuan in Malaysia has been designated as a region to which this procedure is applicable.

In line with these developments, Korean tax authorities have been aggressively reviewing past foreign investments in Korea made by EU countries that have favorable tax treaties with Korea, with a view to challenging foreign investors' beneficial ownership of Korean sourced income and denying treaty benefits. To the extent that foreign investors used their subsidiaries in third countries to make investments in Korea, Korean tax authorities are now seeking to retroactively deny such treaty benefits. Imposition of retroactive taxes would be disturbing to foreign investors who made their investments relying on legal and tax expert opinions as well as accepted market practice. Moreover, such imposition would amount to an override of the treaties Korea has signed. There is little question that resolving these issues would go far towards eliminating frictions between foreign financial institutions on the one hand and the Korean government on the other.

NEED TO REDEFINE THE ROLES OF PUBLICLY-OWNED FINANCIAL INSTITUTIONS

Developing Korea into a world-class financial center entails redefining the roles of publicly-owned financial institutions. In any world-class financial center, the primary role is carried out by players from the private sector competing on equal terms. If, for any reason, public institutions with their unique advantages enter into competition against players from the private sector, this would lead to distortions in financial markets, i.e., destroy the level playing field. This outcome would undermine the most efficient intermediation of savings and investment, a result highly undesirable from the point of view of national welfare. Hence, reviewing how publicly-owned financial organizations have operated is critical.

3.21 Need to Review the Suspended Privatization Policy

While the majority stakeholder in the Industrial Bank of Korea has been the government all along, in the course of resolving difficulties in the banking sector following the 1997-98 crisis, some private-sector banks were merged into the Woori Financial Group and came under the ownership of the government as well. Although it was the government's intention to transfer the ownership of these two government-owned banks to the private sector, they are still owned and operated under government supervision on account of the Roh government's policy of suspending privatization of all government enterprises including financial institutions. For the efficient operation of financial markets in Korea, this policy of suspending privatization should be reviewed as soon as possible.

As a matter of fact, similar reviews are in order for those Korean financial institutions, such as the Postal Financial Service and the National Federation of Agricultural Cooperatives, whose public ownership have never been questioned. For the long-term healthy growth of Korea's financial sector in general and capital markets in particular, it is time to review the roles of these institutions.

In addition, special scrutiny must be given to three public financial organizations in particular at this point in time. They are the Korea Development Bank (KDB), the National Pension Service (NPS) and the Korea Investment Corporation (KIC).

3.22 Need to Redefine KDB's Role

Even before the 1997-98 financial crisis, the continuing roles of state-owned banks were questioned in Korea's market-oriented economy. At the time, many accepted the continued operation of the Export and Import Bank of Korea without question, but many voiced the view that the continued existence of KDB as a development bank would be justified only in the event that it had a significant role in North Korea with rapid expansion of economic cooperation between North and South Korea. In such an event, KDB, as a state-owned bank, would have a significant role in securing financing for many infrastructure projects in North Korea.

It is not surprising that under the current suspension of the privatization policy, KDB continues to be state-owned and has even increased its dominance and power in corporate banking. In addition to the over one hundred industrial companies in which it has equity holdings, it has strengthened its control over Daewoo Securities, the second largest securities company in the country, and KDB Capital. Concerns have been rising about what is called the "KDB Fizzle," wherein the KDB group increases its dominance to the detriment of the growth of private sector banks in the area of corporate banking. Consensus is that KDB should confine itself to the original mandate of providing development financing, especially for infrastructure projects in North Korea. However, the current practice of allowing KDB to expand Daewoo Securities operations and KDB corporate banking, including KDB Capital, should be reviewed.

3.23 Need to Improve NPS Investment Management

The national pension fund managed by the NPS is one of the biggest retirement funds in the world with an asset valued at KRW214 trillion. It was established in 1987 with the express purpose of providing minimum livelihood for all citizens in their old age. At the time the NPS was inaugurated, there was no need to worry much about how to invest funds accumulated through compulsory contributions by both employers and employees because there were plenty of opportunities to earn adequate returns within the public sector. The Korean government thought that if the fund was to be invested in debt instruments issued to finance social infrastructure projects, adequate returns would be guaranteed.

More recently, however, there is no longer any guarantee that investment in these instruments would yield sufficient returns. Furthermore, in recent years, two other important developments bearing on the investment of the national pension fund occurred. One relates to the fact that the government no longer wishes to directly undertake large infrastructure projects. Hence, there is less need for the government to rely on the NPS fund. The other has to do with the changing national demography. With the steady decline in the national birth rate coupled with the steady increase in life expectancy, there is no guarantee that the size of the national pension fund in the future would be sufficient to pay out the benefits promised to the present generation of workers. In other words, the prospect of the NPS being unable to pay out benefits became real. In the face of these new developments, the need to invest NPS resources for higher returns has become imperative.

This is the background for the decision made by the government to increase the percentage of the national pension fund invested in equities. It is also important to note that this decision came at a time when the country needs to accelerate the development of its long-term capital markets as part of its efforts to become an IFC. However, there is no guarantee that the new NPS investment policy will significantly contribute to the development of capital markets in Korea if investment decisions made by the NPS were motivated by political considerations or investment management was carried out by people lacking expertise.

3.24 Need to Restructure KIC

KIC was created in July 2005 with two specific aims: (a) to make more efficient management of Korea's excess foreign exchange reserves and other funds in the public sector and (b) to serve as an important instrument to induce foreign firms to locate to Korea.

Although it is too early to judge, KIC so far has been a disappointment with regard to the two objectives it was meant to achieve. This disappointment is due to a number of factors: (a) the small size of total assets under management, currently less than US$20 billion; (b) inappropriate corporate governance; and (c) failure to attract sources from the National

Pension Fund and other public funds. KIC's current US$20 billion under management provides little leverage to attract foreign asset management companies to Korea. Second, KIC's Steering Committee is heavily influenced by the Bank of Korea (BOK), the nation's central bank, which applies the same investment standard for its own foreign exchange reserves and KIC funds. Third, the KIC Act provides for KIC to manage assets from many funds in the public sector, but to this day it has failed to attract funds from sources other than the BOK.

INSUFFICIENT EDUCATION AND PR EFFORTS AT HOME AND ABROAD

3.25 Need for Domestic Educational and PR Efforts

Building an IFC in Korea is a major historical task requiring strong support from its citizens. Given the nature of this task, from the very beginning, the Korean government should have undertaken major educational and PR efforts. The efforts, first of all, should have focused on promoting the people's understanding of the immense benefits the nation would derive from becoming an international financial center. The efforts should also have targeted those segments of the population who perceive that their interests would suffer from opening financial markets to foreign players. The government so far has not launched any PR programs for any of these segments of the population. As a result, the consensus of the nation on the IFC initiative remains weak.

3.26 Insufficient PR Efforts Targeting the International Community

There is little question that one reason Korea has not been rated highly as an international financial center in various international surveys, such as the one done by the City of London, has much to do with the insufficient PR efforts the government has made to promote Korea as a financial center in the international community. It is no exaggeration to say that except for two international conferences on the subject of Korea as an IFC sponsored by the City of Seoul, the first in 2004 and the second in 2006, there have been no large-scale PR events highlighting Korea's IFC initiative. There were of course occasional references to Korea's commitment to becoming an international financial center in the Deputy Prime Minister's speeches given overseas, but it is difficult to imagine that these have had any significant impact.

Chapter 4. RECOMMENDED ACTIONS

Chapter 3 identified many issues and challenges Korea has yet to address in building an IFC. The purpose of this chapter is to recommend a series of actions to be taken by the incoming government to effectively address those issues and challenges.

The individual recommendations fall under five categories. The first group of recommendations is designed to deal with the need for effective political leadership. Second, several recommendations are offered to accelerate reforms not only in the regulatory regime but also to strengthen regulatory bodies. Third, we also offer a number of recommendations the central purpose of which is to drastically improve the business environment in Korea. Fourth, several recommendations are also made to address the problems related to the operation of publicly-owned financial institutions. The last group of recommendations is offered to enhance the effectiveness of PR efforts to be undertaken by the government.

Before individual recommendations of these five groups are stated, a comprehensive statement is made to communicate the essential recommendation of each group.

RE-LAUNCH THE IFC INITIATIVE AS THE UTMOST POLICY PRIORITY OF THE INCOMING ADMINISTRATION WITH THE COMMITMENT OF THE PRESIDENT TO COMPLETE IT WITHIN HIS TERM

4.1 Move Target Completion Date Forward to 2013 from 2015

The outgoing Roh Government first set the year 2020 as the target for completing Korea's transformation into an IFC comparable in scope to that of Hong Kong today. Then it reset the target date for 2015. Given the pace of the progress being made by Hong Kong, Singapore, Shanghai, and Tokyo, Korea simply cannot afford to wait until 2015 to complete its tasks for becoming a financial hub. In addition, much of the institutional foundation has already been laid down. Moreover, it is in the interest of the new administration to finish the work for the IFC initiative instead of handing what remains to be done to the next administration. For this reason, we strongly recommend that the new administration move the target date forward to 2013, the finishing date for its term of office.

4.2 Provide Strong Leadership and Establish a Fully-Empowered Presidential-level Program Management Office (PPMO)

It is to the credit of the Roh government that it launched the IFC initiative. However, as our analysis in Chapter 3 has made clear, it failed to take into account the political dynamics involved in implementing the initiative. Nor had the Roh government been effective in overcoming the passive resistance to the initiative within regulatory bureaucracies. What's more, President Roh himself should have learned a proper lesson from the UK's success with the "Big Bang" in the mid-1980s, where Margaret Thatcher's personal leadership was critical. Strong leadership itself, however, is not sufficient; this strong leadership only makes a difference when there is an effective mechanism for coordinating policies as well as the actions of individual ministries and agencies within the government. The Roh government failed to do both. If the new incoming government wants to avoid similar failures, it is critical for the President himself to provide leadership and to establish a fully-empowered PPMO that orchestrates wide-ranging policy changes to turn Korea into a world-class financial center during its tenure.

The main roles the PPMO should play include, first of all, designing and executing policies, monitoring and evaluating their progress and making adjustments to policies when necessary. Second, the PPMO should also play the role of a trouble-shooter. As the act of transforming a nation into an IFC will require actions and policy changes of many organizations, not only within the government but in the private sector as well, conflicts among these organizations are bound to occur, and these conflicts must be resolved effectively and promptly. Finally, to ensure satisfactory progress overall, the PPMO should lend its support to all agencies in accomplishing their respective tasks. The PPMO should also be empowered to extend appropriate recognition for the achievements of different players. In short, PPMO should act as the control tower for the IFC initiative at all times.

As the first step towards establishing such a PPMO, the new administration would do well to review the Basic Law for Promoting Korea as a Financial Hub passed by the National Assembly in November 2007, and determine if the act is in any way in conflict with the establishment of a PPMO as just described. In our opinion, the Basic Law sees the implementation of the IFC initiative far too much as the exclusive responsibility of MOFE. In other words, it overlooks the central role to be played by the Office of the President in achieving the policy objective.

Assuming that the office of the DPM will continue under the incoming administration, one way to organize an effective PPMO will be to place the responsibilities of both designing and implementing primarily on the shoulders of the Deputy Prime Minister (DPM) for Economic Affairs. It is worth noting that even under the present arrangement, the DPM has this responsibility, but he does not have enough means to carry out this responsibility. When it comes to coordinating and securing cooperation from economic as well as non-economic ministries, the DPM has little power. To amend this deficiency, the DPM should be endowed with the power to allocate budgetary resources to all government ministries and agencies. This of course means the merger of the present Ministry of Budget and Planning into MOFE.

It is critical to note that the DPM has other responsibilities besides designing and implementing a financial hub strategy. Bearing this point in mind, it is essential to create a position for a Senior Presidential Aide for the International Financial Center Initiative in the Blue House. The primary responsibility of this Aide will be to closely monitor the policy progress and report the results directly to the President on a continual basis. However, to ensure effective implementation, the DPM himself will be required to report progress to the President on a regular basis as well.

Should the position of the current Deputy Prime Minister for Economic Affairs be abolished, the position of the Minister of Finance and Economy be replaced with a Minister of Finance and Policy Coordination, and the present FSC be reorganized to assume greater responsibilities for developing the financial services industry by taking over policy-making functions in the area of financial industry from the present MOFE and be renamed a Financial Services Committee, as has been announced by the transition team of the incoming government, the above recommendation for organizing the PPMO should be adjusted accordingly. In the event that the position of Deputy Prime Minister for Economic Affairs is abolished and the current MOFE is merged with the Ministry of Budget and Planning, and some policy functions are transferred from MOFE to the Financial Services Committee, the responsibilities for designing and implementing the IFC initiative should be placed on the shoulders of both the new Minister of Finance and Policy Coordination and the Chairman of the Financial Services Committee. In this event, the role of the Senior Presidential Aide for the IFC initiative should become more important than has been suggested above in that the Senior Presidential Aide would need to work closely with the two parties, i.e., the Minister of Finance and Policy Coordination and the Chairman of the Financial Services Committee.

4.3 Launch an International Presidential Advisory Council

As noted in Chapter 3, a Presidential Advisory Council would go far to advancing the goal of building an international financial center in a variety of ways. However, for reasons peculiar to the Roh government, this body has never been launched. The incoming government needs to take initiative in this matter. Thus, it is strongly recommended that within the first three months in office, the incoming government launch such a council and call regular council meetings at least twice a year to promote dialogue between the President and first-rate global financial leaders. This would be good for not only the President, but the nation as a whole.

REFORM THE REGULATORY REGIME AND ELIMINATE ALL BARRIERS TO MARKET ACCESS

4.4 Shift Government Management Philosophy to Facilitate the Needs of the Industry instead of Dictating its Evolution

Modern economic development in Korea has owed much to the leadership exercised by the government. It was noted in Chapter 3 that as a legacy of this development, there are far too many tendencies for policymakers and bureaucrats to exercise their discretion. At the same time, owing to democratic political developments as well as the super abundance of rules and regulations on the books, one problem with bureaucracy at the moment is a lack of action when needed. However, by now the Korean economy itself has become large and complex. In addition, the Korean economy is inextricably linked with the global economy to the point where the government is no longer in a position to dictate the evolution of the economy. Hence, the role of the government should no longer be one of dictating but rather responding to and facilitating the market-driven needs of the economy.

This is especially true of the financial sector. Without question, the financial industry is the most globalized of all industries. Not only is it the most linked globally, but its products and modus operandi are evolving everyday. Under these circumstances, it is only natural that the governments of economies most sophisticated financially, such as the UK government, decided some time ago to respond to the needs of the industry rather than attempting to dictate its evolution and have seen good results.

Hence, it is high time for the Korean government to jettison the propensity to dictate the development of an industry or for that matter the whole economy. There are at least three major ways to accomplish this task. One way is to accelerate the ongoing initiative to shift from the positive-list approach to regulation to a negative-list approach. Another way is to require meaningful participation of industry representatives not only in formulating new regulations, but also assessing the impact of existing regulations. This will make rules and regulations user-friendly.

A third major way is to promote the roles and the responsibilities of self-regulatory organizations (SROs). SROs should be encouraged to define new rules of behavior in areas where hard regulations do not exist or are inappropriate to address the real market issues. SROs usually have more intimate knowledge of the markets, can be more responsive to market needs, and have an enlightened self-interest to deal with problems before they give rise to crises.

4.5 Shift Financial Regulation and Supervision from a Rule-Based to a Principle-Based Approach

In Chapter 3, it was observed that Korea's regulatory system is in the early phase of becoming rule-based in the sense that while an effort is made to abide by rules, at the same time rules often are neglected or not enforced at all. Actually, Korea has the opportunity to solve all these problems by making a rapid shift to a principle-based approach. A principle-based approach focuses on "doing the right thing," whereas a rule-based approach relies on observing rules to the last detail. A rule-based approach is limiting in that it will deliver a solution that does not provide sufficient flexibility that financial firms need to better serve their customers or be more truthful to their business models. By contrast, a more principle-based approach makes informed judgments based on a good understanding of firms, their customers, and the markets in which they operate.

The adoption of a principle-based approach allows financial firms to decide for themselves how best to run their businesses and to adopt different approaches to deliver outcomes that meet regulatory objectives, drive innovation, and improve efficiency and competitiveness. Thus, a transition towards a principle-based approach will enhance a business-friendly environment.

A move towards a principle-based approach requires simplification of financial regulations, removing a significant volume of detailed rules while avoiding prescribing new ones in areas without detailed rules. In addition, the transition requires firm establishment of clear, sound, and effective regulatory and supervisory principles.

Regulatory and supervisory principles should set a minimum standard that the financial regulatory authorities require, and these minimum standards should be seen primarily in terms of outcomes, not by prescribing detailed inputs and processes. Obviously, there may be some limited areas where financial regulatory authorities have to continue to rely on detailed rules. However, even in so doing, it is essential that at all times they assure the predictability of rules and regulations.

Fortunately, there is every indication that the present FSC/FSS leadership fully understands the merits of a principle-based approach over a rule-based approach. Thus, the SFF welcomes the commitment of the present FSC/FSS leadership to complete the transition from rule-based regulation to principle-based regulation by 2010.

4.6 Increase Cooperation between Korean and International Financial Regulatory Authorities

Expanding exchange programs between the FSS and its foreign counterparts will help FSS officials develop their supervisory system by providing them with an opportunity to learn from experiences and advanced regulatory systems in major countries.

In this regard, the best partner for the FSS would be the Financial Supervisory Authority (FSA) in the UK, considering not only the status of London as the leading international financial center, but also the pioneering role it has played in developing a principle-based regulatory regime. Moreover, it is encouraging to know that the UK is making great efforts to develop its financial and economic relationships with emerging economies by helping shape the development of their financial services sectors. The development of a strong relationship between Korea and the UK through active exchange programs between the FSS and the FSA will benefit both.

A second stage of the effort to strengthen exchange programs between the FSS and its counterparts abroad should focus on inviting regulators from those Asian countries in which Korean financial institutions are currently interested in establishing their presence. Active exchange programs inviting regulators from these countries will of course facilitate Korea's efforts to expand into their markets.

In addition, Korea should enhance its participation in important international initiatives and fora, such as the Bank of International Settlement (BIS) and the International Organization of Securities Commission (IOSCO), with the aim of underscoring Korea's initiatives and progress towards making Seoul an important IFC and a critical regional hub in Asia. To this end, Korea should assume a more active leadership role in establishing regional priorities aimed at coordinating, strengthening, and harmonizing financial supervisory initiatives within the region.

4.7 Upgrade the Quality of Regulators

In order to deal with the unevenness of quality among supervisors and regulators in the FSS, both educational and training programs must be expanded, particularly the ones sending its mid-career professionals overseas. In addition, the current FSS practice of rotating assignments should be amended so as to encourage specialization by its staff. The FSS should be commended for the policies it has adopted to increase recruitment of its staff from private financial institutions. However, there is much room to expand this policy as well.

4.8 Inject Foreign Talent and Experience into Financial Regulatory and Supervisory Posts

The government should encourage world-class professionals and talents to work and live in Korea. Opening Korean regulatory/supervisory posts to foreign nationals who meet high professional standards will directly provide the Korean government with advanced financial skills and, in turn, strengthen its capability to manage Korea's financial system.

In this regard, the recent recruitment by the FSS of William Ryback, the former Deputy Chief Executive of the Hong Kong Monetary Authority, as a special advisor is commendable. However, he is the first foreigner to take a high-ranking seat with the Korean regulatory authorities, and his position as just a special advisor may limit his role in the FSS policy-making process. The government has to expand the recruitment of foreign talent in responsible regulatory and supervisory posts.

In this regard, the incoming government will do well to learn from the examples of not only the FSA but also regulatory authorities in emerging economies, such as Dubai.

4.9 Promulgate Financial Regulatory Documents in English and Korean

With English as the dominant language for global business, the lack of authoritative English language versions of Korean financial regulatory documents dramatically reduces the attractiveness of Korea as a base for international business activities. The official publication of regulations only in Korean has been one of the factors that explain the low level of communication between regulators and foreign financial institutions. As a matter of fact, there are some financial regulatory documents that have been translated into English, but their numbers remain limited, and they are only for reference, without legal force.

Therefore, the Korean financial regulatory authorities should publish all financial regulatory documents in English, as well as in Korean, to facilitate communication with foreign market participants and to maximize foreign input into the regulation-making process. In addition, KRX should accept documentation from applicants for primary listing in the English language as well.

4.10 Eliminate All Barriers to Cross-Border Sharing of Back Office Utility Functions

As noted in Chapter 3, the application of regulations on the sharing of back office functions between foreign financial institutions operating in Korea and their affiliates or parent groups overseas is still rather restrictive. Fortunately, the FSS has recently started to allow certain back office functions to be shared by legal entities in Korea that belong to the same group, which is an encouraging step in the right direction. It would further be very desirable if the FSS would allow foreign financial institutions, regardless of whether they are a foreign branch or foreign-owned subsidiary, to share the global risk management IT systems used by their respective parent companies or affiliates.

Outside Korea, some progress has been made in allowing shared services between onshore affiliates of the same group. Under the global operating platform of most multinational financial institutions, certain back office functions and IT systems are often centralized in hub locations or in shared services centers. Most jurisdictions allow financial institutions belonging to the same group to share back office services amongst themselves for the sake of enhanced control and synergy. In Korea, however, the application of current regulations is still rather restrictive with regard to such activities, and it would be desirable for Korea to provide foreign financial institutions with more flexibility in delegating any back office functions to regional hubs, including but not limited to risk management functions, VaR calculation, credit risk calculation, MTM (Marked-to-Market) valuations and trade settlement systems.

In our view, there is probably no need to revise the Business Delegation Act, since it already provides a framework for proposed shared services. Hence, it is within the discretion of the FSS to adopt a more accommodating stance on this issue.

The current Korea-US FTA includes a number of useful recommendations regarding sharing of back office utility functions. The SFF recommends that similar recommendations be adopted in the context of other countries.

4.11 Eliminate Barriers to Market Access

It is inconceivable that Korea, in becoming a world-class IFC, allow market access barriers. With this in mind, the current licensing process for any type of foreign and local financial institution should be reviewed with the aim of converting the licensing system into a mere business registration system. The government should provide a regulatory framework that encourages competition and supports all financial institutions to expand their business without restrictions. Thus, it would be desirable to remove any remaining restrictions — whether they are in the form of regulatory restrictions or window guidance — on new business license issuances, new branch openings, and new business approvals as long as applicants meet prudential and technical qualifications.

Furthermore, the Korean regulatory authorities should allow an "unbundling" of financial services instead of the current approach where the license applicant is bound to provide all services covered by the license. For example, it often happens that financial institutions would like to conduct only a certain area of equity derivatives business, but the current license system fails to provide partial licenses in such cases.

4.12 Remove All FX Restrictions on Capital Account Transactions by 2008

It was encouraging that over the past few years the government has taken steps to liberalize foreign exchange transactions on capital accounts, including the conversion of an ex ante permit system into a post transaction reporting system in January 2006. In November 2007, the government also reaffirmed that it will achieve full liberalization of capital account transactions by 2009.

For these policy announcements to be credible, however, there are at least three major actions yet to be taken by the government. First, given that Korea's foreign exchange reserves stood at US$262 billion at the end of 2007, which far exceeds any contingency needs, and the necessity of preventing undue appreciation of the Korean Won, the target date for full liberalization of capital account foreign exchange transactions should be advanced to 2008.

Second, drastic improvements are called for in the procedural aspects of the post-transaction reporting system. The current system requires "prior discussion" with MOFE in the case of cross-border loan transactions between residents and non-residents in both local currency and foreign currency before the loan transactions are reported to one of the "foreign exchange banks" authorized by the government to carry out foreign exchange transactions. "Prior discussion" in this case can easily undermine the integrity of the ex post reporting system. Hence, a relaxation of this "prior discussion" requirement and conversion thereof to simple post-reporting to foreign exchange banks will facilitate the cross-border global cash pooling and funding activities of multinational companies' treasury operations in Korea.

With regard to the procedural requirements in reporting, the SFF also recommends that MOFE further relax the requirement for all non-bank market participants in the foreign exchange market to provide documentary evidence of underlying FX transactions in the form of "original" transaction records. It would be desirable for market participants to simply report the underlying nature of the FX transaction for statistical purposes to foreign exchange banks who in turn report the data to the central bank in any way they want. It is encouraging that MOFE recently took action allowing all market participants to simply submit photostatic copies (e.g., scanned copies) to their foreign exchange banks. This action should be replaced, however, by simple electronic data submission. In the age of electronic banking and, considering Korea's advanced IT financial infrastructure, simple electronic data submission should suffice.

Third, in Chapter 3, we noted that over the course of 2007, the government took a number of direct measures to discourage foreign bank branches from borrowing short-term from their offshore parent companies/affiliates. Put bluntly, these government measures were at best ill conceived — there were no real grounds for such measures nor did they have the desired impact. Compared to many major countries, Korea's short-term external debts as a percentage of total debts were not excessive. From December 2006 to June 2007, this percentage ranged from 43.1 to 45.3%. At the end of 2006, the same percentage for the UK was 75.5%, Hong Kong 70.6%, Japan 62.1%, and the US 41.5%. Furthermore, it could be argued that the curbing of offshore borrowing has created an artificial scarcity of US dollar funding in the local market place, artificially driving up the price for US dollar onshore and creating offshore arbitrage opportunities, distorting the markets. Moreover, it should have been clear to authorities that foreign bank branch borrowings from parent companies/affiliates do not expose Korea to any real default risk. Lastly, we should note that if short-term offshore borrowings had indeed been a problem in any real sense, the BOK should have supplied greater US dollar liquidity out of its huge FX reserves, which are by any standard excessive.

In short, we strongly recommend that the incoming government undo all the direct measures taken by various government authorities last year to curb offshore short-term borrowings by foreign bank branches.

4.13 Allow Hedge Fund Operations to Be Based in Korea

The current restrictions on hedge fund operations leave Korea far behind Hong Kong, Singapore, and even Tokyo in becoming an IFC. Hong Kong very aggressively invites global hedge funds to operate out of Hong Kong so as to attract vast amounts of private capital flows.

It is therefore recommended that a sequential plan be devised to allow hedge fund operations to be based in Korea. More specifically, we recommend the following:

- Lift all current bans that restrict the sale of offshore hedge funds regardless of domicile, degree of leverage, degree of short positions, and extent to which derivatives are used.

- Amend the Indirect Investment Asset Management Act to allow not only organizing (founding and registering) hedge funds in Korea, but also selling products to both onshore and offshore investors.

There will be a need to accompany these actions with some prudential regulations. However, the need for prudential regulations should not be exaggerated as investors in hedge funds need little protection from the government. Nor should regulatory authorities worry too much about introducing fresh supervision on hedge funds on account of leverage, short positions, or derivatives positions. Experience in other countries indicate that hedge funds have become more diverse in strategies, banks better at protecting themselves from counterparty risk with hedge funds, and financial markets deeper and more resilient. Hence, the current plan of the government to introduce hedge funds by 2012 represents an overly cautious approach. Indeed, there is no reason why Korea should continue to be so conservative with regard to hedge funds while its policies are so liberal with private equity, which in many ways resemble hedge funds.

4.14 Encourage Foreign Financial Institutions to Issue Debt in Korean Won

In Chapter 3, we pointed out that the continuing decline of the corporate debt market is a serious issue that should be resolved soon. Resolving this issue requires efforts on many fronts. For one thing, it would take a strong recovery of the demand for investment for the corporate bond market to recover. For another, rating services in Korea must improve. In addition, information and data the investors need should be made more accessible to them. It also goes without saying that there should be active secondary bond markets to improve the liquidity of bonds as an asset. One effective way to address all these problems is to encourage foreign financial institutions currently operating in Korea to issue debt in Korean Won. Fortunately, relatively few changes are needed to encourage foreign financial institutions to issue Won denominated debt. Hence, the SFF recommends the following:

- Introduce dual (local and foreign) ratings for foreign issuers. This will increase rating coverage discipline in the local market. In addition, it will improve the perceived quality of local ratings. The dual ratings also remove concerns over the domination of the local market by foreign ratings agencies. Furthermore, foreign investors will be encouraged to invest in the bonds issued by foreign issuers. It should be remembered that foreign institutional investors generally have minimum rating restrictions on the securities in which they can invest.

- Convert the current practice of taxing bond dividends through withholding taxes to income tax calculated on an annual basis after transactional expenses. The current practice leads foreign bond investors to prefer the domestic bond futures market where taxation through the withholding scheme does not apply.

- Allow foreign financial institutions operating in Korea to issue Won denominated bonds or notes in Korea by offering such instruments through their respective branches. Currently, the Corporate Code does not allow foreign bank branches to issue local bonds or notes as they are not locally incorporated entities. We believe, however, a change in policy would be highly beneficial not only because it would activate the local bond market, but also promote the diversity of financial products available.

DRASTICALLY IMPROVE THE BUSINESS ENVIRONMENT BY ENDING LABOR UNION MILITANCY, PROMPTLY RESOLVING THE LONE STAR CASE, OPENING THE LEGAL SERVICES MARKET, AND OVERHAULING THE CURRENTLY UNCOMPETITIVE TAX REGIME

4.15 End Labor Union Militancy

As noted in Chapter 3, all the effort by the people and the government of Korea to turn Korea into an IFC would make no headway should the current labor union militancy continue. Hence, resolute efforts must be made by the new government to bring an end to this problem that may be rightly called the "Korean disease." To cure this disease, first, law and order should be observed and enforced at workplaces. What this means for the new government is that it should have a much stronger political will than the outgoing government to enforce existing laws and regulations, particularly on unions, when they fail to abide by legal procedures when making demands on their employers.

In the medium and long run, the government should find ways to increase unemployment insurance benefits so that workers' sense of insecurity from the contingency of unemployment is mitigated.

4.16 Permit Lone Star to Sell KEB at the Earliest Possible Date

Korea's reputation in strengthening the rule of law has suffered much in recent years on account of the delay in resolving the Lone Star matter. With every passing day of delay in resolving this case, the nation pays a heavy cost. Given the fact that the current court cases in a worst case scenario can only result in an order for Lone Star to sell its shares, it is unreasonable to delay any approval of the sale until the cases are resolved. There is no benefit to the country in delaying the approval. The cases can continue irrespective of whether the sale is permitted to take place, and permitting the sale will not alter the outcome of these court cases. Thus, the FSS should be encouraged to review the potential sale of KEB without regard to the current litigation involving the acquisition of KEB by Lone Star or the stock price manipulation case.

4.17 Open the Legal Services Market

Likewise, the government should no longer delay opening the legal services market to foreign law firms. A robust and efficient legal system is essential for resolving frequent disputes that are normal and inherent in the functioning of any financial market. Korea has an excellent legal system, but it is not yet sufficiently developed to quickly resolve disputes occurring in a rapidly changing global financial market. A weak or uncertain legal system inherently creates risk, and risk results in higher costs of financial products, services, and intermediation. Reducing these risks would go far towards attracting more investors to Korea than is currently the case.

As far as US law firms are concerned, under the Korea-US FTA they are allowed to open legal consulting offices locally to provide advice on problems relating to US law and treaties between the US and Korea as soon as the FTA is ratified by the legislatures of the two countries. Then, within two years after the FTA takes effect, US firms are also allowed to enter into specific cooperative agreements with Korean law firms to provide joint services on cases involving both Korean and foreign laws. Finally, within five years after the FTA takes effect, US law firms can establish joint ventures, which can hire local Korean lawyers. It is worth noting that the Korean supervisory authorities will have the power to regulate the maximum shares Korean and American firms can have in such joint ventures.

Admittedly, even under the FTA, the pace of opening the legal services market in Korea to American law firms is not satisfactory at all. However, given the strong political influence the legal profession exercises in Korea, one should be realistic and acknowledge that the current provisions in the Korea-US FTA represent the best that could be achieved at the moment. Hence, it is strongly recommended that both the Korean and US governments soon launch a new negotiation to arrive at a separate agreement that will further liberalize the legal services market in Korea at the earliest possible date. Efforts should also be made to further open the legal services market in Korea when negotiating FTAs with Europe and other countries.

4.18 Launch a National Tax Commission

It is clear from Chapter 3 that problems Korea needs to address in the field of taxation are several-fold. First of all, the rate structures of personal and corporate income taxes are highly problematic in that the excessive progressivity embodied in these taxes gives rise to many problems including complexities in tax laws, which serve as a breeding ground for corruption. Second, the current Korean tax system has caused unusual amounts of tax friction in financial transactions. Third, the NTS itself is something of an anomaly within the overall organization of the government. It is true that the NTS should be given maximum independence and autonomy in its operations. However, it does not mean that it should be allowed to behave as if it were a law unto itself. At minimum, the NTS should be accountable to some higher authority. Fourth, there has been a great deal of difference in opinion between the Korean government on the one hand and foreign investors on the other with regard to tax benefits foreign investors have enjoyed under different tax treaties Korea entered into in the past. These differences in opinion are now threatening to become serious tax disputes not only between foreign investors and the Korean government but also between Korea and other governments.

The best way to address all these problems would be not to address them individually but to resolve them in a comprehensive manner. Accordingly, the SFF recommends that the incoming government launch a National Tax Commission within its first few months in office. The Commission should be conceived as an advisory body to the President, and it should come up with a blueprint for a national tax system that will not only boost Korea's competitiveness as a world-class IFC, but also meet the needs of a healthy national economy in this globalizing era.

ACCELERLATE THE PRIVATIZATION AND REVIEW THE ROLE AND GOVERNANCE STRUCTURE OF PUBLICLY-OWNED FINANCIAL INSTITUTIONS

4.19 Accelerate Privatization of Government-Owned Financial Institutions

As noted in Chapter 3, there is a need to accelerate the privatization of government-owned financial institutions, particularly Woori Financial Group and the Industrial Bank of Korea.

Since there is little justification for continuing government ownership of these institutions, government shares in these institutions should be sold as market conditions permit.

The experiences of privatization in other countries show that privatization is a highly complex process that is as politically sensitive as it is technically complicated. Hence, a selling strategy needs to be thoroughly developed in advance. The strategy may incorporate the idea of selling the controlling shares of more than one bank in a package deal so as to maximize economies of scale and scope for the buyers. However, the cardinal principle governing the sales all along should be an open and competitive auction because this is most likely to maximize the sales value and at the same time generate the least political controversy.

It should also be kept in mind that, as part of the effort to turn Korea into a world-class IFC, it has been the policy of the Korean government to attract to Korea as many foreign players as possible. In line with this policy, there should be no discrimination against potential foreign buyers in the sale of government shares in these institutions.

As the new government accelerates the sale of its shares in financial institutions, it will do well to review the existing policy regarding such financial institutions as the Postal Financial Service and the National Federation of Agricultural Cooperatives whose government ownership has never been questioned.

4.20 Redefine the Role of KDB and Privatize Its Investment Banking Business

The integration of Daewoo Securities, KDB Capital, and KDB's corporate banking, if fully implemented, will result in a tremendous synergy and size to become the leading investment bank in Korea. Moreover, through strategic acquisitions, the new KDB Group has excellent potential to become a powerful investment banking house throughout Asia. The depth of global-oriented expertise, business acumen, credit/investment analysis, sales/trading/brokerage skills, and knowledge of industries on the part of the new KDB Group are unparalleled in Asia.

However, such an investment banking business should be owned and run by the private sector. Therefore, KDB's policy loans and development finance business should stay state-owned, but the private sector-type investment banking business, including KDB Capital and Daewoo Securities, i.e., a new KDB Group, which will incidentally require a new name to dissociate from the development function of KDB, should be privatized through a competitive auction where a multiplicity of foreign and local financial institutions should be allowed to bid to take over the controlling equity stake. After privatization, the new KDB Group should pursue a series of strategic acquisitions to grow in size and placement power in global markets. The remaining development finance and policy loan businesses of KDB, which should remain state-owned like the Exim Bank of Korea, will still face ever increasing demand for development finance and policy loans due to the continuously increasing levels of infrastructural developments within South and North Korea.

In short, privatize the current corporate investment banking operations of KDB, and encourage KDB to focus on its development roles.

4.21 Redefine the Role of KIC and Restructure Its Governance

One of the key objectives of establishing KIC was to maximize the growth of national wealth by efficiently managing that portion of foreign exchange reserves deemed to be excessive. However, the managerial freedom of KIC has been substantially curtailed due to frequent interventions by the Bank of Korea in its asset management, thus impairing one of the objectives for which KIC was established. As a result, KIC has been unable to actively carry out asset management while the size of its investments is very modest, reaching only US$11 billion as of August 2007.

To resolve these problems, there is a need to redefine the structure of KIC's corporate governance, giving it more independence in setting investment priorities and asset allocation. To be more specific, the relationship between KIC and the Bank of Korea should be restructured to increase KIC's managerial freedom, and KIC should be empowered to issue bonds to acquire resources for investments on its own account.

4.22 Establish an Independent Asset Management Company for Management of the National Pension Fund

The return on investment by the NPF is still quite low, compared with other funds, reaching only 5.8% in 2006. The low investment return of the NPF is mainly attributable to (a) the overly high share of assets being directly managed by the NPF (88%) and (b) most NPF investments being made in domestic markets. These asset management practices of the NPF are a direct result of its governance structure.

Thus, the National Assembly should amend the current National Pension Fund Act so as to change the current National Pension Fund Management Committee to a new standing committee composed of independent experts. At the same time, for more efficient management of NPF assets, an independent Asset Management Company (AMC) exclusively responsible for investing these assets should be established. In this regard, the current proposal by the outgoing Roh government to place this new standing committee of independent experts directly under the President is a step in the wrong direction.

LAUNCH SYSTEMATIC EDUCATIONAL AND PR EFFORTS AT HOME AND ABROAD

4.23 Involve Market Participants

One of the reasons why Korea has failed to make as much progress as it should have towards an international financial hub over the past four years has been the lack of active participation by local financial players. To be sure, many of the local financial players have participated in several task forces organized by MOFE offering their views on current problems faced by the industry and expert advice on how they should be resolved as a step towards an IFC. However, it is difficult to characterize their participation as being active and fully enthusiastic. As analyzed in Chapter 3, this lack of activism is due to the unpreparedness of the local industry to face competition from foreign players in local markets.

Fortunately, over the past few years, local players have gained some confidence in their ability to meet competition from foreign players. However, there is still a need for the government to boost this confidence. In addition, the government should continue to formulate its policy on building an international financial center with as much participation from local players as possible. To this end, the new government should invite various associations of local financial industries to form an industry-wide advisory council to the President on the financial initiative. Furthermore, the role of the domestic press in creating an intellectual environment favorable to the goal of making Korea an IFC is critically important. Bearing this point in mind, the newly established Presidential-level Program Management Office should periodically brief the press on the progress the government is making towards an international financial center.

4.24 Encourage Investors

The ultimate beneficiaries of Korea's becoming an IFC are the consumers of the financial services offered by the center. Broadly speaking, these consumers are of two groups. On the one hand, there are millions of individual households that want to better manage their wealth and savings. In most Korean households, housewives often have the final say as to how much income is to be saved and where to invest those savings. On the other hand, we have many institutional investors, such as insurance companies and pension funds in the public and private sectors, who manage the collective savings of their members. The aspirations and preferences of these savers/investors ought to be mobilized in the drive towards an IFC. To this end, the government should take the initiative to remind these constituents that Korea's success in becoming an IFC is important for them. Actually, these efforts should not stop at the national border. The government should take the same message to similar "constituents" not only in high-saving neighboring countries, but also to those countries in the Middle East who are anxious to put their growing petro-dollar reserves to better use.

4.25 Undertake Systematic PR Efforts Overseas on Korea as an IFC

In any strategy to develop an international financial center, systematic and effective PR efforts overseas are a must. These efforts are needed not only to convey messages to the international community that Korea is serious about its commitment, but also to gain feedback from abroad. However, as noted in Chapter 3, systematic efforts to promote Korea as a financial center overseas have been lacking, and, as a consequence, Korea has paid a high price. Thus, with the national renewal of the commitment to the vision, there should be a systematic campaign overseas involving both the government and private sector.

For this reason, the new government should lose no time in designing and implementing comprehensive PR efforts on its commitment to accelerating the development of an IFC in Korea.

One effective way to promote Korea's financial center initiative overseas will be to organize conferences and seminars in established financial centers like London and New York jointly with well-known international media, such as *The Financial Times and The Wall Street Journal.*

5. CONCLUSION

At this point in Korea's economic and social progress towards an advanced country, nothing is as important as transforming its economic structure from one primarily dependent on manufacturing activities to one based primarily on knowledge-based, high value-added service industries.

A highly competitive financial sector is in itself a high value-added industry. But more importantly, for Korea to make the structural transformation to a high value-added economy, a huge shift in the allocation of investment resources must occur. In a market-oriented economy, such shifts occur only through the effective intermediation of a competitive financial industry. Korea can achieve such a competitive financial industry best once it makes a full commitment to becoming a world-class financial center in Northeast Asia.

By becoming a world-class premier financial center in Northeast Asia, Korea will bring about enormous benefits not only for its own people, but for the people of the whole region. Unfortunately, Northeast Asia to this day does not have a world-class IFC. The absence of such a center coupled with the under-development of long-term capital markets in the region, forces business firms operating in Northeast Asia to raise long-term capital from outside the region. This exposes the region to the risk of the so-called "triple mismatches," i.e., currency mismatch, maturity mismatch, and capital structure mismatch. It is useful to recall that these three mismatches were the basic cause of the 1997-98 Asian financial crisis. As long as these mismatches are not resolved through the establishment of a well-functioning IFC equipped with strong capital markets, the prospect of continued high growth with stability for the region is less than guaranteed.

In view of the immense benefits both Korea and the region will receive from having an IFC in the region, it was indeed an epoch-making event that the current Roh Moo-hyun government adopted the goal of making Korea into an IFC as part of its official policy in December 2003. By the same token, the progress this administration has made over the past four years towards this goal deserves due recognition. However, one should note that the nation faces many challenges it has yet to overcome to become a world-class financial center. They include strong leadership from the nation's president; a mechanism to channel this leadership; changing the role of the government from that of dictating to facilitating the development of the financial industry; changing the current regulatory approach to a principle-based one; drastically improving the nation's business environment by undertaking fundamental reform in the labor and legal services markets and taxation; and launching effective PR efforts at home and abroad.

No doubt, these challenges are formidable, especially when they have to be met within the next four to five years, but Korea can meet them. As late as the early 1960s, Korea was very poor, even by the standards of developing countries. Today, Korea is a member of the OECD with a per capita income approximating US$20,000. This rapid advancement would not have occurred if Korea had lacked the will or ability to meet challenges. Luckily, today's challenges are by no means more formidable than the challenges Korea overcame in the past. What's more, Korea now has many strengths it could never dreamed of having. Surely, Korea can become a world-class financial center by the time the incoming administration completes its term in 2013 if it follows the set of policy recommendations and overall strategy clearly spelled out in this report. Indeed the Seoul Financial Forum submits this report with every expectation that the incoming government will take the recommendations and strategy very seriously.

APPENDIX

Seoul Financial Forum

Background

The Seoul Financial Forum was founded in October 2001 by a group of practitioners, policy makers and scholars with interest and expertise in finance and concern for Korea's future economic success.

The primary purpose of the Forum is to help Korea emerge as a major international financial center in North-East Asia.

To this end, members have worked together over the past 6 years not only to develop and refine the vision and strategy for Korea to become a major international financial center, but also to urge the Korean government to adopt and implement the vision and strategy. The Forum will continue to inform the Korean leadership and public on the benefits that the country will derive from becoming a regional financial center and the appropriate actions that are required to realize this vision.

With its international membership, the Forum meets at least once a month with either in-house or guest speakers to discuss key developments in both domestic and international financial markets. From time to time, the Forum organizes and presents seminars and conferences for its members as well as for the interested public.

The Forum is a non-profit organization registered with the Ministry of Finance and Economy. All donations to the Forum are tax-deductible.

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SFF Charter

The charter of the Seoul Financial Forum states :

Article 1 This organization will be known as the Seoul Financial Forum.

Article 2 The Forum is comprised of practitioners, policymakers and scholars with interest and expertise in finance and concern with Korea's future economic success.

Article 3 An individual or organization acquires membership only on recommendation by the Membership Committee.

Article 4 The purpose of the Forum is to help Korea emerge as the premier regional financial center in North-East Asia.

Article 5 To this end, the Forum shall engage in activities designed to develop ideas and strategies useful for Korea to emerge as the premier regional financial center; stimulate interest in and discussions on the vision for developing Korea into a regional financial center among professionals as well as the general public; and help leadership in Korea appreciate the enormous benefits the country will derive from being a regional financial center and take actions appropriate to attain the goal.

Article 6 The Forum shall meet at least once a month with either an in-house or guest speaker(s) addressing any of the following:

I. Benefits and costs of being a regional financial center
II. Policy and institutional changes as well as strategies useful for Korea and Seoul to develop into a regional center
III. Key developments in the domestic as well as international financial markets
IV. New policy issues arising from these developments
V. Ideas on new financial products and innovations
VI. Business opportunities in Korea and the region

In addition, the Forum will organize and present seminars and conferences as needed.

Article 7 The regular monthly meetings shall be open to members only. The seminars and conferences may be open or closed to the public depending on the nature of the subjects covered or speaker(s).

Article 8 The Forum will elect one Chairman for two-year term and two Vice Chairmen for three-year terms. The Forum will also elect up to three Directors for three-year terms. These officers will constitute the Governing Board for the Forum. The Board may hire an Executive Director at a modest salary.

Article 9 The Forum's activities will be financed by membership dues, donations from individuals and organizations that endorse the goal and programs of the Forum plus income from seminars and conferences.

Adopted at the Inaugural Meeting, October 31, 2001

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