



Developing an International Financial Center to Modernize the Korean Service Sector

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Along with the revolution in the information technology (IT) industry, the world economy has also witnessed a spectacular rise of the financial industry in recent decades. The GDP share of value-added by the U.S. financial sector more than tripled from 3 percent in 1950 to over 9 percent in 2007. Similarly, the U.S. financial industry profits quadrupled from about 10 percent of total U.S. business profits in the early 1980s to 40 percent in 2006 just before the onset of the recent global financial crisis. Gross financial assets in the United States increased from 100 percent of GDP in 1950 to 450 percent in 2010. A comparable development also took place in the United Kingdom, with its gross financial assets increasing from 50 percent of GDP in 1970 to 550 percent in 2010.¹ Thus, it is no exaggeration to say that global finance has been one of the main engines that have driven the world economy since the end of World War II.

The world GDP was \$63 trillion and the global merchandise trade volume reached \$15 trillion in 2010, while the daily foreign exchange trading volume reached \$4 trillion in early 2010, implying a total foreign exchange trading volume of \$1,000 trillion during 2010. Global foreign exchange reserves amounted to almost \$10 trillion at the end of 2010, with about three-quarters of them accumulated in Asian countries. Total domestic and international securities outstanding are estimated at \$95 trillion as of late 2010, while the total outstanding volume of global derivatives products such as swaps, futures, and options amounted to about \$700 trillion in terms of notional principal amounts by early 2011. Nowadays, a country without a close link to international finance cannot expect to belong to the club of advanced countries.

Because of the recent global financial crisis of 2008 and the current eurozone financial crisis, the international banking

system has been in retreat, but the world of finance overall is still very much alive and active. The traditional commercial and investment banking system is being overshadowed by the rise of the so-called shadow banking system, composed of nontraditional financial institutions such as hedge funds, private equity funds, money market and commodity funds, structured investment vehicles, and conduits. As of early 2011, total shadow banking system assets are estimated at \$16 trillion in the United States alone, much higher than the total assets of traditional banking institutions amounting to \$12 trillion.² The rapid rise of financial industries in recent decades has been accompanied by the emergence of major international financial centers, which have played a key role in the development and modernization of both global financial markets and their host country economies. Hong Kong, Singapore, Bahrain, and Dubai are some of the examples where nurturing a successful international financial center has also pulled the host country into the rank of an advanced economy because of many economic benefits accruing from hosting an international financial center. Korea is one of many countries that have worked hard to follow their examples.

In late 2003, the Korean government adopted the First Financial Hub Roadmap,³ whose goal was to develop a new economic structure based on a strong service sector, including the establishment of an international financial center in Korea. The Lee Myung-bak administration, which came into power in February 2008, was faced with the challenge to convert this ambitious dream into reality as part of the new government's goal to modernize the Korean economy. As part of such a vision, an international financial center in Korea would complement the concept of a Korean business hub for Northeast Asia through the nexus of international trade, investments, logistics, transportation, and finance. As the 13th-largest economy in the world and the 4th-largest in Asia, Korea is strategically situated between

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China and Japan in the heart of Northeast Asia, which has become the most dynamic economic region in the world. In the region, within two and a half hours by plane from Seoul, about one-quarter of the world's GDP is produced, which is likely to produce almost 30 percent of the world GDP in 10 years. This paper studies the economic issues involved in developing an international financial center in a country such as Korea and considers various requirements to achieve this vision, with particular attention to other international financial centers such as Singapore and Hong Kong that have been specifically nurtured by their respective governments as part of a deliberate national policy of economic development.

The Korean strategy to become a financial hub has a rather ironic background. The Asian financial crisis of 1997–98 provided momentum for many Asian countries to improve and strengthen their domestic financial sector. With Korea's manufacturing industry facing increasing challenges from China, India, and other emerging Asian countries and the consequent need for new areas of economic growth as part of a so-called blue-ocean strategy, Korea has recognized the critical urgency to restructure its economy into a high value-added, knowledge-based service economy. The financial industry is a high value-added sector that has positive spillover effects on the overall economy, and a dynamic international financial center creates a virtuous cycle through the combination of economic and financial globalization and the development of modern financial infrastructure and supporting industries integral to such a financial center.

Over the past several decades, the rapid development of international financial centers has paralleled the expansion in international trade and investment activities. Major financial centers such as London, New York, Frankfurt, and Zurich as well as Hong Kong and Singapore have contributed immensely to the postwar growth of international financial markets. Modern telecommunication facilities and the presence of large multinational financial institutions in key time zones around the globe have created a continuous, round-the-clock world financial market. Instead of the old saying, "The sun never sets on the British Empire," nowadays the sun truly never sets on the Citibanks and Goldman Sachs of the world, as these multinational financial institutions maintain a presence in major international financial centers located in key time zones in order to participate in the global 24-hour financial market. As Charles Kindleberger has wisely noted, the continuous reduction in the costs and difficulties of transport and communication over the last 200 years has favored the formation of a single world financial market. The emergence of international financial centers has facilitated the emergence of this global financial market.⁴

Owing to various economic and other benefits of hosting an international financial center, many countries around the world have been eager to develop and promote such a center. For example, Senior Minister Lee Kuan Yew of Singapore has stated, "In the long term, we [Singapore] see ourselves

as a cosmopolitan, regional and world [banking] center."⁵ In the early 1990s, Thailand decided to develop Bangkok as an international financial center by establishing an offshore Bangkok International Banking Facility similar to the U.S. International Banking Facility created in the early 1980s in order to attract eurodollars and other offshore funds to the United States. The governments of both Dubai and Qatar have been active in recent years in developing international financial centers in order to duplicate the Bahraini experience in developing an international financial center successfully on the island of Bahrain in mid-1970s, right after the first oil crisis. In recent years, the Turkish government has embarked on an ambitious drive to develop an international financial center in Istanbul.⁶

International financial centers are distinguished from their domestic counterparts by three important characteristics. First, they deal in various major currencies of the world, not just the currency of the country where a center is located. In this way, financial transactions in the center are not directly linked with the domestic banking system. Since all international financial centers deal in external, or offshore, currencies compared with the purely domestic, or onshore, currency of a national financial center, one may also call them offshore financial centers. Second, most of the financial transactions conducted in foreign currencies in these centers are generally free of the taxes and exchange controls that are imposed on purely domestic financial transactions. This asymmetry in government regulations between offshore and domestic financial markets has frequently been cited as a major reason for the phenomenal growth of the eurocurrency and eurodollar markets and offshore financial centers during the recent decades. Third, international financial centers provide various financial services to both resident and nonresident clients. The scope of interface between residents and their own international center is closely monitored by the host government, which has to balance its conflicting objectives of promoting its international financial center and controlling potential abuses by residents.

International financial centers engage in a number of financial activities, of which foreign exchange trading is very important, including spot, forward, futures, options, and swap transactions. The total global foreign exchange trading volume amounts to \$4 trillion per day. International financial centers also engage in the issuance and trading of a wide range of international equity and debt securities as well as their derivative instruments. Owing to the presence of a large number of traditional banking houses as well as numerous shadow banking institutions, international financial centers are active in international loan syndications, asset management, trade financing, mergers and acquisitions, initial public offerings, and other activities. In addition, such centers attract many nonbank financial institutions such as insurance companies, finance holding companies, and international investment and hedge funds. Multinational companies also prefer to locate their regional headquarters in such centers because of their proximity to major financial institutions and excellent telecommunication and transportation infrastructure.

Why International Financial Centers?

Banking and other financial institutions have developed international financial centers to benefit from economies of scale in their global operations. Such clustering is not unique to banking and finance alone.⁷ Interconnected companies and institutions are located in geographic clusters such as textile-related companies in North and South Carolina, fashion shoe companies in northern Italy, and entertainment industries in Hollywood. Geographic concentration among industries is also due to certain natural advantages.⁸ For example, IT-related firms may be concentrated in Silicon Valley and the wine industry may thrive in the regions suitable to growing grapes owing to soil and climate characteristics.

The same is true of banking and financial institutions. Modern financial centers require a sophisticated and costly infrastructure to support them, including telecommunication, air transportation, accounting and legal services, and other service industries. It would not be cost-effective to establish an elaborate international financial infrastructure in each national market in this era of globalized financial markets. By locating most international banking and financial infrastructure in a central place, financial institutions can spread out the overhead costs of servicing clients in the neighboring countries surrounding the financial centers. And a sufficient number of banking and financial institutions must be located in one financial center in order to provide the critical mass needed to effectively and efficiently service their international clientele. International banking requires both sophisticated financial expertise and up-to-date market information. Such knowledge cannot be generated in a vacuum; it needs constant innovations and cross-fertilization of ideas among bankers and other finance professionals concentrated in financial centers.

Further, modern international banking frequently requires a team of finance experts to work together on loan syndications and other credit transactions. The amount of money involved is often huge, and no one bank can prudently handle such transactions by itself. International banking syndication necessitates close coordination and smooth working relationships among many banks. Familiarity with each other's interests and strengths facilitates such coordination and teamwork. Besides syndication and risk sharing, a cluster of international banking institutions located in one place is helpful for funding and investment operations. The existence of active interbank trading of major world currencies in a center leads to the efficient price discovery and the smooth channeling of financial resources. Some banks invest their surplus funds in the interbank market, while others use the interbank market to fund their international lending operations. An international financial center also serves as a haven for international savings and pools of liquidity seeking profitable investments free from domestic monetary and exchange-control restrictions. Efficient interbank markets provide the opportunity to invest these surplus funds easily and with minimum risk.

Location economics is important not only for manufacturing and logistics firms but also for internationally active financial institutions. Financial centers should be easily accessible to both investors and borrowers in terms of geography and time zone. Contacts with potential borrowers are essential to bankers and financiers for marketing purposes and for packaging and negotiating appropriate financing for their customers. Location economics in international banking implies that a financial center should be in or near the countries whose economies are dynamic and industrializing fast, and which thus require extensive domestic and international financing. Their economies should be relatively highly developed to assure banks of a reasonable credit risk.

Availability of good air transportation as well as secure high-speed voice, Internet, and telex communication links are essential for a financial center. There should be liberal government regulations on banking and foreign exchange transactions, taxation, securities dealings, issuance of work permits for expatriate staffs, and a general environment of political and economic stability. It is also helpful if internationally oriented and English-speaking personnel in the legal, accounting, and clerical professions are readily available locally. Successful international financial centers should also contain first-class educational institutions for the children of expatriate financial and other staff, modern housing facilities, and adequate cultural amenities. A modern judicial system and strong property rights protections would also be needed for a successful international financial center.

Current State of the Korean Service Industry and Its Problems

A middle-income country such as Korea has to develop the service sector of the economy in order to enter the ranks of truly advanced countries. Since the 1970s, the world's advanced countries have embarked upon the transformation of their economies from the manufacturing sector toward the service industries. According to a recent study by Park and Choi,⁹ the service sectors of G-7 advanced countries account for 72.2 percent of the total value added of their economies, while the comparable figure for the manufacturing sectors accounts for less than one-quarter of that of the service sector at only 16.3 percent. The service sector also accounts for 74.9 percent of their total employment, while their manufacturing sector employment stands at only 14.3 percent. For Korea, in contrast, the comparable figures stand at only 60.0 percent for the value added and 67.3 percent for employment.

The economic structure has shifted gradually from manufacturing toward service industries in both G-7 countries and Korea in recent decades. The manufacturing sector in the United States accounted for 22.2 percent of total employment in 1970 but it declined to 9.9 percent in 2007. The Korean manufacturing sector accounted for a peak of 28.7 percent of the total employment in 1989, but its share has steadily declined over the past two decades to 17.3 percent in 2008. However, the Korean service sector productivity is estimated at only one-third of Switzerland

and one-half of the United States, according to the same study. This productivity gap is due to the fact that the service industries in Korea are concentrated in infrastructure services such as wholesale and retail sales, transportation and warehousing, and food services and lodgings. Korea's service sector, in contrast, is relatively underdeveloped in the high-value knowledge service industries such as banking, finance, insurance, telecommunication, medicine, and research and development.

In the financial service industries, Korea's competitiveness is well below that of advanced countries, even though the Korean manufacturing sector has produced many global winners in electronics, steel, and shipbuilding. The main reason for the relative backwardness of the Korean finance industries compared with its manufacturing sector can be traced back to the deliberate government economic development strategies during 1960s through 1990s to focus on export-led growth. Consequently, the Korean banking industry was deliberately relegated by the government to the role of a cash cow to assist the emerging industrial giants such as Samsung, Hyundai, and LG. In Korea, there were plenty of bank clerks but not enough financiers versed in modern banking practices.

Thus, it is critically important for Korea to nurture the high value-added knowledge service sector instead of relatively low-skilled and low value-added infrastructure service industries. Developing an international financial center in Korea will advance the Korean banking and financial industries to globally competitive players. Successful international financial centers also nurture the development of other advanced knowledge service industries such as world-class medical services and educational institutions, sophisticated telecommunications, and renowned cultural institutions.

The greatest barriers to modernizing the Korean service sector are the suffocating regulations and bureaucratic meddling by the government. For example, the skills of Korean medical personnel such as doctors and nurses are highly advanced, as witnessed by many Korean medical personnel successfully practicing in the United States. In Korea, however, it is still nearly impossible to establish for-profit hospitals to treat foreign patients, let alone domestic ones, even though they are already extensively allowed in Singapore, Thailand, and even in China. Consequently, Korean hospitals are very slow in attracting affluent foreign medical tourists. In 2010, for example, hospitals in Thailand treated 1,560,000 foreign patients, while the comparable number was only 80,000 for Korea.¹⁰ A similar situation prevails in attracting foreign educational institutions to Korea. Because of cumbersome regulations and the bureaucratic inertia of the government, Korea has lagged well behind such Asian countries as China, Singapore, and Japan in attracting foreign educational institutions. Because it is also very difficult to get permits to build tourist hotels in Seoul and other metropolitan areas, Korea has lost many foreign tourists, especially the newly rich Chinese tourists, owing to the lack of adequate hotel rooms in major cities.

The Korean service sector needs drastic deregulation and far less bureaucratic interference in order for the Korean economy to advance to the next level. It is not surprising that the Korean service sector lags far behind the average among Organization for Economic Cooperation and Development (OECD) countries in terms of productivity, value added, and employment.¹¹

Classification of International Financial Centers

There are different types of international financial centers. The International Monetary Fund distinguishes three categories among them: international financial centers (IFCs), regional financial centers (RFCs), and offshore financial centers (OFCs).¹² IFCs such as London, New York, and Tokyo are large, full-service international financial centers with advanced settlement and payments systems, and they support large domestic economies with deep and liquid financial markets. Their legal and regulatory frameworks are adequate to safeguard the integrity of principal-agent relationships and financial supervisory functions. RFCs such as Hong Kong, Singapore, and Luxembourg also have modern financial markets and financial infrastructure, but they have relatively small domestic economies and thus intermediate funds mostly for the surrounding regions rather than for their own economies. OFCs such as Bahamas and Cayman Islands are much smaller and provide more limited specialist services, and they are often known as tax havens as they tend to be used, among other roles, as tax havens or tax shelters for corporations, financial institutions, and high-net-worth individuals.

OFCs are more lightly regulated and have traditionally provided various services, largely tax driven, and they have very limited resources to support modern financial intermediation. However, there has been an active international drive recently to introduce transparency and strengthened financial supervision into OFCs, spearheaded by the OECD, Financial Stability Forum (recently expanded and renamed Financial Stability Board), Financial Action Task Force, BIS, IMF, the World Bank, and others. Consequently, many of these centers, such as the Cayman Islands and Dublin, have improved their reputation as genuine centers for legitimate international financial services. In fact, many OFCs serve their neighboring IFCs in a symbiotic relationship, as many Caribbean-area OFCs such as Bermuda, Cayman Islands, Panama, and Bahamas serve New York; Channel Islands and Isle of Man complement London; and Lichtenstein and Luxembourg support Frankfurt and Zurich. In recent years, Labuan (off the coast of Malaysia's Borneo Island) has also risen to complement Singapore.

We can also classify four different categories of international financial centers, according to the sources and uses of funds for the market area being served by an international financial center (*Table 1*).¹³ A primary center serves worldwide clients, but the predominant sources and uses of funds are within its major market area, which consists of highly dynamic economies that supply surplus savings to the center and also borrow from it. A primary center acts as an international financial intermediary for its surrounding market region, just as a domestic financial center does for a country. Because of its dominant intermediary role, a

primary center is the hub of international banking and finance for its market area, providing a complete array of international financial services, such as trading in eurocurrencies and foreign exchange, international financial marketing, eurocredit management and syndication, and international securities underwriting and trading. The financial infrastructure of a primary center is comparable, or even superior, to that of any major domestic financial center.

Table 1: Four Types of International Financial Centers

Types	Sources of funds	Users of funds	Financial centers
Primary centers	Worldwide	Worldwide	London, New York
Booking centers	Outside	Outside	Nassau, Cayman Islands
Funding centers	Outside	Inside	Singapore, Panama
Collection centers	Inside	Outside	Bahrain, Dubai

Source: Author's data.

At the opposite end of the international financial center spectrum is a booking center that, owing to its highly favorable tax and other regulatory regime, is used by international banks as the location for “shell branches” that book offshore deposits and international loans. Because banks can maintain only post office boxes or mail drops in order to benefit from the favorable tax treatment offered to such a presence, the booking center has only minimal requirements for the financial infrastructure. Financial intermediation is primarily for and between nonresidents who may be located anywhere in the world. In this sense, a booking center plays the role of a financial entrepôt where the sources and uses of funds are oriented toward the regions largely outside its neighboring environs.

In between the two extremes of a primary center and a booking center are two other types of international financial centers—funding centers and collection centers. Their respective financial roles are opposite each other. Funding centers such as Singapore and Panama play the role of inward financial intermediation, channeling offshore funds from outside their market areas toward local uses. For example, more than half the funds collected in Singapore originate outside the Asian countries. In particular, the London financial market is the largest net supplier of funds to the Singapore Asian dollar market, although the Middle Eastern countries as a group have also become an important net supplier of funds. Most of the funds thus collected in Singapore are utilized in Asia; the 10 ASEAN member countries as a group are the largest net borrowers of funds from the financial center, followed by other East Asian countries. Similarly in Panama, foreign banks have been a major source of external financing for the local public sector both in capital project expenditures and current account deficits. For the local private sector, foreign banks provide short-term commercial credits and long-term investment funds in the region for agriculture (especially cattle raising and sugar), industry (especially in the Colón Free Trade Zone), and construction.

In contrast with inward intermediation of offshore funds

by the funding centers, a collection center such as Bahrain and Dubai engages primarily in outward financial intermediation. The market area of a collection center generates excess savings because of the low absorptive capacity of the region's economies. The surplus savings are accumulated in the collection center, where international financial institutions in the center can invest the funds in a far more professional manner than would local financial intermediaries. Therefore, the economic rationale of a collection center is efficiency in the management of investment funds on an international scale. This efficiency is made possible by the economies of scale and positive externalities arising from specialization, joint facilities, and the services of support industries in the financial center.

International financial centers can also be divided into three classes in terms of their operational and geographic reach.¹⁴ Global players such as London and New York serve a global clientele in the broadest range of financial services currently available, and they are in the forefront of innovations in developing new financial products and services as well as new risk management techniques. Regional players such as Frankfurt, Tokyo, Shanghai, Hong Kong, and Singapore primarily cater to their regional-market clients as their comparative advantages lie in their intimate knowledge of, and their close geographical proximity to, their clients located in the respective regions that they tend to serve. Finally, the so-called niche players such as Sydney, Zurich, Luxembourg, and Edinburgh tend to specialize in certain financial service sectors in which they have developed special expertise and reputation. For example, Zurich is well known for its efficient and discreet global asset and investment fund management for a number of international clients, while Luxembourg is famous as the preferred location of many finance holding companies and the listing of international securities on its stock exchange owing to a liberal regulatory environment and a favorable tax regime. This classification, however, neglects to include some of the well-known as well as not-so-well-known offshore financial centers including the Bahamas, the Cayman Islands, Panama, Nauru, Andorra, the Isle of Man, Labuan, and Liechtenstein.¹⁵

Anthony Johns identifies four clusters of international financial centers, each linked to a major onshore center and its time zone.¹⁶ The Caribbean–Central American centers are intertwined with New York and serve the North American and Latin American economies largely within New York's time zone. The European enclave, including continental European financial centers and various island offshore centers, operates within London's time-zone sphere. Some Mediterranean and Gulf region financial centers form the Middle East enclave. Finally, Hong Kong and Singapore on one side and Vanuatu and Nauru on the other serve the Asia-Pacific region while spanning Tokyo's time zone within the Asian enclave.

Functional Specialization of Financial Centers

International financial centers differ greatly in their function and structure. The difference is accounted for primarily by location economics as well as by government regulatory environments. This point may be illustrated clearly by comparing Singapore

and Hong Kong, two premier international financial centers in Asia. There are many similarities between Hong Kong and Singapore, such as a generally dynamic economy; political stability; good sea and air transportation links; a hard-working, English-speaking workforce; good communication facilities; a well-developed service infrastructure in the legal, accounting, and insurance sectors; and a British-influenced efficient civil service.

On closer observation, however, there are some important differences. In terms of geography, Singapore has the time-zone advantage of business hours that overlap with the major Asia-Pacific financial centers such as Tokyo and Sydney as well as the European centers such as London and Zurich. This advantage has helped Singapore to develop more active international money-market trading activities than Hong Kong. Foreign exchange and derivatives trades in Singapore have been extensive and sophisticated, enabling the Asia-Pacific region to connect with the European market on a daily operational basis. Singapore has also developed into a premier market for trading nondeliverable forward contracts in major currencies such as Chinese yuan and Korean *won*.

Hong Kong, however, has the geographic advantage of being located near dynamic and fast-growing economies such as China, Korea, Japan, the Philippines, and Taiwan. International banking, like a hotel business, is substantially affected by location. Proximity to these dynamic economies in East Asia has made Hong Kong important for the arrangement, syndication, and management of eurocredits to borrowers from the Asia-Pacific region. This is further helped by the liberal work-permit rules for expatriates there, allowing easy transfer of finance professionals to Hong Kong. Its government has played an active role in promoting Hong Kong as an international financial center, announcing a series of financial liberalization measures since the late 1970s abolishing the withholding tax on the interest income of foreign currency deposits (1982) and abolishing all forms of other taxes on interest incomes. Hong Kong's original role as China's main hub for international finance has not declined since its return to Chinese sovereignty in 1997. In fact, close economic cooperation with mainland China via the Pearl River Delta region has significantly helped Hong Kong's efforts to transform from the original manufacturing-focused economy to a diversified, modern, service-based economy based on banking and finance, logistics, marketing and trading, and legal and accounting services.

Therefore, one can easily see specialization of international banking functions between the two centers. This specialization results not only from the different geographical advantages of the two centers but also from different government policies. Hong Kong's approach to financial development differs from that of Singapore in that it relies heavily on private sector initiatives and little on government controls or incentives. The government has been content to provide only the general framework but otherwise avoids any direct sponsoring role in stimulating the growth of Hong Kong as a financial center.¹⁷ The government of Singapore, however, has taken a more ac-

tive role in promoting Singapore as an international financial center. Singapore's two sovereign wealth funds, Temasek Holdings (established in 1974) and Government of Singapore Investment Corporation (established in 1981), have also played an important role in enhancing Singapore as an international financial center.

Singapore has a thriving foreign exchange trading operation, ranked as the fourth most active foreign exchange trading center in the world after London, New York, and Tokyo.¹⁸ It is also a major wealth management center in Asia, offering an array of services through many world-class financial institutions with operations there. More than 500 local and foreign financial institutions are offering a wide range of financial products and services, including trade financing, foreign exchange, derivatives products, capital market activities, loan syndications, securities underwriting, merger and acquisition services, asset management, financial advisory services, and specialized insurance services.

Apart from funding and money-market trading activities, Singapore has become the most important Asian market for long-term international bonds. It is true that some questions still remain as to whether Asian dollar bonds are genuinely Asian or simply another name for eurobonds. Nevertheless, Singapore has offered the most important Asian alternative to the eurobond market for international bond issuers. Many Asian as well as non-Asian borrowers have tapped the Singapore Asian dollar bond market as an alternative to eurobonds. The fact that some of these Asian dollar bonds have been placed in Europe does not negate the role of Singapore as the most important Asian international bond market. We can detect similar patterns of functional specialization and complementation among other international financial centers, and they can be accounted for by their locational and regulatory environments. In recent years, however, Hong Kong has emerged as the new center for trading offshore Chinese yuan as well as for issuing international bond issues denominated in yuan, known as dim sum bonds.

Economic Effects of International Financial Centers

International financial centers contribute to the local and regional economies in a number of ways. First of all, such a center promotes regional and international integration of national financial markets, thus encouraging mobilization and allocation of savings on a regional basis and exerting a positive influence on the host country's economic growth. Integration of national financial markets helps to eliminate local and sectoral monopoly and monopsony and stimulates the formation of savings and their pooling internationally. Allocational efficiency is not suboptimized at a country level but optimized at a regional or even global level. As the local financial system thus becomes more robust and efficient, the economy can be more resilient to a potential future financial crisis or shock.

For a capital-scarce country such as a typical developing nation, an international financial center can provide a transitional substitute until the development of its own domestic financial

market. Location of an international financial center in a developing country stimulates the growth of modern financial infrastructure for a robust local financial market. The presence of many international finance professionals in the center is bound to enhance the financial skills of local financial institutions, thus contributing to more efficient and higher-quality service to their domestic clients as well. The transfer of sophisticated international finance techniques assists in the modernization of domestic banking and financial industries. Latest financial techniques in risk management, funding and investment activities, and trading operations can be more easily transferred to local markets through the presence of an international financial center.

International financial centers have positive effects also on local employment in such areas as banking and related financial institutions, as well as legal, accounting, printing, and telecommunication industries, where job opportunities open up for both professional and clerical workers. Establishment of international financial centers stimulates development of related industries as the demand increases for air and sea transportation, modern medical services, world-class educational institutions, hotels and other lodging services, modern office buildings, and cultural and entertainment industries. Positive stimulus to employment and infrastructure in the international financial center has other spillover effects on the rest of the economy, as the benefits to the immediately affected sectors cascade down toward other segments of the economy.

International financial centers, because of their apparent convenience, have been used not only for international banking and related financial activities such as insurance and investment management but also for other purposes. They are often used as the site for regional headquarters of major corporations through which a multinational corporation (MNC) owns and operates its overseas subsidiaries in the most advantageous fiscal and regulatory climate. They also serve as a location for financial subsidiaries of MNCs that are employed in tapping international money and capital markets with greater freedom of action than is feasible in their home countries. For example, numerous U.S. MNCs previously set up financial subsidiaries in offshore financial centers in order to issue, among other instruments, eurobonds free of the U.S. withholding tax.

International financial centers also provide additional tax revenues to host governments in the form of personal income tax from the extra jobs created in the financial and other ancillary sectors, registration fees on foreign financial institutions, and stamp duties and transfer taxes on securities traded. But apart from tangible economic and fiscal benefits, one of the most significant contributions of international financial centers is their stimulant impact on internationalization of the local economy. These financial centers attract not only foreign investment funds but also flows of valuable financial, commercial, and industrial intelligence from all over the world. They indirectly promote both foreign direct

investment in the host country and joint ventures with local partners, thus helping local industries to become more internationally competitive.

Furthermore, for countries such as Singapore (next to huge Muslim countries of Indonesia and Malaysia) and Korea (separated from its heavily armed North Korea by a thin demilitarized border line), which are surrounded by potentially hostile and belligerent neighbors, the presence of large and well-known international banking and other financial institutions from powerful Western nations can provide an added deterrent to their neighbors. Powerful home countries of international financial institutions would not look kindly on any potential military and political threat to the host country of an international financial center where their own economic and financial interests are also intertwined. One of the primary reasons why the government of Singapore decided to develop an international financial center there in the late 1960s was to use the presence of powerful Western banking institutions to enhance Singapore's national security.¹⁹

There are also disadvantages connected with international financial centers. Some scholars have mentioned the adverse tax impact caused by the fact that a host government has to lower taxes in order to attract foreign financial institutions to the financial center. Therefore, the net revenue effect depends on whether such a negative revenue impact outweighs the positive revenue impact caused by higher tax receipts generated by the enhanced employment and a faster economic growth of the host country as well as extra fee income and stamp duties resulting from incremental trading activities and other financial operations of an international financial center there.²⁰ Implementation of domestic monetary policies may also become more complicated because of internalization of offshore funds and the resulting excess money supply growth. Thus, monetary policy objectives may be countermanded through leakage in the domestic banking system in the presence of offshore funds. In addition to internalization of offshore funds, the potential also exists for capital outflows from the domestic financial market since there are generally no taxes levied on deposits in the offshore center. A certain degree of interface between the international financial segment and the domestic banking system is not only inevitable but also desirable as a safety valve. The Singapore government, for example, has adopted increasingly more liberal attitudes toward resident investment in the local Asian dollar market.

In recent years, increasing attention has been directed toward certain offshore financial centers for their potential abuse in money laundering and the financing of terrorism. In this connection, considerable work has been undertaken on the multilateral level by the Basel Committee on Banking Supervision, International Association of Insurance Supervisors, International Organization of Securities Commissions, Financial Action Task Force, OECD, and others.²¹ The International Monetary Fund has also participated in the ongoing assessment of offshore financial centers to check for potential abuses.²²

Requirements for a Successful International Financial Center in Korea

Money and finance are very sensitive to external factors such as war, social and political instability, new taxes, and government regulations. International financial centers are attracted to those countries that are politically stable, with low taxes, and with minimum government interference in the environment of a free market economy. The macroeconomic environment should also be healthy, with low inflation and a sound fiscal situation and conservative monetary policy. While government regulations should be minimal, a modern financial supervisory framework is required to ensure a healthy and transparent financial system. There should be a robust legal system providing for adequate property rights protection, contract enforcement, and bankruptcy processes, all properly chaperoned by a functioning court system.

An international financial center requires modern infrastructure in such areas as telecommunication and high-speed Internet connections, convenient air and sea transport, modern mass transit and other local transportation system, electricity, gas, sanitation and health systems, and first-class education facilities from kindergarten through graduate school. An efficient financial center also needs advanced legal and accounting firms, hotel and other lodging facilities, modern housing, and well-educated and English-conversant finance professionals and support staff. Visas and work permits for foreign workers should be readily available as well. Finally, it would be helpful to have a dynamic economy in the host country as well as the surrounding regions, with ample economic opportunities for the financial services to be provided from the international financial center.

Korea has many advantages in its plan to develop a major international financial center. The Seoul Financial Forum has identified eight of them as most pronounced.²³ First of all, Korea—with the 13th-largest economy in the world—is strategically located at the heart of Northeast Asia, which produces one-fourth of the world GDP and is expected to lead the world economic growth in this century. Second, with its financial assets amounting to over eight times that of GDP, Korea has the third-largest pool of domestic financial assets in Asia after Japan and China, thus providing a growing demand for various investment opportunities. Third, Korea is home to a large number of world-class companies, with their brand names readily recognized not only in Asia but also throughout the world. Fourth, it has large and active financial markets, supported by Korean corporations and a wide range of financial institutions such as banks, mutual funds, and life and nonlife insurance companies. In addition, a strong demographic and human-capital base, well-developed IT infrastructure, momentum for financial reforms since the 1997–98 Asian financial crisis, a strong and independent judiciary, and Korea's vibrant and deep-rooted democracy are mentioned as key advantages for Korea.

Korea has many challenges to overcome, however, before a

successful international financial center can be established. First, the government is very intrusive, with domestic financial institutions still unduly constrained by cumbersome bureaucratic meddling. Although there has been a significant improvement since the 1997–98 Asian financial crisis, Korea has a long way to go in order to realize a paradigm shift in the regulatory and supervisory regime. Second, the rigid labor market is one of the major barriers to developing an international financial center in Korea, where there are severe procedural restrictions on any worker layoffs. Korean labor unions have truly earned notoriety for their militancy and illegal union tactics, including frequent and violent labor strikes and disruptive demonstrations. This labor problem has to be resolved to an international standard in order for Korea to reach the next level of economic development, including a successful international financial center. Third, tax rates need to be lowered substantially. Korea's maximum personal income tax rate of 35 percent is much higher than Singapore's (20 percent) and Hong Kong's (17 percent), while Korea's corporate income tax rate of 25 percent also compares poorly with that of Singapore (20 percent) and Hong Kong (17.5 percent). There are also no capital gains taxes in both Hong Kong and Singapore. In addition, Korean firms suffer from excessive quasi taxes in the form of semimandatory dues, donations, and allotments. Fourth, accounting practices in Korea are still opaque, as demonstrated in some of the recent corporate scandals. Other negatives include cumbersome visa and work permit rules, xenophobic mind-sets of many Koreans, and the lack of an English-friendly environment.

The greatest uncertainty at this stage, however, concerns the military threats from North Korea. Money and finance are extremely sensitive to the threat of war or social and political instability. One of the major international security concerns is the North Korean nuclear weapons development, considered by some as even more troublesome than the ongoing Arab-Israeli conflict and the al Qaeda problem.

On balance, Korea possesses the required infrastructure for a successful international financial center, but at the same time it has many shortcomings that need to be addressed before the establishment of an international financial center. Still, Korea has made some progress in developing an international financial center. For example, the Global Financial Centres Index published by City of London put Seoul at number 35 in 2010, but its ranking advanced to 16 in 2011 among international financial centers (*Table 2*).

Unlike well-established international financial centers such as London and New York, situated in industrialized countries with many decades of experience in modern finance, a new international financial center in an emerging economy like Korea's has to be actively nurtured by its own government, at least in its initial stage. As early as 1968, Singapore's then prime minister, Lee Kuan Yew, played an active role, despite some strong opposition in his own government for being premature, in developing Singapore into an Asian financial center. At that time, Singapore had just become independent from Malaysia, and it was still a dirt-poor, resource-deficient small city-state with a double-digit unemployment rate and no industrial base. Still, Prime Minister Lee boldly abolished the 25 percent withholding tax on nonresident bank

Table 2: Comparison of Major Global Financial Centers with Korea

Financial center	Rank	
	2010	2011
London	1	1
New York	2	2
Hong Kong	3	3
Singapore	4	4
Tokyo	7	5
Shanghai	10	5
Chicago	8	7
Zurich	6	8
Geneva	5	9
Sidney	11	9
Frankfurt	12	14
Seoul	35	16
Dubai	21	28
Cayman Islands	26	38
Bahrain	43	49
Mumbai	53	58
Bahamas	48	67

Sources: City of London, *The Global Financial Centres Index 7* (March 2010); City of London, *The Global Financial Centres Index 9* (March 2011).

deposits and adopted other deregulatory measures in order to attract foreign financial institutions and to free up its financial market. Similarly, in 1975 the ruler of Bahrain, the only country in the Gulf region without any significant oil or gas reserves, decided to go ahead in developing his desperately poor and underdeveloped country into the Gulf region's international financial center. For this purpose, he invited a retired Bank of England executive from London to Bahrain and gave him a blank check so to speak to do anything necessary to turn the country into an international financial center. The same is generally true with Dubai, Labuan, Dublin, Lichtenstein, and numerous other financial centers.

It takes a determined commitment from the highest level of the government to tackle the myriad of regulatory, tax, and other barriers in order to develop an international financial center. Korea should take on the task of developing a viable international financial center as its top priority, as this strategy fits in nicely in its grand design of turning Korea into a truly advanced, first-world country.

Korea as an International Financial Center for East Asia

We have discussed several different types of international financial centers in the world. Despite the recent global financial crises involving Wall Street and eurozone countries, London

and New York still remain the premier global players, providing a comprehensive range of international financial services to clients located around the world.²⁴ At the same time, other financial centers have also flourished by exploiting their comparative advantages. Luxembourg has developed into the second-largest mutual fund market after the United States, and Switzerland is well known for its asset management as it handles one-third of the world's cross border invested wealth. Other specialized offshore financial centers have engaged in certain aspects of financial services by taking advantage of their locational or regulatory advantages. For example, Cayman Islands is the leading domicile for hedge funds and special-purpose companies, and Mauritius has utilized its close links to India to become the largest foreign investor in India as Indians have used the country to disguise investment in their own country as tax-advantaged foreign investment. We can easily detect each financial center maximizing its comparative advantage to develop its own unique business model.

Korea is the fourth-largest economic power in Asia, and it is the home of many globally competitive industrial firms such as Samsung Electronics, Hyundai Motors, and Pohang Iron & Steel. Potentially, Korea can become a successful regional financial center serving East and South Asia. By exploiting its dynamic economy and its central location in the fast-growing East and South Asian region, Korea can become an international financial center serving this region by modernizing and globalizing Korea's debt and equity markets, foreign exchange markets, and derivatives markets. To achieve this goal, Korea has to develop and also attract a variety of modern commercial banks, insurance companies, brokerage and securities houses, investment banks, asset management firms, hedge and private equity funds, and various other financial service providers.

The international financial center in Korea should be able to complement such global financial centers as New York and London by specializing in the service of foreign investors eager to do business in East Asia as well as providing resurgent financial service needs such as asset management for the rising financial wealth in the region. One way to promote Korea as the regional financial center serving East and South Asia is to allow both deposits and bond issues denominated in a number of international currencies, including the Japanese *yen* and the Chinese yuan as well as U.S. dollars and euros.

A vibrant international financial center in Korea is likely to promote further globalization of the Korean economy and modernization of its service industry, which is essential for Korea to join the club of the truly advanced countries in the world.

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