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Policy Implications of Korea's Low Level of Foreign Direct Investment

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FDI IN KOREA

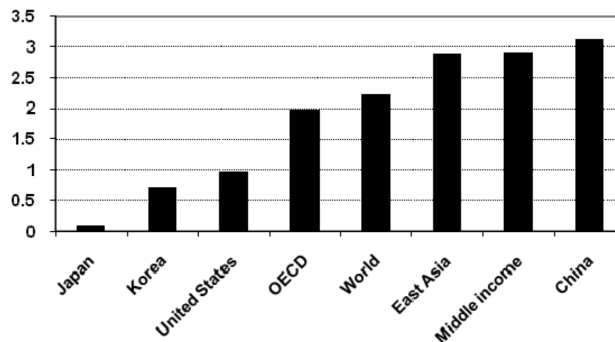
Korea is notable for its relatively low value of inward foreign direct investment (FDI).[1] FDI flows into the country are considerably less than those seen in other middle-income economies. In recent years, they have averaged around 0.7-0.8 percent of GDP, whereas the rate for all middle-income countries is almost 3 percent. (World Bank 2007) The policy implications of Korea's low level of FDI are the main issues addressed in this report.

In the early stages of Korea's industrialization, the country restricted FDI, relying instead on foreign long-term loans to finance domestic investment. However, in the 1997-98 financial crisis that affected Korea, along with many of its neighbors, Korea agreed to the International Monetary Fund's conditions to open its economy to foreign investment. In addition, domestic policy makers recognized that further development would require the participation of foreign firms with their specialized knowledge, technology, and competition.

As the policy direction underwent dramatic reorientation, many laws and regulations were changed immediately. Others changes were in response to impediments uncovered by the growth of FDI. The government also established two FDI promotional agencies. Nevertheless, old habits have been slower to change and several residual barriers to FDI continue to retard a more vigorous foreign involvement. Despite significant shifts in policy directions, FDI remains at relatively low levels.

Figure 1 shows comparative data for Korea and other areas, averaged over five years to reduce the effect of short-term fluctuations. Except for Japan, Korea has the lowest ratio of FDI to GDP among the leading Asian economies and most middle-income countries.

Figure 1: Inward FDI/GDP, 2002-06 Average (%)

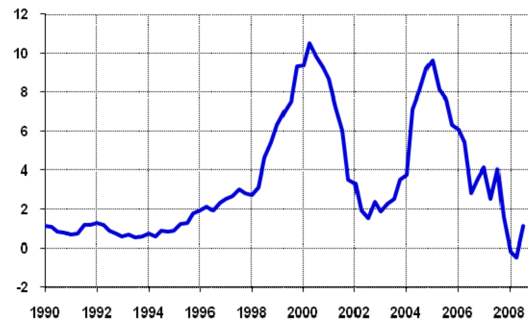


Source: World Bank 2007

Not only is the relative value of FDI low, it is falling, both absolutely and relative to global trends. The flow of inward FDI is shown in Figure 2. It increased at a rapid rate after 1997 as foreign companies participated in the many corporate restructurings occurring in the wake of the Asian financial crisis. However, after this surge, the flow of foreign money slowed, especially after 2000 in the wake of the collapse of an information technology investment boom. Investment then rose again in 2005, almost reaching the previous peak. Since then, Korea seems to have lost its allure as new funds declined precipitously; there was even a net outflow in 2008 as investors cashed out more of their assets than they put into new projects.

[1] FDI is defined as an investment by a foreign entity in a domestic enterprise involving a long-term relationship with a significant degree of influence by the investor. For statistical purposes, the IMF defines a direct investment relationship to exist when the investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad.

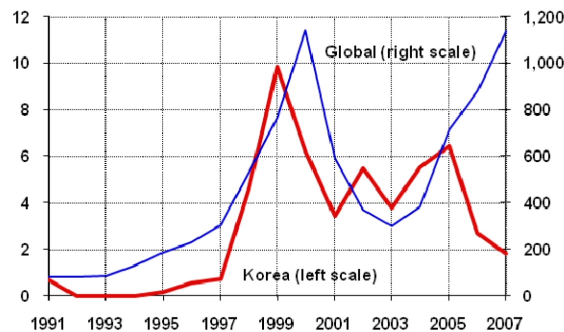
Figure 2: Foreign Direct Investment Inflows, 1990-2008 (billion $)



Note: Moving four-quarter sum.
Source: Bank of Korea, Balance of Payments

The ups and downs shown in Figure 2 depend partly on global economic activities. As the world booms, so does investment into Korea, and vice versa. This parallelism is shown in Figure 3, which traces cross-border mergers and acquistions (M&A) of foreigners buying Korean firms along with worldwide M&A activity. Both trends rose throughout the 1990s and then both collapsed; cross-border deals recovered after 2003 as investors with plenty of cash went hunting for new targets. While worldwide M&A hit new records in 2006 and 2007, Korea's fell in both years.

Figure 3: Korean and Global Cross-Border M&A (1991-2007, billion $)



Sources: Thomson Reuters, UNCTAD 2007

This divergence of trends suggests that something is happening in Korea to scare away investors. There are several possible explanations, but most do not hold up to scrutiny. First, a worsening legal, regulatory, and official support environment is not the answer because the institutional framework has grown steadily more receptive to FDI over the past decade. Second, falling returns to investment is inconsistent with the evidence; returns on American direct investment in Korea, for example, held steady through the end of 2007 and were comparable to returns earned elsewhere by American investors. Third, Korean assets did not become more expensive; in fact, they grew cheaper in terms of New York and Korean stock market relative prices when converted to dollars, which would tend to increase, rather than decrease, foreign investment. Indeed, foreign portfolio investment in stocks and bonds responded to the change in relative prices as they continued to flow into the country in near-record amounts. In light of the above, one other explanation for the retreating foreign investment is that a perceived rise in economic nationalism alarmed foreign investors and drove away potential business. This issue will be explored below in describing Lone Star Funds' attempts to sell its stake in Korea Exchange Bank.

[2] Returns through 2005 are shown in Alexander 2008a: 18. Updates through the end of 2007 show stable returns. Returns are calculated as the ratio of direct investment income to direct investment position at historical costs.

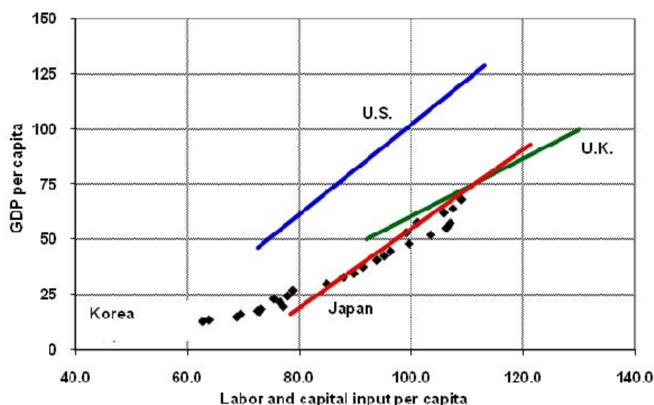
FDI CRITICAL TO KOREA'S PRODUCTIVITY GROWTH

The weak participation of foreign firms in Korea's business activities is important because FDI has the potential to deliver many positive benefits to a receptive country. The beneficial effects of FDI are dependent on whether the host has the human capital, infrastructure, and business networks to support positive spillovers from FDI. When a country has such an infrastructure, as Korea does, FDI boosts productivity, advances domestic technology, enlarges exports, increases competition, and enhances the skills and capabilities of the domestic work force.[3] Korea's potential to attract more FDI is indicated by cross-country statistical estimates linking an economy's characteristics to foreign investment; based on these estimates, Korea's projected ratio of FDI to GDP is 4.0-5.5 percent of GDP, more than five times the actual amount. (Alexander 2008b: 7)

The likely benefits from FDI are particularly important for Korea at the present stage of its economic development. The country is reaching economic maturity. It has successfully managed the transition from being an undeveloped economy to one that is moving into the ranks of the richer nations. Promotion into the major leagues of the economic players, however, is not automatic. It requires a focus on productivity. Korea's past growth has depended on investments in human and physical capital, greater work efforts from its people, and improvements in how those capital and human resources are used. Economic maturity requires a shift in emphasis from increasing resources to enhancing efficiency.

The importance of improving Korea's productivity is illustrated in Figure 4, which shows the comparative efficiency of transforming resources into national economic output for several countries. The chart shows real GDP per person on the vertical axis and combined capital and labor per person along the horizontal axis. Both inputs and outputs are indexed to the U.S. 1990 for comparability. According to these estimates, Korea gets only about half as much output for its effort. Another way to interpret the figure is that Korea achieved the level of GDP per person in 2002 as the United States did 30 years earlier; however, the United States used 25 percent fewer resources to produce that output. Although Korean productivity has caught up with Japan and even the U.K., its progress in catching up with the U.S. seems to have stalled.[4]

Figure 4: Labor and Capital Inputs per Capita and GDP per Capita



Notes: Labor, capital, and GDP indexed to US 1990 values. Input weights: capital, 0.35; labor, 0.65. Trend lines shown for US, UK, and Japan.
Source: Labor hours, population, GDP from EU KLEMS database; capital stock estimates from Alexander 2003 (updated)

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[3] This literature is reviewed in the first report of this series (Alexander 2008a).
[4] This chart is modeled after one in a McKinsey Global Institute study on Korea's productivity. (McKinsey 1998: Aggregate Analysis, 6) Alternative data sources showed similar results, although the details varied somewhat. In the other estimates, the U.S. always was the most productive, followed by the U.K., Japan, and then Korea. The American trend was the steepest, indicating that the American productivity lead was widening.

This evidence says that Korea is wasting resources, mainly labor. People work considerably more hours, but have considerably less to take home for their effort, compared to Americans. The fact that the American trend line is steeper than Korea's indicates that the gap is widening. In other words, American growth is coming more from doing things better than from using more labor or capital.

A major source of Korea's relatively low productivity is captured in Table 1, which focuses on the service sector. Service-sector productivity is only about two-thirds that in manufacturing, whereas across the member states of the Organization for Economic Cooperation and Development (OECD) the two sectors are virtually equal. Low productivity in services arises from past industrial and tax policies that deliberately favored manufacturing; companies in services, for example, had difficulties obtaining bank loans for expansion or improvements because finance was reserved for heavy industry. Continued regulation of large parts of the service sector—medical care, for example—creates barriers to both foreign and domestic investors. An additional explanation for low service sector productivity is that entry barriers are generally higher, weakening competition and resulting in a large number of small firms. The government has recognized these problems and, in 2006, took steps to equalize the incentives between manufacturing and services.

Table 1: Value Added per Worker in 2003 (manufacturing = 100)

	Korea	OECD
Services	64.8	97.1
of which: wholesale and retail trade, hotels, and restaurants	28.1	70.5

Source: OECD 2007a: 153

Because of continuing barriers in services, the potential stimulative effects of FDI are thwarted. As highlighted by the OECD, the share of the service sector in Korea's inward FDI stock is one of the lowest among member countries—about one-third less than the average—reflecting a relatively high level of restrictions to foreign ownership, as well as product market regulations. (OECD 2007a: 152)

BARRIERS TO FDI

Barriers to FDI in Korea arise from several sources. The most obvious are laws and regulations aimed directly at limiting FDI. Other barriers are side effects of policies directed toward other objectives. Labor market problems are a third source of FDI barriers; rigid labor market practices, particularly those related to eliminating jobs, as well as fractious labor relations are frequently mentioned obstacles. A different type of obstruction lies in a perceived anti-foreign bias among many Koreans, including government officials charged with implementing official policy.

Explicit Barriers: Since 1998, foreign companies have been allowed to invest in all but a few manufacturing industries. Restrictions on investment in the services sector, also, were loosened, although many remained in effect. In place of the former requirement for official approval for FDI, simple notification was instituted as the norm. Another 1998 law removed restrictions on foreign ownership of real estate. At the same time, a promotional agency, Invest Korea, was established to stimulate FDI, and a foreign investment ombudsman was created to centralize and deal with complaints.

Several restrictions, however, still apply to foreign investment. Foreign entities may not cultivate rice and barley; beef and dairy farming and coastal fishing firms are limited to 50-percent foreign ownership. Foreigners may not own more than 30 percent of newspapers and 50 percent of magazines; radio and television remain closed to foreign investment with additional restrictions in other media. Foreigners may not exceed half ownership in most telecommunication or transport ventures, including airlines.

Foreign institutions of higher education and medical clinics may not function except in designated free economic zones. In the services sector, foreign lawyers may not operate except in advisory or consultative roles. Professional engineers, architects, accountants, and management consultants may work only on a contractual basis for local firms.

Although restrictions remain, 99.8 percent of all business lines (out of a total of more than 1,100) are open to foreigners. Limitations on foreign participation still exist in 26 sectors, as noted above.

Product Market Barriers: Regulations that hinder the entry of new firms or products act to reduce competition, retard productivity growth, and—by their nature—impede FDI. Entry barriers and regulations are concentrated in services, contributing to the low level of productivity in this sector. A complex and nontransparent framework for land use limits entry. In the retail sector, obstacles to the opening of large-scale outlets restrict both foreign and domestic operations. Other sectors where regulations stifle competition include business services, health care, and long-term nursing care. (OECD 2005: 33)

A June 2008 survey conducted by the Korea Chamber of Commerce and Industry of 549 foreign firms whose investment level was at least 80 percent of a company's total capital bears on this question. According to these firms, which are already operating in the country, regulatory change comes at the top of their wish list, and anti-foreign sentiments at the bottom. Table 2 reproduces the KCCI survey results.

Table 2: Most Preferred Policy Measures to Improve FDI Environment (% of responses)

Measure	%
Mitigation of administrative regulations concerning approvals and authorizations	28.4
More tax reduction/exemptions	27.3
Consistency in policy	19.5
Improvement in logistics infrastructure	10.4
Stability in labor-management relations	8.9
Supply of land at reasonable prices	3.8
Removal of sentiment against foreign capital	0.9

Source: KCCI (2008)

Another obstacle to foreign investment is the relatively high tariffs on manufactured goods. The simple average has fallen to 7 percent for non-agricultural goods, but they remain higher than in most other OECD countries.

Barriers as Side Effects: The OECD notes the impact of regulations introduced for quite other purposes. An outstanding example is the set of rules restricting new investment in the capital region; although intended to promote balanced national growth, the rules have the side effect of discouraging FDI because foreign investors' preference is to locate in Seoul, given its high quality infrastructure, the availability of skilled human resources, and access to a large local market. Despite temporary exemptions for designated high-tech industries, each foreign investment proposal still requires approval from the relevant ministries, based on its overall contribution to the economy. As evaluated by the OECD, the case-by-case approach undermines the transparency of the FDI framework, thereby discouraging potential investors. (OECD 2007a: 159)

Constraints on competition involving the legal profession may be the most important services-related barrier to FDI according to OECD analysts. Limits on the admission of new lawyers and unnecessary restraints on forms of practice undermine the development of stronger legal oversight of corporate governance and hamper foreign investment. Foreign lawyers have requested permission to set up branch offices, form joint ventures with Korean law firms, and employ Korean and foreign lawyers. However, foreign licenses are not recognized in Korea, and foreign lawyers can only be employed as "legal assistants" in local firms. Limited acceptance of professional qualifications established in other countries restrict the availability of legal, as well as accounting services. Since the absence of these professional capabilities discourage foreign investors, failure to open this market can act as an indirect barrier to FDI. (OECD 2007b: 28)

Labor Market Problems: The OECD's Korea reports in 2004 and 2005 each devoted a chapter to this issue. The 2004 edition begins by describing the basic situation: a lack of flexibility resulting from strict employment protection for regular workers. The strong opposition of workers to relaxing constraints on dismissals is due in part to the limited social safety net to protect the jobless. In addition, "There is the problematic state of industrial relations, which has weakened the confidence of investors in the Korean economy." (OECD 2004: 79)

Not only do these conditions negatively affect FDI, but they also create incentives against hiring in the first place because of the difficulty of firing people; moreover, the difficulty in eliminating jobs encourages the growth of temporary and part-time employment.

From 2000 to 2004, the number of working days per 1,000 employees lost due to strikes was the sixth highest among the OECD countries, well above other Asian economies, although the rate fell by almost half from 2000. According to a 2003 poll of CEOs of Korean and foreign firms, about half were reluctant to invest in Korea because of labor-management problems. (OECD 2004: 94)

To deal with labor market impediments to economic growth and foreign investment, the OECD published a list of recommendations, which included: reduce employment protection for regular workers and specify in the law the conditions under which dismissals are permitted; increase compliance with the employment insurance system to enlarge the social safety net; expand coverage of non-regular workers; and develop more cooperative industrial relations, on the lines recommended by an advisory group of expert academics. (OECD 2005:161)

Although the employment insurance system has been greatly improved since it was first introduced in 1995, as of 2004, only 24 percent of unemployed workers received benefits; this low proportion reflects the strict conditions necessary to qualify for benefits, as well as their relatively short duration. (OECD 2005: 150)

Several other studies confirm the existence of serious problems in the labor markets. The World Bank and International Finance Corp. have been conducting annual surveys on the ease of doing business; the 2008 report includes 181 countries. The surveys are built around a fictitious case of business start-up or standardized actions taken by an existing business. The built-in similarities of the cases help to guarantee comparability across economies.

Table 3 shows the percentile rankings of Korea for the past two years across sub-categories as well as its overall rank. (The percentiles range from a best score of zero to the worst of 100.) Korea performed relatively well overall—within the top one-fifth of all countries in both years—and improved from one year to the next. However, its worst scores are for starting a business and worker relations, both of which are related to the ease of a foreign investor starting and running a business. The labor index is comprised of several sub-indices, including rigidity of employment (hours, hiring, and firing) and the costs and difficulty of firing. Korea's performance overall was downgraded by rigid working hours, as well as by the high costs and other difficulties of reducing a workforce. (World Bank/IFC 2007: 130)

The World Bank/IFC survey is not alone in identifying labor issues as a major element affecting the Korean economy and its receptiveness to foreign investment. The World Economic Forum's global competitiveness index places Korea's employment practices in the lowest performing group of countries, even while the country ranks in the top decile overall (based on 110 separate items). Korea's firing costs and cooperation in labor-employer relations are at the very bottom of the list. (World Economic Forum 2008: 209)

The image held by many observers is that the relationship between employers and employees is marked by struggle and confrontation. The number of working days lost due to strikes averaged 100 days per 1,000 workers in 2000-03, the sixth highest in the OECD area and significantly above other Asian countries. Although the number of labor confrontations has fallen subsequently, the number of days lost remained high at 77 days per 1,000 workers in 2006.

Table 3: Korea's Percentile Ranking in "Doing Business" Survey, 2006-07

	2006	2007
Ease of doing business, overall rank	17	13
Starting a business	62	70
Dealing with licenses	12	13
Employing workers	74	84
Registering property	38	37
Getting credit	20	7
Protecting investors	36	39
Paying taxes	60	24
Trading across borders	7	7
Enforcing contracts	6	4
Closing a business	6	7

Note: Best score is zero, worst is 100.
Source: World Bank/IFC 2007: 130

According to the survey cited above, of the 280 foreign firms polled, half were dissatisfied with labor-management relations, while only 19 percent were satisfied. (OECD 2007a: 159)

Anti-Foreign Bias: Near the top of foreign complaints is the suspicion that Korean government officials do not enforce laws and regulations in consistent, predictable, and transparent ways. Such suspicions are fueled by cases in which anti-foreign sentiments seem to have been the basis for regulatory decisions. These misgivings exist despite government leaders' repeated assertions that the playing field is level between domestic and foreign firms. However, actions lower down in the agencies may belie the proclaimed policies of those at the top.

A Seoul newspaper article documents this split between upper and lower level officials. "Despite all the slogans and gestures by the government to attract foreign investment, foreigners have turned their backs on Korea as the world's 13th largest economy has become increasingly less friendly to foreign investment. The view, which has long been denied by ranking government officials, has been backed by the latest report on foreign direct investment into Korea. … Despite the government's denial, the view that Korea has become less attractive to foreign investment has been widely shared among global investors." (*Korea Times* 5 May 2008)

The article goes on to provide explanations of the phenomenon: "The nation's inconsistent and heavy-handed rules have become a major bottleneck, scaring away foreign capital and businesses, according to an analysis by the central bank." A Bank of Korea economist explained, "Excess regulations and complex administrative procedures here have deterred investment inflow over the past few years. In particular, the entry barrier for foreign businesses is set too high. The government has introduced a number of projects to attract foreign investment, including Invest Korea in 2003, but most of them have turned out to be no more than slogan-oriented projects." This critical article ends by quoting a former Morgan Stanley, Asia-based economist: "I don't think Korea can change in the near future to reverse the poor FDI trend. Korea may be unwilling to make the changes to attract FDI. Korea may never become a truly open economy. The mere fact that people always talk about foreign versus local means that the economy cannot be truly open." (*Korea Times* 5 May 2008)

The commercial counselor at the Spanish embassy in Seoul echoed these contradictions. "Korea is sending foreign investors confusing signals, drawing attention with optimistic promises, then disappointing them with pessimistic reality. The Korean authorities are positive in their message, willing to attract foreign direct investment, but no real measures are in place." (*Korea Times* 3 August 2008)

POLICY PRESCRIPTIONS

American Prescriptions: There is no lack of diagnoses and advice to remedy Korea's FDI deficiency. The United States Trade Representative, for example, discusses it in its annual trade barriers report. It notes that the Korean government has continued "support for the establishment of a more favorable investment climate in order to facilitate foreign investment." Following this positive introduction, the report advises: "However, while progress has been made in recent years, additional reforms would make Korea more attractive to foreign investors, such as resolving certain labor market issues (e.g. better pension mobility, more flexibility in hiring and firing workers, expanded unemployment compensation, less rigid worker visa rules, and better job training and placement services), reducing labor-management disputes, and improving regulatory transparency." The American agency continues by acknowledging significant capital market reforms, but complains: "The Korean government still maintains foreign equity restrictions with respect to investments in various state-owned firms and many types of media, including basic telecommunications service providers, cable and satellite television services and channel operators, as well as schools and beef wholesalers." (USTR 2006: 411)

Similarly, the American Chamber of Commerce in Korea has described the considerable efforts made by the government to encourage FDI. It also pays attention to the country's excellent infrastructure, high quality technology and manufacturing facilities, skilled workforce, and sizeable domestic market. Nevertheless, the Chamber states, "There is still concern on the part of foreign investors over lingering nationalistic and occasional anti-foreign sentiment and the continued lack of transparency in financial reporting, among other concerns." The American business group offers additional complaints and suggestions: "The single most consistent complaint by multi-nationals about investment in Korea concerns the labor market. … Many foreign multinationals feel that labor costs, labor laws that limit the ability of employers to hire and fire workers, and the need to devote scarce management time to labor relations make it more expensive for multinationals to produce in Korea than in other countries in Asia." The Chamber buttresses its case by arguing that many domestic manufacturers are expanding in countries such as China in order to access a more competitive labor market. (AMCHAM 2004) Labor is not the only issue. Other items include insufficient government regulatory transparency and accountability, and lack of transparency in corporate financial reporting.

OECD Analyses: In addition to the suggestions on labor market policy noted above, the Paris-based organization made increased globalization of the Korean economy a priority in its annual assessments. It asserts that Korea requires greater international exposure in several different areas: "One key to raising productivity is to increase Korea's integration in the world economy, given that rising flows of FDI, international trade, and movements of labor are key forces driving economic growth. Although Korea has become more integrated in the world economy over the past decade, it still ranks low in terms of the stock of inward FDI relative to GDP, import penetration, and foreign workers as a share of the labour force." (OECD 2007a: 35)

Turning their sights specifically to FDI, the OECD team of economists recommended that to improve the environment in Korea for FDI inflows, the major tasks are to develop the M&A market, further relax restrictions on FDI, ease product market regulations, and improve the business environment. The reason to focus on M&A is that it has become the main vehicle for FDI in most advanced economies. In turn, Korea's small M&A market partly reflects funding difficulties in its still developing capital market and the negative attitude of management, labor unions, and non-governmental organizations concerning M&A. (OECD 2007a: 156) These negative attitudes were exacerbated by foreign private equity funds earning very large profits on investments in distressed Korean financial institutions. The profits were considered by many Koreans to be the illegitimate plunder of foreign vulture funds that added little additional value.

In addition, in the wake of a few unsolicited takeover attempts by foreign companies, Korean business groups argued for the inclusion of poison pills, golden shares, and multiple voting rights in the commercial code to allow domestic firms to protect themselves from unsolicited takeovers. The government rejected these demands because

they were inconsistent with equal-treatment principles of domestic and foreign firms. To overcome these attitudes toward foreign investors, the OECD recommends that the authorities expand their public relations explaining the positive benefits of FDI and M&A.

POLICY TO REDUCE FDI BARRIERS

FDI Promotion Agencies: In the wake of the Asian financial crisis, two bodies were created to promote FDI: Invest Korea and the Investment Ombudsman, both situated in the Ministry of Knowledge Economy. Invest Korea is part of KOTRA, the Korea Trade-Investment Promotion Agency. It aims to provide one-stop service to potential investors, focusing on identifying, inducing, and facilitating FDI. It has 150 people in its Seoul headquarters and in 40 KOTRA offices in key locations around the world.

The Investment Ombudsman, established in 1999, also is formally located in KOTRA, but is a direct presidential appointment. The office aims to offer aftercare services by reducing or eliminating problems faced by foreign investment companies; it does so by obtaining the direct involvement of relevant government agencies, the legislature (if laws require modification), and private organizations. One example involved rewriting legislation that prohibited sub-contracting on construction jobs to allow Otis Elevator Korea (and others) to hire specialized wiring and installation contractors on construction jobs; this effort also involved ministerial directives and other legal mechanisms to allow work to go forward without violating the law. (Ombudsman Office: 22 November 2007)

In another example, the Ombudsman assisted Gyeonggi province to increase the region's attractiveness for FDI by signing an agreement with the Korean Labor-Management Mediation Association. The agreement is intended to allow labor and management personnel who are unable to resolve difficult conflicts to come to a resolution more quickly and in a legally binding manner. Once it gains experience, the mediation association will open up its services for use by any interested party. (Ombudsman Office: 12 October 2007)

Since its creation in 1999, the Ombudsman office has solidified its role by resolving most grievances brought before it. Table 4 shows the annual breakdown of cases. The most numerous over the period have been issues related to labor management. However, that category has declined markedly since 2002, both because of less labor strife overall, and because experience has educated labor, foreign management, and the ombudsman's office in how to prevent and resolve contentious issues. In fact, by 2007, grievances requiring either legislative changes or administrative actions were resolved in more than 90 percent of the cases. That rate has improved from resolution success closer to 20 percent just a few years earlier. (Ahn 2008: Table 10)

Tax-related cases shot up to their highest level in 2006, perhaps related to the tax service launching a nationwide audit on foreign companies. Nearly 5,000 companies in which offshore investors owned more than half the stake as of the end of 2004 fell under the probe. (*Korea Herald* 2 May 2006)

Caseworkers, called "home doctors," accumulated insight into resolving grievances. Armed with this knowledge, and working closely with clients, the consultants played a key role in resolving many of the grievances submitted. Since 2003, government officials dispatched to Invest Korea worked alongside ombudsman staff, paying on-site visits and looking for feasible solutions. A larger number of dispatched government agents increased the direct channels to various government agencies, allowing for a higher rate of resolution. For example, in 2006, seven consultants paid visits to 482 foreign firms.

The Ombudsman, though, has said that cooperation from other government officials is not as forthcoming as it should be. "The Foreign Investment Promotion Act dictates that government agencies should reply within a week once they receive a recommendation from the Ombudsman. Though many of the proposals submitted to the Office of the Foreign Investment Ombudsman are quite reasonable, government bureaucracy frequently keeps many cases

Table 4: Annual Grievance Registrations with Investment Ombudsman by Type

	2001	2002	2003	2004	2005	2006	2007
Tax & Tariffs	49	67	63	64	61	76	62
Labor Management	63	106	93	75	42	38	24
Investment Process	20	51	34	22	31	27	36
Customs & Trade	74	62	41	25	25	44	35
Investment Incentives	1	0	1	3	25	30	42
Finance & foreign exchange	37	32	24	23	25	21	25
Visa & Immigration	15	20	17	19	20	21	21
Construction	52	43	34	35	19	16	22
Operations & Distribution	18	14	8	13	17	5	13
Plant Location	2	1	1	4	16	13	15
Private Disputes	6	6	4	1	11	5	10
Certification Examination	8	3	5	1	9	8	10
Insurance & Public Welfare	7	9	3	5	6	2	3
Environment	13	12	7	6	4	10	2
Highway & Transportation	2	0	0	1	4	1	3
Living Conditions	15	6	2	7	3	2	2
Power Sources	7	1	3	2	2	1	0
Other	39	42	29	18	31	33	45
Total	428	475	369	324	351	353	370

Source: Ahn 2008: Table 9

from being resolved. Therefore, the taking of steps to strengthen the authority of the Ombudsman and to improve the system is highly recommended." (Ahn 2008: 13)

Foreign Economic Zones: The Korean government has adopted several policies to overcome some of the well-known barriers to FDI. Many involve incentives to foreign firms that are not available to domestic ones. One approach is the creation of foreign economic zones (FEZs); advantages to locating in one of these zones include lower taxes, rent subsidies, and cash grants for investments in designated technologies and R&D facilities.

Specifically, major tax incentives are available for high-tech firms and industry located in FEZs, including full exemption of corporate income tax for several years. Cash grants are also provided to high-tech greenfield investment and R&D facilities, subject to government approval.

These measures to induce greater FDI, however, have themselves drawn criticism. The selective nature of the grants and subsidies means that resource allocation in the economy is skewed, resulting in projects that would not be profitable otherwise and disadvantaging firms outside of the incentive schemes. In addition, the focus is on manufacturing, further biasing the incentives against low-productivity service sectors. OECD analysts suggest that these programs can distract policymakers from addressing the more important structural problems that poison the overall business environment. Furthermore, benefits given foreigners in the various special zones, such as the ability to open and run hospitals, should be made universal to foreign and domestic firms alike. (OECD 2007a: 163)

In addition to these critiques of the incentive schemes, there are additional concerns about their effectiveness. For example, there are four types of FEZs. With various rationales and eligibility requirements, implementation is unclear and confusing, especially since each project must still get individual approval from national ministries. (OECD 2007a: 165)

Criticism of this approach is not confined to foreign observers. A newspaper article complained: "But skepticism is growing regarding the FEZs, which experts say have not lived up to expectations. … The first three economic zones have attracted a total of $1.3 billion in foreign direct investment as of September 2007, accounting for a meager 2.5

percent of the total FDI." (*Korea Herald* 21 August 2008)

The newspaper asks a critical question. Given all the listed benefits for locating in one of the zones, "Then why are foreign investors hesitating to invest in the FEZs?" The article supplies some answers. "Experts say that the number of regulations pertaining to the FEZs is a main reason for the poor performance in attracting FDI." Citing a fellow of the Korea Institute for International Economic Policy, "The government says that they have lowered the regulation level as much as they could. But from the business point of view, they want more deregulation policies that would be attractive enough to invest in the FEZ." (*Korea Herald* 21 August 2008)

Another consideration is that the government tends to see the FEZs as extensions of its industrial policies. However, foreigners are not proceeding along the lines preferred by some policymakers. The 2007 Invest Korea annual report made just this point: "Concentrated efforts to attract more foreign direct investment to Korea has resulted in a gap between foreign direct investment and industrial policies. Rather than seeing investments being made in preferred fields where Korean industrial structure can be advanced, foreign investment has primarily been concentrated in areas where the interests of foreign investors lie." (Invest Korea 2007: 3)

Anti-Foreign Bias: In the weeks before President-elect Lee Myung-bak took office he addressed concerns that lower level officials were not supporting policies to encourage FDI. At a meeting of the American Chamber of Commerce in January 2008, the president-elect acknowledged many points made frequently by foreign observers. For example, he noted the sometimes heavy-handed role and lack of consistency of regulation: "Korea should also undertake an extensive reform of its business regulatory regime, which is a legacy from the era when Korea achieved high growth through government-led development strategies. … The lack of predictability of economic policies, with high-level policymakers saying one thing, and working-level bureaucrats doing another, may be one source of such frustration." (Lee 2008)

The current Investment Ombudsman, who has first-hand knowledge of the problems facing foreign investors, has declared: "Above all, Koreans need to grow their understanding of international economics to relieve deeply instilled xenophobia, and specifically, their negative sentiment against foreign capital." (Ahn 2008: 19)

The significant point here is that the president and the chief official responsible for smoothing the way for FDI have acknowledged the anti-foreign bias that governs at least some lower level decisions. Although this recognition does not eliminate it, the clear recognition of the problem is a necessary step to its amelioration.

An OECD study on regulatory reform notes that, despite considerable formal market openings and regulatory change to ease FDI, it is critical to strengthen efforts to alleviate the perception of *de facto* discriminatory effects against foreign goods, companies, and investment. Such perceptions, the report underlines, "remain a major challenge, as changing mindsets necessarily takes time. As in other OECD countries, some negative perceptions persist among the media and the public. Laws and legal instruments may not always be sufficient to improve investors' confidence, as there is also a perception among some foreign investors that officials sometimes interpret and apply regulations more strictly for foreign firms." (OECD 2007b: 11)

Regulatory Reforms: Since 2000, the government has undertaken significant improvements in regulatory procedures, greater engagement of the business community, and streamlining of burdensome procedures in customs and public procurement. Transparency and openness of decision making have greatly improved. Digitization and automation of procedures have not only reduced the scope for subjective assessments and corruption, but also generated considerable savings and efficiencies.

As recently as seven years ago, Korea had a cumbersome system of standards, which created obstacles to trade and investment. Since then, considerable progress has been made in harmonization of standards through the

implementation of two national standards plans. As of 2005, 90 percent of Korean standards were either harmonized with international standards or were established with reference to them. The second plan aims to renovate national standardization and conformity assessment procedures and eliminate duplication among different standards and certification schemes. (OECD 2007b: 33)

President Lee proclaimed a policy goal of raising FDI to $20 billion annually by 2012. The government announced in May 2008 that it was responding to criticisms by revising many regulations that act as investment barriers. Under the plan, the designation of investment zones for foreign companies will be simplified. In addition, the government said it will "handle with special care" labor disputes in foreign companies, "as confrontational labor relations are said to scare away foreign investors from Korea. By special care, the government means a special labor law, consulting, and other advisory services, officials explained." (*Korea Herald* 17 May 2008)

These measures indicate government backing for the key objective of increasing the role of foreigners; the presence of President Lee at the meeting announcing these plans was an indicator of the priority given to it. Skepticism, however, quickly emerged. A *Korea Times* report on the investment promotion agency, Invest Korea, described the discrepancy between the agency's 2006 FDI figures of $12.3 billion and the OECD's $1.6 billion. The agency's tally was based on a "reports and commitments" basis, while the OECD statistics are a compilation of actual financial transactions rather than the plans that are submitted to the government; in addition, FDI as reported by the OECD and Korea's balance of payments subtracts sales of assets by foreigners from inflows. The article noted, "a survey by the Korea Chamber of Commerce and Industry showed seven out of ten foreign investors don't want to continue to invest in Korea for a variety of reasons." (*Korea Times* 28 July 2008)

Free Trade Agreements: National economic policy strategists look to free trade agreements with the United States and European Union as a means to liberalize and open markets in Korea, moves that are deemed necessary for continued economic growth.[5] Korea has adopted an approach to trade agreements that combines multilateral arrangements such as support of and adherence to World Trade Organization rules, as well as the pursuit of regional trade agreements. So far, it has completed or is in the process of negotiating eight FTAs.

Korean policy makers believe that successful conclusions of FTAs are likely to result in transforming Korea into a more competitive and attractive investment destination. They see the Korea-U.S. (KORUS) FTA, in particular, as a highly significant event—the largest cross-Pacific free trade deal. However, they note that to maximize the benefits from the deal, FDI must increase. "Unless this additional FDI is realized, all the economic benefits expected as a result of a ratified KORUS FTA could be substantially reduced. For these reasons regarding the potential impact of the KORUS FTA, Koreans should see the agreement as a critical turning point, that is, a chance to deepen the country's commitment to becoming a sophisticated, advanced, and truly open economy. The KORUS FTA should serve as a golden opportunity for Korea to enhance trade, labor, and intellectual property-related laws and systems to meet the level of global standard." (Ahn 2007: 17)

Just how realistic are these expectations? The KORUS FTA does include important support for FDI, both procedurally and substantively. For example, it establishes a stable legal framework for U.S. investors operating in Korea. "All forms of investment will be protected under the agreement, including enterprises, debt, concessions and similar contracts, and intellectual property. With very few exceptions, U.S. investors will be treated as well as Korean investors (or investors of any other country) in the establishment, acquisition, and operation of investments in Korea." (USTR April 2007: 3)

The agreement calls for liberalization across the services sector, including delivery services, legal services, health care,

[5] Negotiations on the Korea-U.S. trade agreement were completed in April 2007; as of the end of 2008, it is awaiting confirmation by the United States Senate. The EU agreement is in the latter stages of negotiation.

and education. Financial institutions will have their rights extended to establish or acquire financial institutions in Korea to supply a complete range of financial services; to establish branches of U.S. banks, insurance companies, and asset managers; and to supply a specified list of financial services, including portfolio management services for investment funds in Korea. In addition, restrictions in telecommunications, broadcasting, and the provision of audio -visual services will be liberalized. Opening of the markets for pharmaceuticals, medical devices, and health care should help to make this sector more competitive and productive.

In short, Korean political leaders are counting on the KORUS FTA to accomplish what domestic politics makes difficult or impossible. By opening previously closed markets, FDI will become feasible where before it was prohibited.

Conclusions on Policy Responses: Korea has made great strides since 1998 in opening its economy to foreign participation. Its political leaders are certainly aware of the major remaining impediments, including lingering anti-foreign sentiments. Minor ones, such as the multitude of interpretations of such things as standards and customs harmonization, are being dealt with at the detailed level by agencies like the Investment Ombudsman. The KORUS FTA carries the potential for significant opening of the remaining restricted markets and for resolving procedural issues. In many ways, Korean policy makers have been listening to foreign critics and following their advice.

It is necessary to reconsider, therefore, the collapse of foreign inflows in the past two years or so, even as global FDI boomed. Prohibitive regulations and worsening labor relations cannot be blamed; as noted above, there has been a general deregulatory trend and labor strife has quieted. What must be considered is the possible role of perceptions held by potential investors that Korea's *de facto* policies as implemented by ordinary officials are prejudiced against foreigners, even as the political leaders express a long-term strategy of further opening the country. One major event captured foreign attention as an indicator of Korea's underlying preferences: the troubles surrounding the Lone Star Funds' acquisition and attempted resale of the Korea Exchange Bank.

The Case of Lone Star Funds and Korea Exchange Bank: In 2003, U.S.-based Lone Star Funds acquired half the shares of Korea Exchange Bank (KEB) for $1.2 billion after no other buyer of the distressed bank could be found.[6] Following a required two-year holding period, the Texas company announced that it was seeking buyers for the bank at a price of $6.6 billion, netting the private equity fund an estimated profit of almost $4.5 billion. These returns were viewed as outrageous by the public and set off a storm of protest that found resonance in government circles.

The first issue that brought government into the affair was that Lone Star, along with most other foreign investors in Korea's financial sector, paid little tax on the capital gains earned on their Korean investments, largely because of bilateral tax treaties between other countries and Korea. The tax agency raided Lone Star and other private equity firms; in September 2005, it levied $200 million in tax penalties on the foreign investors. Meanwhile, the Seoul prosecutor's office started an investigation of possible criminal fraud over the earlier capital gains taxes; if Lone Star were convicted, its purchase of the bank could be negated because a convicted firm would be ineligible as a bank buyer.

Politicians in the National Assembly then called on the government's independent watchdog agency to investigate the conditions surrounding the original KEB sale. Additional probes looked into whether Lone Star had bribed local officials in return for their support, and whether Lone Star, along with others, had understated KEB's capital, thereby lowering its price and allowing a nonbank to acquire a distressed banking institution.

In February 2006, Kookmin Bank, Korea's largest, entered negotiations to buy $7.8 billion of KEB's shares. With a

[6] The detailed story of the Lone Star case is told in the Appendix.

domestic takeover in prospect, the KEB union raised its own objections to the proposed sale, fearing layoffs due to consolidation of the two domestic banks.

Within a month of the Kookmin offer, inspectors raided the offices and homes of Lone Star executives, seeking evidence of tax evasion, embezzlement, and fraud involving financial statements. Two former Lone Star executives were arrested in April 2006 on bribe allegations. In May, the government announced it would revise its tax treaties in order to garner capital gains taxes for Korea and the tax agency launched an audit of foreign companies.

Lone Star's CEO in Seoul and another executive were arrested in April 2006 on charges of tax evasion and illegal currency dealings. Suspicion that these multiple cases were being driven by the public outcry against foreign investors rather than by clear evidence of wrong-doing was supported by a Seoul court's denial of the prosecutor's arrest warrant, saying that there was insufficient facts to support the warrant.

The watchdog agency announced the results of its investigation in June 2006, seeking prosecution of 20 former government officials and KEB executives, but naming no Lone Star personnel. As the several other prosecutions and investigations dragged on and as prosecutors said that the process could continue for a long time, negotiations between Kookmin and Lone Star were terminated.

Meanwhile, three Lone Star executives were indicted following several more refusals of the court to authorize arrests; prosecutors finally found a court friendlier to their case. This time, the warrant was rejected by the Supreme Court. Throughout this affair, the prosecutors' office was feeding reports to the media about foreign corporate misdeeds, exacerbating public animosities toward the alien firms.

U.K.-based HSBC Holdings entered negotiations for KEB in August 2007, offering $6.1 billion for Lone Star's remaining 51 percent stake. However, the deal awaited the outcome of the ongoing trials and investigations. In February 2008, a trial court found the Lone Star CEO guilty of stock price manipulation and sentenced him to five years in prison. However, four months later, an appellate court reversed that verdict and acquitted both the company and its officials.

Despite the acquittal, the financial supervisory agency still refused to authorize the sale of KEB, stating that all investigations had to be completed before it could approve the deal and that this process could take many more months. Within days of this statement, however, the agency chairman reversed these views, saying in early September 2008 that final disposition could be accomplished within a few days. This reversal followed talks between Korean President Lee and U.K. Prime Minister Gordon Brown, who vigorously pushed for approval.

Despite these positive signs, HSBC withdrew its offer because it could not renegotiate the price to reflect the subsequent collapse in the global banking business. President Lee rued the fact that the government scuttled the sale by failing to respond quickly enough; he issued a veiled criticism of public officials by saying that they should make national interest a top priority, implying that personal views may have influenced their decisions.

Finally, in late November 2008, a Seoul court found that the original sale of KEB to Lone Star was not illegal and that the various charges could not be supported. Thus, two courts and the watchdog agency had cleared Lone Star three years after it had been charged.

CONCLUSIONS: RECOVERING KOREA'S IMAGE

Two potential deals collapsed in the wake of the charges against Lone Star. The international business press, as well as Korean newspapers, followed the case assiduously. A Lexis-Nexis search of articles about Lone Star and KEB found more than 1,200 stories between 2005 and 2008 in major world publications. The stories often commented on

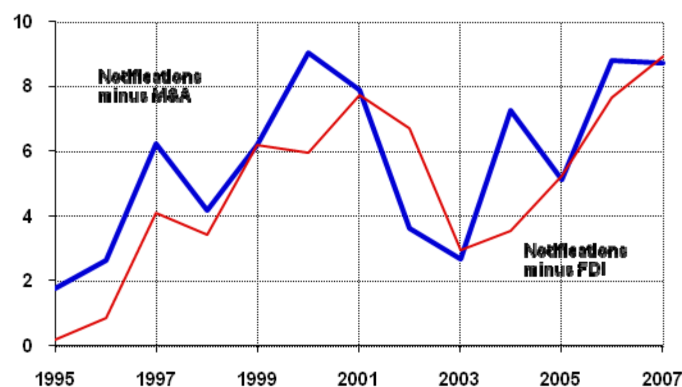
the *de facto* bias against foreign firms in Korea.

Since the negative sentiments about foreign "vulture funds" were spread so widely among the population, it should not be surprising that government officials also shared and acted on these perceptions, even when they contradicted high-level policy. In addition, it should not be surprising that business people around the world who read these stories appear to have been dissuaded from investing in the country. Surveys of potential investors show that Korea has declined year by year in its appeal. The relative loss of Korea's attractiveness must be seen against the rising appeal of its Asian neighbors. For example, the management consultants A.T. Kearney's 2007 survey of global corporate executives on their FDI plans placed Korea next to the bottom among 25 countries. Asian competitors China and India were numbers one and two on the list of preferences. (A.T. Kearney 2007)

Was the Lone Star affair the cause of Korea's FDI collapse? Certainly, the notoriety of the case did not cause foreign investors to flock to the country. However, whether this single case was behind the fall cannot be demonstrated with certainty. Still, additional evidence is, at a minimum, highly suggestive.

In addition to FDI data published in the balance of payments, for administrative purposes the Ministry of Knowledge Economy collects plans and commitments information (so-called, notifications) for individual investment projects. Unlike FDI and M&A data, which represent real money moving across borders, notifications may not result in an actual investment. Therefore, the difference between the prospective ambitions revealed in the notifications and the measures of actual FDI and M&A represent changed plans. These differences are shown in Figure 5.

Figure 5: Unrealized Plans: Differences between Preliminary Notifications and Subsequent FDI and M&A ($ billion)



Sources: Thomson Reuters, UNCTAD (2007), Ministry of Knowledge Economy

FDI and M&A tell the same story: investors seemed to drop out of their original FDI commitments in increasing amounts after 2003. The difference between recorded M&A transactions and planned investments, for example, reached a high in 2007 with almost $9 billion of planned investment not implemented.

What these numbers seem to say is that investors felt more enthusiasm about the prospects of future investment than they did when they had to put up the money. It would be over-interpreting these data to say that the Lone Star affair scared off potential investors to the tune of almost $20 billion over the past two years, but the difficulties illustrated by that one company did little to polish Korea's image in the world of cross-border investment.

All the evidence points to a sharp deterioration in Korea's appeal to foreign investors. The surprising thing about this drop is that the Korean government has been devoted to changing its laws, regulations, and institutions to make the country more hospitable to foreigners. It has been listening to and following the advice of experts at home and

abroad. However, Korea is in competition with its neighbors. Moreover, it is harder to change opinions than laws. Nevertheless, it appears that the emphasis should now be placed on changing public opinion, beginning within the government that is charged with implementing official policy. National leaders support expanding the presence of foreign participants in the economy. It is in Korea's own long-term interests to spread that enthusiasm more broadly in society.

Appendix: The Lone Star Funds Episode

Lone Star Funds, headquartered in Dallas, Texas, purchased half the shares of the distressed Korea Exchange Bank (KEB) in 2003 for $1.2 billion. It later increased its total stake to 64.6 percent. The attempted sale of these shares in 2006 at a price of $6.6 billion would have generated estimated profits for the fund's investors of $4.5 billion. Public outrage at this seemingly exorbitant profit was accompanied by at least four separate government investigations, although officials said that they were independent of the public outcry.

Like other South Korean banks, KEB, which was privatized in the late 1980s, suffered when loans to the country's conglomerates became uncollectible during the late 1990s Asian financial crisis. Smaller lending bubbles involving consumer credit and small businesses hit the bank in later years. Lone Star worked to clean up the credit-card debt and divested noncore subsidiaries. It cut 400 jobs, closed low-traffic branches, trimmed other expenses, implemented rigorous credit-risk analysis, and updated technology. Restructuring, plus a strong Korean economy and booming Asian neighbors, generated healthy profits. KEB's ratio of bad loans to total loans fell to a low 1.32 percent in the first half of 2005, making the bank a healthy and profitable asset when it came time for Lone Star to sell it. (*Wall Street Journal* 31 August 2005, 22 November 2006)

The private equity company's problems began early in 2005 as Korean lawmakers and government officials realized that Korea was not receiving taxes from the sales of Korean companies that foreign firms bought during the late 1990s financial crisis. The reason for the missing taxes was that Korea had signed 62 bilateral tax treaties that banned dual taxation on income earned in Korea; earnings were to be taxed in the home country. Many foreign investors, including Lone Star, had created subsidiaries in these favored countries expressly as a place in which to house their Korean investments; in Lone Star's case, the tax haven was Belgium. Tax authorities in Seoul said that Korea was empowered to impose taxes if the funds were invested by bogus subsidiaries with no other identity, so-called paper companies, even in tax-haven areas. (*Korea Times* 16 February 2005)

In April 2005, tax agency officials raided Lone Star and other foreign private equity firms, seeking information on their asset sales. Following six months of investigation, the tax service levied $200 million in tax penalties on Lone Star and four other funds for evading capital gains taxes; however, the KEB deal was not listed as a suspicious transaction at that time. A month later, the tax agency sued the former head of Lone Star for personal tax evasion. (*Korea Times* 30 September 2005)

The two-year "lock-up period," during which Lone Star was prohibited from selling its stake in KEB, ended in October 2005. It solicited potential bidders soon thereafter, amidst speculation that Lone Star was moving to unload its stake as soon as possible before regulators could slap it with fines for alleged tax evasion, a fate that had just hit London-based Hermes Investment Management on charges of manipulating stock prices. Germany's Commerzbank AG, the second-largest shareholder of KEB with a 15-percent stake, also indicated that it wanted to unload its shares. (*Korea Times* 1 February 2006)

The main political opposition parties entered the act directly in February 2006 when they considered ways to slow down or suspend Lone Star's planned sale of KEB, pushing for investigations. The National Assembly committee on political affairs approved a request by lawmakers for an inspection by the government's independent watchdog agency, the Board of Audit and Inspection (BAI), on suspicions surrounding the original 2003 buyout of KEB. Meanwhile, the Seoul district prosecutor's office, which was investigating the original charges of capital gains fraud in Lone Star's sales of other assets, said that its investigation were proceeding slowly. The significance of this probe was that Lone Star could be disallowed as an approved majority owner of a bank if it were convicted, thereby complicating its ownership and sale of KEB. At the same time, the opposition parties requested a separate investigation of both government and KEB personnel immediately before the sale to Lone Star, under the suspicion that they may

have received bribes for misreporting KEB financial figures. (*Korea Herald* 17 February 2006)

Within a month, Lone Star was the subject of multiple probes, including charges that it bribed high-ranking government officials in return for their support of the KEB purchase. In addition, it was alleged that Lone Star, along with high-ranking government officials and KEB executives, had conspired to misstate the bank's capital, coming up with a figure below regulatory requirements, which drastically lowered the value of the bank.

Weeks later, the former head of KEB admitted to manipulating its capital adequacy ratio to open the way for Lone Star to take over the bank, according to the BAI. What had raised suspicions was that KEB had reported a capital adequacy ratio of 10 percent to its board, while showing a lower figure to the regulatory agency. The state inspection agency also said the former KEB president admitted that documents were fabricated to lower the Bank for International Settlements capital adequacy ratio to 6.16 percent, below the minimum requirements of 8 percent. The watchdog agency concluded that the revelation indicated that KEB executives, the financial regulator, and Lone Star collaborated in the deal to allow the Dallas-based fund to buy the bank at a price below its real value. (*Korea Times* 11 April 2006)

Another possible rationale for misstating the critical capital ratio was that Lone Star, as a private equity fund, was registered as a non-financial company, and therefore was not ordinarily qualified to take over a bank. A takeover could be authorized only if a bank did not meet minimum requirements for financial health.

Despite the ongoing criminal investigations, Kookmin Bank—Korea's largest—agreed in late February 2006 to pay 7.6 trillion won for a controlling stake in KEB, beating out opponents in what would be the country's largest-ever acquisition. Its offer for three-quarters of KEB's shares was worth $7.8 billion. (*International Herald Tribune* 24 March 2006**)**

In the middle of these investigations, the KEB union launched its own offensive against Lone Star. The company's union head remarked, "Recent cases show Lone Star is a public enemy." Several opposition lawmakers participated in a union-organized rally involving thousands of unionized workers against the sale of the bank. (*Korea Times* 3 April 2006)

With a deal in prospect, Lone Star refused to pay part of the 140 billion won ($145.6 million) fine levied by local tax authorities, appealing to the tax tribunal. However, the company also announced that it would donate 100 billion won to social programs in South Korea and set aside 725 billion won, or about $760 million, in a Korean bank account to cover any taxes owed on KEB. This amount would be equivalent to an 11 percent withholding tax on proceeds that normally would be imposed in the absences of a treaty. (*Korea Times* 19 April 2006)

Lone Star's founder and chairman, John Grayken, also confirmed that the company's former top Korea executive confessed to the firm that he had embezzled millions of dollars from the company, which subsequently were repaid. (*Wall Street Journal* 20 April 2006) He had returned to the United States and refused to go back to Korea, where he faced prosecution on embezzlement and tax evasion. Grayken told reporters the fund was considering bringing criminal charges against the former executive over the "personal crimes," apparently trying to distance the firm from the executive. (*Korea Times* 10 May 2006)

A day or so after Mr. Grayken's news conference, the current president of Lone Star's Korean ventures was summoned by the BAI for questioning on the purchase of KEB, focusing on allegations that government regulators and KEB executives manipulated reports about the bank's financial state to facilitate the sale. In addition to the Lone Star executive, the investigators were calling in finance ministry officials and the former head of KEB.

On March 30, 60 inspectors raided the offices of Lone Star and the homes of five company executives, seeking evidence of "tax evasion, embezzlement, and other allegations." They were also investigating a question that had

been raised by civic groups and lawmakers and so far denied by government officials: whether government regulators and KEB executives altered financial statements and bent regulations to help Lone Star take over the bank in 2003. (*International Herald Tribune* 31 March 2006)

Kookmin's due diligence examination of KEB was being delayed by the various legal entanglements surrounding its American owner. The bank hinted in April that it might delay, or even cancel, the agreement to take over KEB if things were not resolved soon. Some observers thought that this stance might simply have been a move to get a better price for KEB.

Prosecutors arrested two former Lone Star executives at the end of April over allegations that they had accepted bribes from businesses when the buyout fund took part in corporate restructuring schemes, not involving KEB.

In the first week of May, Seoul announced its plan to revise several cross-border tax treaties with other countries in a move to tax capital gains earned by foreign shareholders of local firms. A finance ministry official said that the government would begin to have talks with Belgium to review the controversial taxation rules. If the two countries rewrote their treaty before the sale of KEB, the Korean government would have better legal grounds to collect taxes from Lone Star. (*Korea Times* 25 May 2006)

The National Tax Service also joined the hard-line tax stance of the government, launching a nationwide audit of foreign companies. Nearly 5,000 companies in which offshore investors owned more than half the stake as of the end of 2004 fell under the probe. (*Korea Herald* 2 May 2006)

A week later, prosecutors arrested the current head of Lone Star's Korean operations in connection with an investigation into the fund's alleged tax evasions and illegal currency dealings. "We took Yoo into custody early in the morning on charges of embezzlement and breach of trust," the prosecutor told reporters. "Yoo allegedly worked closely with former Lone Star Korea head Steven Lee until Lee, a Korean-American, was kicked out of management for his alleged involvement in illegal foreign exchange transactions and embezzling millions of dollars in company money." (*Korea Times* 10 May 2006)

At this point, affairs took a bizarre turn. A Seoul court refused to issue arrest warrants for the two Lone Star officials. The court rejected the prosecution's request, saying it was illegal to arrest them without clear evidence of their involvements. Despite this rebuff, the prosecution indicted the two Lone Star officials on bribery charges involving earlier deals, but did not take them into custody.

According to the prosecutor's office, the indictments were for alleged misappropriation of funds and bribe taking that occurred as Lone Star units resold distressed assets after 1999. The alleged bribes and misappropriations were for personal gain, not for Lone Star's benefit, and they were not directly related to the KEB investigation, although the prosecutors said the charges came out of their ongoing investigation of Lone Star. (*Wall Street Journal* 18 May 2006)

Thus, by May 2006, a number of current or former Lone Star executives were under indictment, the private equity firm was being investigated for manipulating financial data, and the government was attempting to collect taxes that presumably had been protected under tax treaties. Moreover, the government was attempting to rewrite bilateral tax treaties and was auditing the books of nearly 5,000 foreign companies. The domestic and foreign press at this time blossomed with references to the unwelcoming attitudes of the Korean government to foreign investors.

Despite these events, negotiations had continued between Lone Star and Kookmin Bank, which came to a conclusion on May 20, 2006, when they signed a sales contract for Kookmin to buy Lone Star's KEB stake for 6.33 trillion won ($6.7 billion). The two sides agreed to settle payment after the various probes were completed. The worst-case scenario for Lone Star would be that the investigations proved Lone Star's involvement in illegal dealings,

in which case the American company could be deprived of its status as the majority stakeholder in KEB. In that case, the government could cancel the business contracts it had made in South Korea. Observers, though, called that situation unlikely. (*Korea Times* 20 May 2006)

Days later, Lone Star was hit by a 25.2 billion won ($26.9 million) tax bill plus penalty for asset sales in 2004. The Dallas company's chairman counter-attacked with a New York news conference in which he described Korean government actions as creating a "hostile, anti-foreign investor climate." His remarks were interpreted as an attempt to delay revisions of the bilateral tax laws. (*Korea Herald* 25 May 2006)

The government watchdog agency announced the results of its probe in June. It asked for prosecutions of up to 20 individuals: former officials in the financial supervisory agency, prime minister's office, and KEB executives. The agency indicated there had been suspicions that government officials directed bank personnel to manipulate records to make KEB's financial status look worse than it really was, allowing Lone Star to take over the bank at a discounted price in exchange for kickbacks. (*Korea Times* 20 June 2006) No Lone Star officials were named. Government officials said that they had failed to prove that the U.S. fund was involved in the fabrication process. "If prosecutors can prove any criminal acts perpetrated by Lone Star in the 2003 sale process, we would reconsider the validity of the share sale. But for now we have no evidence to nullify the contract," said a BAI official. (*Korea Herald* 20 June 2006)

As the several other investigations dragged on, the date approached for the conclusion of the KEB sale to Kookmin. Prosecutors indicated that their process could continue for many months after the sales contract expiration date in September 2006. Lone Star was particularly anxious to conclude the transaction at the scheduled time, both to realize its profits on the deal and also because Korean banks then were highly profitable on the basis of sustained growth within the country and in other Asian economies.

While the two companies were awaiting the outcome of the various legal cases, the Financial Supervisory Commission (FSC) referred the case of alleged stock price manipulation by KEB to prosecutors after a five-month probe, saying it was asking prosecutors to determine whether the bank tampered with the share prices of the KEB-owned credit card company, KEB Credit Service Co. Artificially lowering the distressed credit card company's price would have affected the ultimate value of KEB itself. Determination of whether Lone Star was involved in the alleged wrongdoing was also left in the hands of prosecutors. (*Korea Herald* 28 September 2006)

The prosecutors struck Lone Star directly at the end of October as they sought the arrest of three company executives. However, as in May, the courts refused to issue the arrest warrants. Within days after the court's rejection, the prosecutors appealed and the court reaffirmed its original decision based on "lack of reasons." Resubmission to a different judge brought the same decision. Comments to the press from legal observers in Korea suggested that the prosecutor's office was engaging in nationalistic reactions to the foreign company rather than to the evidence. (*International Herald Tribune* 4 November 2006) (*Associated Press* 7 November 2006)

Two weeks later, the prosecutors tried again, this time with success in the courts, after challenging the integrity of the original judges hearing the case. Arrest warrants were issued for two Lone Star executives residing in the U.S., as well as for the Seoul-based CEO. On November 20, the company itself was indicted on charges of stock manipulation of KEB's credit card company. An indictment of a company in Korea is a step in the legal process that usually precedes indictments of company executives.

Within days, Lone Star terminated its deal with Kookmin. Among the worries of foreign investors was the way in which investigators from the Supreme Prosecutors' Office fed a steady stream of insinuations about corporate malfeasance to the Korean media, stoking nationalist resentment against foreign investors. Critics accused the prosecutors of harboring a grudge against foreign private equity firms. (*Los Angeles Times* 24 November 2006)

On December 7, the prosecutors announced the results of its nine-month probe, saying it had concluded that the Dallas-based company colluded with government officials and KEB's former management to understate the bank's financial health to lower the price below its fair market value. The prosecution identified a former director of financial policy at the Ministry of Finance and Economy and the former KEB president as the key suspects who deliberately understated the assets of the bank and inflated the risk of insolvency, after being lobbied by Lone Star. Several others were charged also and the prosecutors announced they had plans to indict the head of Lone Star's Seoul office, after the Supreme Court made its ruling on whether to issue a warrant to detain him. (*Korea Times* 8 December 2006)

The high court, however, was not so accommodating, as it upheld a lower court decision refusing to grant prosecutors an arrest warrant for the head of Lone Star's Seoul office. The lower court had rejected four applications by prosecutors to arrest the Lone Star executive, saying he had been cooperative with the probe and was unlikely to destroy evidence or run away. (*Yonhap* 18 December 2006)

Despite their lack of success in obtaining an arrest warrant, the prosecutors indicted the company executive in January 2007 on charges of stock price manipulation and tax evasion, for which he went on trial in March. While the trial was in progress, an FSC official predicted, "It would take a considerable amount of time for the U.S. private equity fund to sell its stake in the bank." The spokesman gave the reason that both buyer and seller would have to be thoroughly investigated before a sale could be approved. He noted that the various legal challenges would have to be fully taken into account. (*Korea Herald* 27 June 2007)

Against this backdrop, Lone Star was reducing its Korean holdings. Earlier in June 2007, the fund sold a 13.6 percent stake in KEB via block sales to institutions for approximately $1.3 billion and cashed out of two other Korean ventures for more than $2 billion.

Overlooking the warnings of likely delays from the FSC, U.K.-based HSBC Holdings announced in August 2007 that it was in talks to buy the remaining Lone Star stake in KEB. (*New York Times* 21 August 2007) Two weeks later the deal was confirmed when HSBC agreed to pay $6.3 billion for Lone Star's remaining 51 percent stake in KEB, the second-largest acquisition in Korean financial history. It was clear that the deal would not be approved automatically by government regulatory agencies. Shortly after the announcement of the agreement, the FSC reaffirmed that it would not endorse the sale of KEB before the courts ruled on the legality of Lone Star's original acquisition. Indeed, the agreement stated that the final sale was dependent on official approvals. (*Korea Herald* 4 September 2007) After extending the contract once, it was set to expire by the end of July 2008.

The trial court of the local Lone Star chief delivered its verdict February 1, 2008, shocking experts when it unexpectedly found Lone Star Funds' local head guilty of stock price manipulation and sentenced him to five years in prison. The verdict jeopardized the HSBC deal. Financial regulators reiterated that they would not review HSBC's application until a final verdict was reached on appeal. "We will continue to defer any regulatory decision regarding Lone Star until ongoing legal issues surrounding KEB and Lone Star are fully resolved," said a representative for the FSC. (*Daily Deal* 4 February 2008) Lone Star officials said that they would appeal the verdict, a process that could take a year or longer.

A response came sooner than that—at the end of June—when the Seoul Appellate Court acquitted Lone Star and its chief executive. Lone Star asserted that it would now be able to move forward expeditiously with the HSBC deal, but was warned once again by the FSC that it would withhold approval of the sale until all outstanding legal procedures had been completed. Press reports said that the financial regulator's rigid position was adding to speculation that it was deliberately stalling its decision on the KEB sale in consideration of the unfavorable public opinion against Lone Star. (*Korea Herald* 27 June 2008)

By early September 2008, Lone Star reportedly was considering suing the government over continued regulatory delays in approving the still languishing KEB sale to HSBC. An FSC official said that any decision would be impossible for at least several months. A court ruling on the Lone Star takeover in 2003 and a Supreme Court ruling on the alleged KEB Card stock price manipulation case were not expected until at least October 2008. (*Korea Times* 4 September 2008)

Within days, it appeared that higher-level officials at the FSC had second thoughts about the extended delays as the chairman indicated that the agency might have to review only a few documents to render its judgment. He said that he saw no major problems with approving the HSBC acquisition of KEB. (*Korea Herald* 9 September 2008) Talks between U.K. Prime Minister Gordon Brown and South Korean President Lee, coupled with threats by Lone Star to sue the FSC, also may have contributed to ending the regulatory stalemate.

Those assurances, however, were too late. On September 18, HSBC announced that it was abandoning its year-long pursuit of KEB after failing to renegotiate a lower price to reflect the declining fortunes of global banking during the period that the deal had been pending. "People close to the bank said HSBC was concerned that government approval would allow Lone Star to force it to buy the bank at the original price. Turmoil in the global credit markets has also dulled the appetite of other banks that might previously have been interested in expanding in Korea." (*Financial Times* 19 September 2008)

Illustrating the gulf between the nation's political leaders and working level bureaucrats, President Lee acknowledged that the government "failed to move quickly" in making a decision on whether to clear the Lone Star-HSBC deal. "Korea lost an opportunity as it failed to move quickly. All public servants should place national interests on top priority and have a sense of responsibility when they deal with such a crucial contract." (*Korea Times* 21 September 2008)

Two major South Korean banks, Kookmin Bank and Hana Financial Group, said they would be interested in looking at KEB. With bank valuations falling, Kookmin and Hana figured they could buy KEB for less than HSBC's offer, but both faced tightening global credit conditions that could crimp consideration of a bid. Complicating any domestic transaction for KEB was the bank's union, which repeatedly said it did not favor a local bidder for fear of post-merger job losses. Alternatively, Lone Star could dispose of its shares on the market in block sales, though it would lose its controlling-shareholder premium and would have to accept a lower overall price.

To find potential buyers, KEB established an internal task force and Lone Star engaged a European investment bank to assist in the process. Among the possible suitors was Singapore-based DBS Group, which had entered negotiations twice previously, but without coming to an agreement. Financial analysts in October 2008 estimated that a reasonable price for KEB could be around $4.5 billion, considerably below the offer a year earlier. Analysts also suggested that the Korean government might be anxious to remove lingering suspicions that it was hostile to foreign investors amidst the repeated failures to secure a deal for the bank. (*Wall Street Journal* 2 October 2008)

Finally, in late November 2008, the Seoul court ruled that the sale of KEB to Lone Star in 2003 was not illegal as it would not have been possible to prevent the then troubled bank from entering bankruptcy at that time. The court also ruled that the sale of controlling stake in the bank to the U.S. private equity fund involved no behind-the-scene deals aimed to help Lone Star obtain KEB at unfairly low prices, clearing a former high-ranking government official and former KEB executives of charges of understating the value of the bank to sell it for a price below its market value.

"Ahead of the takeover, KEB sought major investors at home and abroad for a large amount of capital injection. But no investors with sufficient funds emerged except for Lone Star," said the presiding judge of the Seoul Central District Court. "With only Lone Star pursuing the bank's management control, KEB had no other choice but to

transfer the management control to Lone Star." In effect, the court ruling cleared Lone Star of all legal disputes that stood in the way of selling the nation's fifth largest lender. (*Korea Times* 24 November 2008)

The court also cleared a Finance Ministry official of the charges that he artificially lowered the bank's capital adequacy ratio. "We cannot judge that the capital ratio estimate for KEB had been manipulated to lower the acquisition price or make Lone Star eligible to buy the bank," the judge said. The court also cleared the official of all the allegations that he took bribes before and after the KEB deal was closed.

As of the end of November 2008, Lone Star and its executives had been exonerated of criminal charges in the context of the KEB deal. The government watchdog had cleared Lone Star, but had called for prosecutions against former KEB and government officials. High-level officials were exonerated while bribery charges were upheld against two former KEB executives.

The fact that bribery and other criminal activity may have occurred should not be surprising in the Korean context. Transparency International, for example, placed Korea in the bottom two-thirds of countries in its bribe-paying index; the rankings in the Heritage Foundations' index of economic freedom put Korea in the bottom quarter in its measure of corruption. (Transparency International 2007) (Holmes et al 2008)

The trial of Lone Star's Korean chief, the investigation by the audit agency, and the foot-dragging by the financial regulator brought forth scores of articles in the global business press questioning Korea's openness, the transparency of its legal system, and the fairness of its regulators. The fact that the president criticized these questionable practices within his own government suggests that he was aware of the international business sentiments and likely agreed with them. Unfortunately, he was unable to change the views of people within his own government in the months that he was in office.

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