2005 INVESTMENT CLIMATE STATEMENT

REPUBLIC OF KOREA

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OVERVIEW

In the aftermath of the 1997-98 Asian financial crisis, Korea made rapid progress in reforming its financial institutions and capital markets. The Korean government has also taken steps to tighten competition policy and enacted measures to enhance foreign investment incentives, and to allow non-Koreans to own land and real property. In the aftermath of those "crisis" times, the Korean government sold its interest in a number of large, high-profile companies to foreign investors, and many officials and Koreans in general began to see more foreign investment as something positive, even necessary, for Korea. These changes have combined to help the Korean economy become more attractive to outside investors and for it to begin to shed its long-standing reputation as a difficult environment for foreign capital. Foreign direct investment in Korea accelerated in 2004 to roughly $13 billion, twice the prior year's total. Of that figure, roughly half came in the form of cross-border mergers and acquisitions.

Despite these improvements and attitude changes, however, the environment for foreign direct investment (FDI) in Korea is still hampered by significant flaws. Mergers and acquisitions in particular are hindered by insufficient transparency in corporate governance and mixed signals -- including from some senior government policy makers -- concerning just how much foreign investment is good for the country. The still-dominant position of Korea's "*chaebol*" conglomerates in the domestic economy also continues to represent a significant problem for many foreign competitors seeking to invest in the Republic of Korea. The Korean government has initiated a program of corporate restructuring which aims to make the business activities of Korean companies, including the *chaebol*, more transparent and more accountable to shareholders, but this is still a work in progress. Reform measures, combined with market realities, have encouraged some *chaebol* to sell off some of their constituent companies and have weakened *chaebol* dominance in the economy at large. For all practical purposes, 12 of Korea's top 30 *chaebol* prior to 1998 have ceased to exist as coherent entities.

Although Korea boasts a hard-working, educated and highly productive workforce, foreign investors cite volatility in labor-management relations and Korea's inflexible labor laws as another set of key problems that hamper direct investment. Korea loses proportionally more workdays to strikes than any other OECD country. Although the rate of unionization is not especially high, unions, kept down during decades of authoritarian rule, are now more forceful and often make high wage and benefit demands. Korea's rigid labor laws make it difficult to dismiss workers and therefore hard to hire new staff. A lack of pension mobility in the private sector is also a problem, as is a weak social safety net for unemployed workers. Korean management, meanwhile, often takes a confrontational approach.

Another key concern of foreign investors is intellectual property rights protection. The situation is most serious in the entertainment industry, and Korea's shortcomings in protection of sound recordings and films earned it a "Priority Watch List" designation

from the United States Trade Representative in January 2004. Problems also continue involving trademark and patent violations of manufactured goods.

Korea's President Roh Moo-hyun, who entered office in 2003, hopes to make Korea a financial and logistics "hub" to promote long-lasting regional peace and strengthen Korea's economic competitiveness, particularly within the Northeast Asian region. The Korean government has created special economic zones near the ports of Busan, Gwangyang and the Incheon International Airport. The Korean government has also enhanced regional cooperation with its neighbors in hopes that multinational corporations might set up regional headquarters in Korea.

The United States has the largest single-country share of foreign direct investment (FDI) in Korea, totaling $32.3 billion or about 31.1% of Korea's total stock of FDI since the 1960s. The EU (25 countries) has invested $30.7 billion (29.5% of the total) followed by Japan with $15.5 billion (14.9%). Overall, FDI increased 97.4% year on year in 2004, to $12.8 billion on a filing basis, the fastest pace of inward direct investment seen since 1999, in the immediate aftermath of the 1997-98 financial crisis. Citigroup's acquisition of KorAm Bank for $2.7 billion was the largest single investment in 2004. The financial, telecom and other service sectors are expected to absorb the most FDI in Korea in the near future, largely through mergers and acquisitions (M&A), in line with global trends.

Foreign portfolio investment into Korean has recently risen sharply, in part due to government liberalization measures. Aggregate foreign investment ceilings at the Korean Stock Exchange (KSE) were abolished in 1998, and by the end of 2004 foreign shareholders owned 41.9% of KSE stocks, and 20% of the tech-heavy KOSDAQ.

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GENERAL OPENNESS TO FOREIGN INVESTMENT

The Korean government's attitude toward foreign direct investment is generally positive and most policy-makers realize the value of FDI, especially since the 1997-98 Asian Financial Crisis. Reforms, most evident in the financial sector, and other positive changes have advanced the idea that foreign investment is positive for the country. As a result, Korea has become more attractive to outside investors and has begun to shed its long-standing reputation as a difficult environment for foreign capital. Despite these improvements and attitude changes, however, FDI in Korea is still hampered by underdeveloped corporate governance, insufficient regulatory transparency, lingering economic domination by the country's remaining conglomerates "*chaebol*," an inflexible labor system, and a need for better protection of intellectual property rights.

A sluggish domestic economy in 2003 and 2004 has also dampened somewhat the Korean public's positive attitude toward foreign investment. Public pronouncements on the part of some policy makers reacting to an increase in the market share of FDI in the financial sector and other parts of the economy have also had a negative effect. Reacting to the growing%age of foreign participation in the banking sector and in foreign portfolio investment in the Korean stock exchange in 2004, some activists on the fringes of the labor union movement formed an organization (SpecWatch Korea) to "monitor" such investments. Political figures are sensitive to this possible antagonistic change in public opinion against "too much" foreign investment.

Korea's Foreign Investment Promotion Act (FIPA) went into effect in late 1998. The FIPA (and related regulations) categorizes business activities as either open, conditionally or partly restricted, or closed to foreign investment. The FIPA considerably reduced the number of restricted sectors, although restrictions remain on 29 industrial sectors, two of which are entirely closed to foreign investment. The Korean government reviews restricted sectors from time to time for possible further openings. According to the Ministry of Commerce, Industry, and Energy (MOCIE), the number of industrial sectors open to foreign investors is well above the OECD average.

FIPA highlights included:

- Simplified procedures, including those for FDI notification and registration;
- Expanded tax incentives for high-technology FDI;
- Reduced rental fees and lengthened lease durations for government land (including local government land);
- Increased central government support for local FDI incentives;

- Establishment of a one-stop Investment Promotion Center (IPC) within the Korea Trade Promotion Corporation to assist foreign investors in dealing with the bureaucracy (since renamed "Invest Korea"); and

- Establishment of an Ombudsman office within the IPC to assist foreign investors.

Following is a list of Restricted Sectors for Foreign Investment (as of March 14, 2004) (Figures in parentheses denote the Korean Industrial Classification Code):

Completely Closed

- Radio broadcasting (87211)
- Television broadcasting (87212)

Restricted Sectors (partly closed)

- Growing of cereal crops and other food crops (01110)
- Farming of beef cattle (01212)
- Inshore fishing (05112)
- Coastal fishing (05113)
- Publishing of newspapers (22121)
- Publishing of magazines and periodicals (22122)
- Processing of nuclear fuel (23300)
- Electric power generation (40110)
- Transmission of electricity (40121)
- Other transmission/distribution of electricity (40122)
- Wholesale of meat (51312)
- Coastal water passenger transport (61121)
- Coastal water freight transport (61122)
- Scheduled air transport (62100)
- Non-scheduled air transport (62200)
- Leased line services (64211)
- Wired telephone and other telecommunications (64219)
- Mobile telephone services (64221)
- Cellular telephone services (64229)
- Other telecommunications (64299)
- Domestic commercial banking (65121)
- Investment trust companies (65931)
- Cable networks (87221)
- Cable and other program distribution (87222)
- Satellite broadcasting (87223)
- News agency activities (88100)
- Radioactive waste disposal (90230)

In categories open to investment, foreign exchange banks must be notified in advance of applications for foreign investment. (All Korean banks are permitted to deal

in foreign exchange, including branches of foreign banks.) In effect, these notifications are pro-forma, and approval can be processed within three hours. Applications may be denied only on specific grounds, including national security, public order and morals, international security obligations, and health and environmental concerns, but it is rare for these grounds to be invoked. Exceptions to the advance notification approval system exist for project categories subject to joint-venture requirements and certain projects in the distribution sector.

Relevant ministries must still approve investments in conditionally or partly restricted sectors. Most applications are processed within five days; cases that require consultation with more than one ministry can take up to 25 days or longer. The Government's procurement law no longer favors domestic suppliers over foreigners, but some implementation problems remain. Korea changed its procurement law effective in 1997, to comply with its accession to the WTO Government Procurement Agreement.

Restrictions on foreign ownership of public corporations remain, though ownership limit levels have been raised. Currently, foreign ownership is limited for government-controlled utilities. Foreign ownership in Korean telecommunications companies is limited to 49%. The Korean government intends to privatize many of the remaining state-owned corporations.

The Ministry of Finance and Economy (MOFE) administers tax and other incentives to stimulate advanced technology transfer and investment in high-technology services. There are three types of special areas for foreign investment including Foreign Economic Zones, Foreign Investment Zones and Tariff Free Zones, where favorable tax incentives and other support for investors are available (see related section below.)

A Korean government initiative to encourage research and development (R&D) in strategic industries -- the New Growth-Driving Forces (NGF) program -- wound down in 2004. In its place the Korean government has increased its R&D budget to local areas from 27% to 32% to support its 21st Century Frontier R&D Project, designed to raise Korean technology to the level of the G-8 countries. Focusing on information technology, biotechnology, nanotechnology and new materials, the Korean government launched development programs in 20 new strategic areas at the end of 2003, at a total cost of $3.5 billion. Much Korean government-funded R&D taps the expertise of foreign partners.

In 2004, Intel, IBM and HP opened R&D centers in Seoul and several other U.S. firms have expressed an interest in the dynamic and fast-growing Korean information technology sector. General Motors Corporation spent $400 million in 2002 to buy out Daewoo Motors and establish a new auto manufacturing company -- GM Daewoo Auto and Technology Company (GMDAT). In 2004, GM Daewoo announced a $1.5 billion R&D investment, focused primarily on a new design center and 5 years of factory upgrades.

BASIC INVESTMENT RIGHTS

Conversion and Transfer Policies: The Korean government has substantially removed restrictions on financial transfers into and out of Korea. Prior to 1999, the Foreign Exchange Control Act and associated regulations strictly regulated foreign exchange transactions. The Korean government subsequently liberalized transactions in medium-and long-term overseas borrowings, purchase and sale of local real estate, and trading in over-the-counter (OTC) stocks and bonds.

In 1999, the Foreign Exchange Transaction Act (FETA) fully liberalized all current-account transactions by business firms and banks, and pared down a formerly long list of restricted transactions to five items, most of which cover foreign exchange transactions by individuals. A second-stage liberalization dismantled most of the remaining restrictions in 2001. Only transactions that could harm international peace and public order, such as money laundering and gambling, remain controlled. Three specific types of transactions were not liberalized:

1) Non-residents are not permitted to buy won-denominated hedge funds, including forward currency contracts;

2) The Financial Supervisory Commission will not permit foreign currency borrowing by "non-viable" domestic firms; and

3) The Korean government will monitor and ensure that Koreans firms that have extended credit to foreign borrowers collect their debts. The Korean government has retained the authority to re-impose restrictions in the case of severe economic or financial emergency.

Capital account liberalization under the Foreign Exchange Transaction Act has also been extensive. All capital-account transactions are permitted unless specifically prohibited. In addition, 72 of the 91 transactions specified by the OECD code of liberalization of capital movements now are permitted. Non-residents may open deposit accounts in domestic currency (won) with maturities of more than one year and may engage in offshore transactions and issue won-denominated securities abroad.

The right to remit profits is granted at the time of original investment approval. Banks control the now pro- forma approval process for FETA-defined open sectors. For conditionally or partially restricted investments (as defined by the FETA), approval for both the investment and remittance rests with the relevant ministry.

When foreign investment royalties or other payments are proposed as part of a technology licensing agreement, the agreement and the projected stream of royalties must be approved either by a bank or the Ministry of Finance and Economy (MOFE.) Again, approval is virtually automatic. An investor wishing to enact a remittance must present

an audited financial statement to a bank to substantiate the payment. To withdraw capital, a stock valuation report issued by a recognized securities company or the Korean appraisal board also must be presented. Foreign companies seeking to remit funds from investments in restricted sectors must first seek ministerial and bank approval, after demonstrating the legal source of the funds and proving that relevant taxes have been paid.

Expropriation and Compensation: Korea follows generally accepted principles of international law with respect to expropriation. The law protects foreign-invested enterprise property from expropriation or requisition. If private property is expropriated, it can only be taken for a public purpose, and only in a non-discriminatory manner. Property owners are entitled to prompt compensation at fair market value. The Embassy is not aware of any cases of uncompensated expropriation of property owned by American citizens.

Dispute Resolution: Serious investment disputes involving foreigners are the exception rather than the rule in Korea. The exceptions are cases involving intellectual property rights protection. There exists a body of Korean law governing commercial activities and bankruptcies that constitutes the means to enforce property and contractual rights, with monetary judgments usually levied in the domestic currency. Foreign court judgments are not enforceable in Korea.

Although commercial disputes can be adjudicated in a civil court, foreign businesses often feel that this is not a practical means to resolve disputes. Proceedings are conducted in Korean, often without adequate translation. Korean law prohibits foreign lawyers who have not passed the Korean Bar from representing clients in Korean courts. Civil procedures common in the United States, such as pretrial discovery, do not exist in Korea. During litigation of a dispute, foreigners may be barred from leaving the country until a decision is reached. Legal proceedings are expensive and time-consuming and lawsuits often are contemplated only as a last resort, signaling the end of a business relationship.

Commercial disputes may also be taken to the Korean Commercial Arbitration Board (KCAB). The Korean Arbitration Act and its implementing rules outline the following steps in the arbitration process: 1) parties may request the KCAB to act as informal intermediary to a settlement; 2) if unsuccessful, either or both parties may request formal arbitration, in which case the KCAB appoints a mediator to conduct conciliatory talks for 30 days; and 3) if unsuccessful, an arbitration panel consisting of one or three arbitrators is assigned to decide the case. If one party is not resident in Korea, either may request an arbitrator from a neutral country.

When drafting contracts, it may be useful to provide for arbitration by a neutral body such as the International Commercial Arbitration Association (ICAA). U.S. companies may wish to seek local expert legal counsel when drawing up any type of contract with a Korean entity.

Korea is a member of the International Center for the Settlement of Investment Disputes (ICSID). It has also acceded to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). Korea is a member of the International Commercial Arbitration Association and the World Bank's Multilateral Investment Guarantee Agency (MIGA). It is important to keep in mind that Korean courts may ultimately be called upon to enforce an arbitrated settlement.

Performance Requirements and Incentives: South Korea does not maintain any measures notified to the World Trade Organization (WTO) as being inconsistent with TRIMs requirements, nor does the ROKG maintain any measures that are alleged to violate the WTO's TRIMs text. Korea ceased imposing performance requirements on new foreign investment in 1989 and eliminated all pre-existing performance requirements in 1992. The ROKG has no requirement that investors purchase from local sources or export a certain%age of output. There is no ROKG requirement that Korean nationals must own shares in foreign investments or that technology be transferred on certain terms. The Korean government does not impose "offset" requirements on investors to invest in specific manufacturing, R&D or service facilities. There are also no government-imposed conditions on permission to invest.

The Korean government allows the following general incentives for foreign investors:

- Cash grants for the creation and expansion of workplaces for high-tech business plants and R&D research centers;
- Reduced rent for land and site preparation for foreign investors;
- Grants for establishment of convenience facilities for foreigners;
- Reduced rent for state or public property; and
- Preferential financial support for investing in major infrastructure projects.

Right to Private Ownership and Establishment: Korea fully recognizes rights of private ownership and has a well-developed body of laws governing the establishment of corporate and other business enterprises. Private entities may freely acquire and dispose of assets; however, the Fair Trade Act may limit cross-ownership of shares in two or more firms if the effect is to restrict competition in a particular industry.

Korea liberalized its property ownership law in 1998. The Alien Land Acquisition Act (as amended) grants even non-resident foreigners and foreign corporations the same rights as Koreans in purchasing and using land. Korea has took further steps to liberalize its property ownership laws by implementing the Real Estate Investment Trust (REIT) Act in 2001, which supports sound indirect investments in real estate and restructuring of corporations. The REIT Act allows investors to invest funds

through an asset management company, and in real property such as office buildings, business parks, shopping malls, hotels and serviced apartments.

Almost no restrictions remain on foreign ownership of stock in Korean firms. As of 2000, Korean law permits foreign direct investment through mergers and acquisitions with existing domestic firms, including hostile takeovers. Nonetheless, no hostile takeovers have occurred in Korea because of the lack of relevant implementation regulations for the Foreign Investment Promotion Act. In addition, the political environment for hostile takeovers remains unfriendly. In early 2005, the Ministry of Finance and Economy (MOFE) announced new stockholding disclosure rules aimed at further complicating any possible hostile takeover attempts. A prohibition on cross-ownership between companies was repealed in 1998.

Protection of Property Rights (Including Intellectual Property): Although respect for basic property rights in Korea, including land use rights, is solid, and generally a matter of course, Korea has significant shortcomings in its protection of intellectual property rights (IPR). The problem is particularly serious in the area of protection of digital content -- where IPR protection is made more complicated by Korea's very high Internet access rate and degree of broadband connectivity. As a result of these shortcomings, Korea was elevated from the United States Trade Representative's Special 301 "Watch List" to the "Priority Watch List" in January 2004 after an Out-of-Cycle Review and was kept on the "Priority Watch List" in May 2004. While Korea has made progress on tightening IPR enforcement in recent years, the U.S. government's review found that the growth of online music piracy had caused serious economic damage to recording companies. Continued piracy of U.S. motion pictures in Korea has also resulted in revenue loss for U.S. and Korean copyright holders.

In June 2003, the Ministry of Justice issued a directive to prosecutors to pro-actively pursue IPR infringement violations. Since that time, Korean police and prosecutors have conducted more consistent raids against software end-users. In October 2003, the National Assembly granted policing authority to the Standing Inspection Team responsible for investigation of software piracy, which resulted in more frequent raids based on leads from the software industry.

Protection of digital content has suffered, however, due to some specific shortcomings in Korean law:

- *Insufficient Transmission Rights for Sound Recordings:* Korea has one of the highest levels of broadband Internet penetration in the world, but struggles to keep pace with the transformation resulting from digitization and high-speed Internet access. A critical element missing from Korea's Copyright Act is exclusive rights for online dissemination of recorded music. A bill passed by the National Assembly in September 2004 provided only narrow "interactive" transmission rights for sound recording producers and performers. Without broadening these rights to cover transmission through web-casting or other non-

interactive digital transmissions, on-line piracy will continue to damage the revenues of domestic and foreign phonogram industries.

- *Copyright Act Shortcomings:* Revisions to the Copyright Act passed by the National Assembly in July 2000 and April 2003 included permission for enhanced technical protection measures (TPM's) and the introduction of a framework for a "notice and takedown system" to give an Internet service providers (ISP) a legal incentive to respond promptly to requests from right holders for removal of pirated content. However, in order to fully comply with the WIPO Copyright Treaty (WCT) ratified by Korea in 2004, further revisions to the Copyright Act are still needed. In particular, Korea remains in violation of its obligations under the Berne Convention's Article 18 and TRIPS Article 14.6 to provide full retroactive protection for pre-existing works and sound recordings.

- *Computer Program Protection Act Shortcomings:* In December 2002, the National Assembly revised the Computer Program Protection Act (CPPA) to provide for transmission rights, a critical part of effective copyright regimes in the digital age. The revision also requires Internet service providers (ISP's) to immediately stop infringing activity upon request of the copyright owner, for the purpose of revising or updating programs, or for encryption research. The CPPA should be further strengthened, however, to clarify that the right holder has the exclusive right to make copies, temporary or permanent, of a work or phonogram. Unlike the Copyright Act, the CPPA does have provisions on protection of technical protection measures used with computer programs, although several broadly worded exceptions still need to be narrowed.

In 2002, the National Assembly enacted the Publication and Printing Business Promotion Act, allowing the private sector to participate in enforcement activities against book piracy. In 2003, Korean authorities and the private sector began joint book piracy enforcement efforts, especially on and near university campuses. In 2004, the Ministry of Education sent a letter to Korean universities requesting them not to tolerate copyright infringement on their campuses.

Pirating of audio-visual materials in DVD format, illegally sold by street vendors, remains a serious problem in Korea. Despite active Korean National Police enforcement efforts, video-DVD pirates in Korea have developed increasingly sophisticated production facilities and distribution methods.

Korean patent law is fairly comprehensive, offering protection to most products and technologies. Still, despite legislative progress, deficiencies remain in the interpretation of claims and in the treatment of dominant and subservient patents. The Korean Intellectual Property Office (KIPO) strengthened restrictions on patent term extension for certain pharmaceutical, agrochemical and animal health products that are subject to lengthy clinical trials and domestic testing requirements, but problems still remain. Lack of coordination between Korean health and safety officials and IPR

personnel sometimes results in market approval being granted for products that infringe on existing patents.

Korea's Trademark Act, amended in 1998 to prohibit the registration of trademarks without the authorization of foreign trademark holders, allows examiners to reject any registrations made in "bad faith." Despite this change, the complex legal procedures that U.S. and other companies must follow to seek cancellation proceedings act as a barrier to effective enforcement, by discouraging U.S. companies from pursuing legal remedies.

Concerning counterfeiting and trade secret protection, in revisions to the Copyright Act made in 2000, textile designs were afforded copyright protection as well as protection under Korean design law. But enforcement efforts are not consistent. The Korean Customs Service upgraded its computer system in 2003 in an effort to enhance border enforcement against the export of counterfeits.

Korean laws on unfair competition and trade secrets provide a level of protection in Korea, but are sometimes insufficient. For example, some U.S. manufacturers report government regulations that require submission of very detailed information of sensitive products as part of registration procedures. The Korean Food and Drug Administration (KFDA) revised the Pharmaceutical Affairs Act implementing regulations to stipulate that submitted data must be protected from authorized disclosure when the submitting party requests protection. In 2004, the Unfair Competition and Trade Secrets Act was amended, strengthening penalties for disclosing trade secrets.

An Internet Domain Name Dispute Resolution Committee was created in 2002 to arbitrate disputes and minimize court actions. To better protect trademarks unjustly used as a domain name, the Unfair Competition Prevention and Trade Secret Protection Act was amended in 2004 to include such an unjust registration of another person's trademark as a domain name as an unfair competitive act. In addition, the fraudulent manufacturing and sale of goods for which the trademark has not yet registered in Korea is also considered an unfair competitive act.

SYSTEMIC ISSUES

Corporate Governance and Investment Decision-Making: Investors and financial markets remain wary of corporate governance in Korea despite significant improvements since the 1997-98 Asian financial crisis. Concerns about corporate governance mean Korean shares often trade at earnings well below those of comparable companies elsewhere. Korean policy makers acknowledge that foreign investors often exact a "Korea Discount" when dealing with Korean companies or in making investment decisions. As the Chairman of the Korean Free Trade Commission (KFTC) has stated, "the main reasons for the Korea Discount are opaque accounting techniques, less respect for minority shareholders, insufficient openness and excessive control by controlling families."

Large gaps still exist between the ownership and control of a significant number of firms in Korea, with many traditional "*chaebol*" conglomerates still being run by their founding families, despite the family's generally small ownership stakes. Korea's accounting reform plan and Code of Best Practices are admirable efforts, but more can be done in these areas as well. Increasing participation by foreign investors and stockholders, modernizing business-government relations, and infusing professionalism in the corporate culture could go a long way toward improving corporate governance.

Korea's development strategy in the latter part of the 20th Century, which transformed the country from one of the poorest nations in the world to a member of the OECD, created a number of structural legacies that increased the country's vulnerability during the 1997-1998 Asian financial crisis. At that time, Korea's generally weak corporate governance framework was compounded by a history of government-directed financing, creating significant "moral hazard" -- that is, the assumption that government would make good all losses and not permit large companies to fail. This allowed large segments of the corporate sector to become excessively leveraged, increasing vulnerability. Korea responded to the financial crisis by implementing a number of corporate reforms that improved accounting transparency, promoted corporate restructuring, and strengthened the nation's insolvency framework. Nonetheless, corporate governance reforms remain incomplete. In 2003, for example, an accounting scandal at a subsidiary of the country's third-largest *chaebol* revealed that questionable corporate practices remain, including shady accounting, reflecting disparities between ownership and control.

The Korea Fair Trade Commission aims to reduce the gap between ownership and control by encouraging the *chaebol* to improve internal checks and balances (for example, by adopting cumulative voting for the selection of independent directors). The KFTC has also urged the *chaebol* to adopt a vertical holding company structures so that all of a group's equity investments are held by one company (a common practice in other OECD countries). As an incentive for firms to pursue these two tracks, the Korean government has said that it would exempt complying firms from limits on their equity investments. Few *chaebol* have pursued either one of these tracks, however, in part because of stringent conditions regarding the creation of holding companies.

The Anti-Monopoly and Fair Trade Act has been repeatedly changed -- most recently in 2003 -- to address the issue of excessive *chaebol* control over affiliates. In the latest revision to the Act, the Korean government re-instituted restrictions on *chaebol* cross-ownership, including a ceiling on *chaebol* investments in affiliated firms equal to 25% of a *chaebol*'s net assets. Prior to that, Korea's top 30 *chaebol* committed to eliminating all intra-group payment guarantees by March 2001.

The practical impact of Korea's laws and policies regulating monopolistic practices and unfair competition, however, has been limited by the long-standing economic strength of the *chaebol*. Management control at the Korean *chaebol* continues to involve complicated webs of murky cross-shareholdings among *chaebol* affiliates, and

many *chaebol* still conduct business based on family and personal connections. Vestigial *chaebol*-government relations can also sometimes influence the business-government dialogue, to the detriment of foreign and small and medium-sized enterprises (SME's). Thus, *chaebol* influence in the Korean economy causes some practical business problems for foreign investors. SME suppliers, for example, may be reluctant to deal with foreign firms for fear of jeopardizing a prized *chaebol* relationship. Obtaining access to credit may be complicated by the privileged relationships competing *chaebol* enjoy with local banks -- although this is mitigated by the fact that regulations limit a bank's exposure to any single *chaebol* group's companies to 25% of capital, and stipulate that 35% of all banks' lending must go to SME's.

There are several large Korean corporations that have transformed themselves into well-managed multinational corporations that have adopted "best practices" in corporate governance consistent with U.S. and international standards. Some of their "best practices" include more frequent board meetings covering real operational issues; boards with more independent board members and fewer or no founding family members; a nominating committee for the board; financial report certifications; and frequent and substantive outside audits.

Foreign ownership is also playing a significant role in promoting corporate governance reform in Korea. Korean firms with significant foreign investment, for example, are generally understood to be more reluctant to participate in government-sponsored bailouts of troubled firms, impacting the evolution of Korean financial markets. As foreign investors now own about 60% of Korea's top companies and over 40% of stock listed on Korea's main stock exchange, the rights of minority and non-Korean stockholders are becoming more clearly expressed. To some extent, this trend has provoked a backlash against foreign investment on the part of some *chaebol* and other conservative forces in Korean society. This has led the Korean government to consider some ill-advised policies, such as limiting the number of foreign directors allowed on corporate boards or requiring Korean nationality to sit on a bank's board of directors. But few such policies have actually been implemented thus far, and many corporate leaders in Korea are starting to understand that -- as Korean empirical research has demonstrated -- companies that have high disparities between ownership and control also have lower profitability, higher leverage ratios and lower price-to-earnings ratios.

The Korean government is currently implementing an accounting reform plan, taken largely from the U.S. Sarbanes-Oxley Act, aimed at making Korean accounting standards consistent with rigorous international standards. Key elements of the reform plan encompass measures to increase the responsibility and accountability of the corporate board, management, and the audit committee. In parallel, a committee of Korean private sector experts has established a Code of Best Practices in response to a tasking by the Ministry of Finance and Economy. The voluntary recommendations included in this Code are in line with OECD principles, and the Korea Stock Exchange (KSE) has reinforced the importance of the Code by requiring that companies listed on the KSE provide information to investors about the extent to which they conform to the

Code. Following are some of the key recommendations contained in the Code of Best Practices:

- Easing of ownership thresholds to allow small shareholders greater rights to inspect company books;

- Having outside or independent directors make up at least half (rather than a quarter) of the board members of listed companies;

- Establishing a nominating committee to choose board members, with at least half of the committee consisting of outside directors;

- Ensuring that outside directors are truly independent, with no interests in the company, the management, or the controlling shareholder;

- Having the board of directors meet at least once every three months; and

- Requiring that companies have audit committees consisting of at least three directors, of which two-thirds are outside directors.

The Korean government also plans to introduce class action lawsuits in 2005. Minority shareholders will be able to file class action suits against companies with assets totaling more than 2 trillion won for manipulation of share prices, false disclosure of information, and accounting malpractice. This system is also expected to have a significant impact in improving corporate governance practices in Korea.

Transparency of the Regulatory System: The Korean regulatory environment, difficult for domestic companies, poses an even greater challenge for foreign firms. Laws and regulations are often framed in general terms and are subject to differing interpretations by government officials, who rotate frequently. While the regulatory process has improved since the Asian financial crisis, it is often not transparent and frequent informal discussions with the bureaucracy are necessary. Mid-level bureaucrats often rely on unpublished office guidelines and unwritten administrative advice for direction.

Vestiges of Korea's former industrial policy are also still evident in the business environment despite the efforts of the Kim Dae-jung and Roh Moo-hyun Administrations to increase regulatory transparency. The Korean government bureaucracy still influences the decisions of businesses and investors through prescriptive regulations, policies favoring domestic industry, and even threats of retaliation. Investors, whether Korean or non-Korean, are often required to disclose proprietary information to government officials as part of the regulatory approval process. Some foreign investors complain that the proprietary nature of the trade information provided has not been respected and has been obtained by local competitors.

According to Korea's Administrative Procedures Act, proposed laws and regulations (Acts, Presidential Decrees or Ministerial Decrees) should be published and public comments solicited for 20 days prior to promulgation. Draft bills are often available on the web sites of relevant ministries. Nonetheless, the rule-making process often remains non-transparent, particularly for foreigners. Proposed rules are not always published prior to promulgation, or are published with insufficient time to permit public comment and industry adjustment. For example, regulatory changes originating from legislation proposed by members of Korea's National Assembly are not subject to public comment periods. When notifications of proposed rules are made public, they usually appear in the Government Gazette, but not consistently, and only in the Korean language, meaning that much of the 20-day comment period can be exhausted translating complex documentation. After promulgation, rules are sometimes applied arbitrarily.

President Roh Moo-Hyun has made deregulation one of the key elements of his economic policy. The Korean government has made efforts to cut back on the number of regulations, and some important changes have been made, but generally speaking deregulation has so far taken a back seat to other economic and financial system restructuring concerns. The regulatory picture is mixed, depending on the ministry or agency, although some have made unprecedented efforts reach out to foreign business.

Capital Markets And Portfolio Investment: Financial sector reform has been a bright spot for the Korean government in the past 7-8 years and could provide a positive example for reform efforts in other sectors of the economy. Financial sector reforms have aimed to increase transparency and investor confidence, and generally purge the sector of moral hazard. Since 1997-98, the Korean government has recapitalized the banks and non-bank financial institutions; closed or merged weak financial institutions; resolved many non-performing assets; introduced internationally-accepted risk assessment methods and accounting standards for banks; forced depositors and investors to assume appropriate levels of risk; and taken steps to help end the policy-directed lending of the past. Weak supervision and poor lending practices in the Korean banking system helped cause and exacerbate the 1997-98 Asian financial crisis.

In the course of stabilizing Korea's banking sector during the financial crisis, the Korean government injected public funds, thereby acquiring *de facto* ownership of many of Korea's commercial banks -- although it publicly committed to refrain from interfering in bank lending and management decisions, except with regard to prudential supervision. In late 2002, the Korean government began its ambitious plan to re-privatize the banks under its control, with the program was initially scheduled to end by the first quarter of 2005. Much of this re-privatization has taken place, although the government continues to own the majority of shares in Woori Bank and minority shares in some other banks. Foreign banks are allowed to establish subsidiaries or direct branches. Further relaxation of regulations has widened foreigners' access to Korea's capital markets and permitted foreign financial firms to engage in non-hostile mergers and acquisitions of local financial institutions. Currently, foreign interests control three of Korea's eight major commercial banks: KorAm Bank (recently renamed Citibank); Korea Exchange Bank and Korea First Bank.

Korea routinely permits the repatriation of funds, but reserves the right to limit capital outflows in exceptional circumstances, such as situations when uncontrolled outflows might harm the balance of payments, cause excessive fluctuations in interest or exchange rates, or threaten the stability of domestic financial markets. The Korean government did not impose such restrictions even during the height of the Asian financial crisis.

Foreign portfolio investors now enjoy good access to Korea's stock markets. Aggregate foreign investment ceilings in the Korean Stock Exchange (KSE) were abolished in 1998, and foreign investors owned 41.9% of KSE stocks and 15.3% of the KOSDAQ by the end of 2004. The market turnover rate was 151% of market capitalization in 2004. Retail investors are extremely active in the Korean stock markets. Some 60% of KSE retail trading and 80% of KOSDAQ trading is conducted online. Thus, a large majority of retail investors are day traders, implying a constant source of volatility for the markets. The Korean government permits stock purchases on margin, requiring that transactions be settled within three business days.

Portfolio investors have shown less appetite for the smaller, more volatile, technology-rich KOSDAQ or for Korean fixed-income investments. Since the 1999 collapse of the Daewoo Group in 1999, Korea's largest corporate bankruptcy, the country's bond market has been almost moribund, as sellers have far outnumbered buyers. The total assets of Korea's commercial banks as of the end of 2003 were 774 trillion won, or about $649 billion.

Short-term interest rates remain low, at around 3.7%, but inflation at 3.6% remained high throughout 2004. Inflation for 2004 is expected to have been around 4.0%. The spread between short-term money (the overnight call rate) and long-term money (the benchmark 3-year corporate bond rate) fell from its 400-plus basis points high in 2000 to about 60-basis points in December 2004. The Bank of Korea (BOK) has maintained its target for the overnight call rate at the record-low level of 3.25% since November 2004, in consideration of sluggish domestic consumption and investment. The target rate was 3.75% from July 2003 until July 2004, but on August 12 and November 11, the BOK lowered twice its target rate to 3.5% and 3.25%, respectively, to stimulate domestic consumption and investment.

LABOR ISSUES

While Korea boasts a hard-working, educated and productive workforce, foreign investors cite volatile labor-management relations and Korea's inflexible labor laws as a primary investment impediment. In 2004, South Korea was ranked 44th among 60 countries in labor market flexibility by the Swiss-based International Institute for Management Development. Korea loses proportionally more workdays to strikes than any other OECD country. Although at around 11% the unionization rate is not especially high, unions, kept down during decades of authoritarian rule, are forceful in making high

wage and benefit demands. Korea's out-dated labor laws, designed decades ago to primarily with the intention of encouraging businesses to provide the social safety net the Korean government could not at that time afford, contribute to the rigidity of the system and make it difficult to dismiss workers and expensive to hire new staff. A lack of pension mobility in the private sector compounds the problem, as does general lack of confidence in the social safety net for unemployed workers. Korean management, meanwhile, often takes an old-fashioned, confrontational approach to labor relations.

The Roh Administration is working to reform the labor structure in Korea to make the country more attractive to investors and help spur economic growth. Reforms to date, however, have focused on the more politically visible aspects of Korea's labor problems, such as how to deal with strikes and labor-management conflict, instead of promoting labor flexibility and mobility to stimulate the job market. International organizations such as the ILO have urged Korea to bring its labor code into conformance with international standards to enhance global competitiveness. According to ROKG figures, the number of days lost to strikes declined from 1,271,126 in 2003 to 1,160,000 in 2004.

The Korean labor market is increasingly a polarized one, with a core of regular workers enjoying a high level of employment protection, and rapid wage growth, supplemented by a large group of temporary (contract) workers whose numbers can be more easily adjusted in line with changing economic conditions. Korean and foreign employers cite the difficulty of reducing the number of regular workers and the expense of hiring new workers as reasons for hiring non-regular workers. Temporary workers are generally not union members and do not demand the higher wage increases expected by union members, so their wages better reflect the overall supply and demand conditions of Korea's labor market. Contract workers also most often do not receive fringe benefits, and can be terminated at the end of their contract without severance benefits -- compounding fearful attitudes among workers about the downsides of a flexible labor market. Many employers have sought to replace retiring regular workers with temporary ones. Temporary workers usually earn about 60% of what regular workers make for the same job. The National Statistics office believes 49% of Korean workers can be classified as "irregular," while the unions claim the real number may be as high as 60%.

The temporary worker phenomenon has a significant downside for management, however. Korea's labor laws stipulate that if a temporary worker's contract is extended more than once, that worker becomes a *de facto* permanent worker, protected by termination and other benefit provisions. As a result, many companies limit such contact extensions to just one time, and regularly turn over a significant part of their work force. This limits productivity growth for companies, as they must invest considerable time training new workers, and also impacts on the employment prospects of both new workers and those being let go. The Korean government, labor and management sector has yet to come to grips with this system. As a result, an entrenched unionized workforce continues to receive significant wages increases every year, while the remainder of the labor force sees fewer benefits and lower wages and wage growth, and dimmer prospects for the future.

The Roh Administration has adopted a Tripartite Commission (Labor, Employers and Government) approach to address these dysfunctions in the labor sector. After initial high expectations, the Commission crafted and agreed upon a "Social Compact on Job Creation" in February 2004. But employers, labor, and the government are all less than optimistic that this non-binding agreement will yield fruit, since it is heavy with generalities and light on specifics.

An earlier "Roadmap for Industrial Relations Reform," drafted by the government in 2003, drew criticism from labor confederations and business organizations. Of the 29 proposals set forth, the following were some of those considered most problematic:

- Redefinition of the Basic Wage: Employers argued that the new Basic Wage would have raised expenses and impeded the creation of new jobs. The roadmap proposed that the new Basic Wage expand the definition of a basic wage to include all regular benefits such as periodic bonuses, supplementary allowances, raises, bonuses, overtime, night work, and work on holidays;

- No payments of wages to full time union officials: Current laws require that companies must pay 100% of the salaries of those whose full time job is to run the union at the company. Unions oppose the elimination of this provision;

- Prohibition of any given industry from having more than one union: Current laws state otherwise. Unions oppose this change;

- Replacement workers: Current labor law permits management to hire replacement workers only in the case of illegal strikes. The government would like to permit the hiring of replacement workers without condition in the case of "public corporations;"

- Mandatory maintenance of minimum level of essential public services during strikes: Supported by government but opposed by labor.

Korean and foreign experts agree that more attention should be paid to finding ways to promote labor mobility while stimulating the job market. According to the OECD, only 70% of all Korean wage and salary earners in 2002 were eligible for unemployment insurance and only 51% were actually insured. Expanding coverage would be a step in the right direction. The government's plan to extend unemployment insurance to daily workers would also help. Exploring ways to better connect workers with employers could promote labor market efficiencies. Specifically, the Public Employment Service could seek greater cooperation with Korea's large and long-established network of the more than 5,000 private job placement agencies. Vocational training in Korea lags behind other countries with a similar level of development. Current programs could target their participants more carefully, keep the training programs small in scale, and ensure that the training results in a qualification that the market recognizes and values.

In the Korean system, government employees and schoolteachers can carry their pension rights when they quit one occupational plan and enter another. But there are no such linkages between the National Pension Scheme (NPS) and occupational pensions. The lack of portability puts such relatively mobile workers at a disadvantage and discourages movement between the public and private sectors. More broadly, Korea lacks a portable 401(K)-type system for corporate pensions. The establishment of such a system could assist in reducing disincentives to labor mobility.

In the area of labor-management relations, Korean labor groups are quick to escalate disputes and commonly resort to work slowdowns, abuse of leave, and disruption of business by holding rallies, wearing inappropriate clothing or displaying protest signs at the workplace. These tactics fall outside the scope of Korea's labor law and lead to confrontations with management and authorities. Sit-in strikes are common, and workers have occupied company offices and factories. Korean workers were united in seeking a reduction in the workweek from 44-45 hours a week (five-and-one-half-work days) to 40 hours a week (five work days), while keeping the same pay; this system began gradual implementation in July 2004.

While labor disputes are relatively more frequent at Korean companies than foreign-invested firms, union members at foreign-invested firms often make greater demands on management. Workers at foreign-owned firms perceive, most often incorrectly, that job stability and career prospects are relatively less attractive than at Korean firms, and as a result, labor is concerned about reductions-in-force and issues such as severance pay. At times, labor organizers portray disputes with a foreign employer as issues that offend Korean nationalism, a hot button for the Korean public psyche. For some companies such as banks, whose activities are considered to be essential public services, the government has the right, although seldom used, to order binding arbitration to solve labor disputes.

Korea joined the International Labor Organization (ILO) in December 1991. However, Korea still has not ratified the basic ILO conventions on Workers Rights (Convention 87 on freedom of association, Convention 98 on the right to organize and collective bargaining, and Convention 151 on public service employees' right to organize), and a number of international and domestic labor groups have filed complaints against the Korean government with the ILO's Committee on Freedom of Association.

In 1997, Korea amended its labor laws to permit more than one national labor federation. Korea now has two national federations, the Korean Confederation of Trade Unions and the Federation of Korean Trade Unions, along with some 1,600 distinct labor unions. Also, in 1997, the government repealed its ban on intervention by "third parties" in labor disputes, thus enabling labor unions to seek outside assistance and counsel.

COUNTRY RISK ISSUES

Political Violence: Korea does not have a history of political violence directed against foreign investors. The Embassy is not aware of any politically motivated threats of damage to foreign-invested projects or foreign-related installations of any sort, nor of any incidents that might be interpreted as having targeted foreign investments. Labor violence unrelated to the issue of foreign ownership, however, has occurred in foreign-owned facilities in the past.

The Roo Moo-hyun Administration has continued South Korea's policy of economic cooperation with North Korea, even while maintaining a credible defense against any possible North Korean hostilities. This North-South engagement helps ease tensions caused by revelations in 2002 that North Korea had undertaken a second nuclear weapons program after it had agreed to freeze an earlier one under the U.S.-DPRK agreement signed in October 1994. Six party talks involving the two Koreas, the United States, China, Russia, and Japan on the elimination of the DPRK's nuclear programs continue -- but the DPRK has still not committed to dismantling its nuclear programs.

Corruption: Despite significant improvements in recent years, Korea's political structure still tolerates a degree of non-transparency in the formation of laws and regulations, which when combined with still-inadequate institutional "checks and balances" and a societal structure heavily based on personal ties can create opportunities and incentives for corruption and influence peddling.

The Korean government's hosting of the third Global Forum on Fighting Corruption in 2003 helped reinvigorate anti-corruption efforts, and the Roh Moo-hyun Administration began its tenure in 2003 with an ambitious agenda to reform political funding laws, decentralize government and compel greater corporate transparency and accountability through a mix of political pressure and new laws and regulations. The April 2004 National Assembly election, which took place under new, much stricter campaign finance laws, is widely considered to have been the cleanest ever, hopefully setting a new precedent whereby Korean corporations are no longer expected to bankroll political campaigns.

Bribing a Korean official is a criminal act. Penalties for bribery range from probation to life imprisonment, depending on the amount involved. Legislation has been approved bringing Korea into compliance with the OECD initiative against international bribery. The Supreme Prosecutor in each province is responsible for ferreting out corruption. Many business leaders and officials, including former ministers and former presidents, have been found guilty of corruption in recent years, sometimes for offenses committed years earlier. Still, few have paid heavy fines or served much time in prison. Amid spreading public sentiment denouncing bribery and corruption, particularly after the April 2000 general legislative election, civic groups have become very vocal and achieved considerable progress by identifying supposedly "corrupt" officials and working

against their re-election. Public outrage helped propel Roh Moo-hyun, viewed by many as an untainted outsider, to the presidency in 2003.

The controversial Anti-Corruption Law passed by the National Assembly in 2002 is now in effect. Most notably, this law created the Korea Independent Commission Against Corruption (KICAC), which is semi-autonomous and empowered to investigate public complaints of corruption at every level of government. KICAC has established "reporting centers" in Korea's six largest cities and invites citizen complaints about their public officials via telephone, facsimile, email or Internet. Despite KICAC's quick start and seeming sincerity, many Koreans believe corruption is still rampant in Korea, and believe even the most aggressive independent body will have difficulty rooting it out.

The National Assembly passed an Anti-Money Laundering Bill in 2001. That legislation met the objectives of the Financial Action Task Force on Money Laundering's forty recommendations, and created a Financial Intelligence Unit (FIU) to trace suspect accounts and transactions and to facilitate international cooperation. The government has cooperated fully with U.S. and United Nations efforts to identify and shut down sources of terrorist financing.

FOREIGN TRADE ZONES AND FREE ECONOMIC ZONES

The Korean government has established three "Free Economic Zones:" near Incheon International Airport outside Seoul, near the port in Busan and at Gwangyang. When fully developed, these areas are designed to provide a specially enhanced business environment for foreign-invested firms. Specific tax and tariff measures and other incentives such as eased restrictions on foreign investment in certain services (such as education and hospitals) are still being debated in the National Assembly. Major infrastructure enhancements at each site are already underway.

There are also six Foreign-exclusive Industrial Complexes in Korea in different parts of the country, designed to provide inexpensive plant sites, with the national and local governments providing assistance for leasing or selling such sites at discounted rates. In addition, there are four "Free Trade Zones" in Iksan, Kunsan, Daebul and Masan where companies may pursue their business with government support, but without the usual legal requirements such as approval procedures for export and imports and customs duties. There are also seven Foreign Investment Zones designated by local governments to accommodate industrial sites for foreign investors. Special considerations for foreign investors vary among these options.

A good source of information on Korea's various free trade zone schemes is the government-run "Invest Korea," an inward investment promotion organization under the The Korea Trade and Investment Promotion Agency (KOTRA). It can be reached at:

Invest Korea, KOTRA Bldg. 300-9
Yomgok-dong, Seocho-gu, Seoul 137-170, Republic of Korea

INTERNATIONAL ARRANGEMENTS

Bilateral Investment Agreements: The United States has a bilateral Treaty of Friendship, Commerce, and Navigation with Korea, which contains general provisions pertaining to business relations and investment. During former Korean President Kim Dae-jung's visit to the United States in 1998, President Clinton and President Kim agreed to negotiate a Bilateral Investment Treaty (BIT) between the two nations. However, negotiations in 1998 and 1999 stalled after the two sides could not resolve differences on certain issues, including Korea's screen quota limiting the importation of foreign motion pictures. The Korean government and public continues to debate the merits of meeting U.S. requirements on the screen quota, while business groups from both countries continue to believe that conclusion of a BIT would help deepen economic relations.

OPIC and Other Investment Insurance Programs: U.S. investments in Korea are eligible for insurance programs sponsored by the U.S. Overseas Private Investment Corporation (OPIC). OPIC has not, however, guaranteed any U.S. investments in Korea since June 1998, when OPIC reinstated coverage it had suspended in 1991 due to concerns about worker rights. Coverage issued prior to 1991 is still in force. Korea has been a member of the World Bank's (IBRD) Multilateral Investment Guarantee Agency (MIGA) since 1987.

FOREIGN DIRECT INVESTMENT STATISTICS

($ Millions)	Annual Flow			Cumulative Stock
	2002	**2003**	**2004**	**2004**
Total Inward FDI	**9,102**	**6,468**	**12,770**	**103,890**
United States	4,500	1,240	4,725	32,260
EU	1,680	3,062	3,005	30,682
Japan	1,404	541	2,249	15,509
China	249	50	1,165	1,687
Other	1,269	1,575	1,626	23,752
Total Outward FDI	**2,145**	**2,998**	**4,308**	**38,736**
China	872	1,388	1,654	8,355
United States	460	738	1,034	10,222
EU	527	144	550	6,278
Japan	68	47	272	915
Other	218	711	798	12,966

Source: The Export-Import Bank of Korea and Ministry of Commerce, Industry and Energy

Note: Inflow data is based on the notification of cases, while outflow is based on the net investments notified. 2004 outflow is data reported in the first 11 months of the year.