The Northeast Asian Financial Hub Project in South Korea and the Conditions for an Asian Financial Center

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I. Introduction

In December 2003 the South Korean government under President Roh Moo-hyun announced a policy on developing a Northeast Asian Financial Hub.[1] For about 18 months little visible progress was made. However, in July 2005, the government published an action plan—an indication that further concrete measures can be expected. At about the same time and in a controversial move seen by some as nationalism, the tax authority announced that it was investigating the activities of a number of foreign funds and would levy back taxes and penalties on some of them.

This report considers the strategic options available to the South Korean government in trying to become a financial hub by looking at the experience of Hong Kong, Singapore and, to a certain extent, Japan, in trying to achieve the same objective.

Figure 1 A Comparison of the Size of Each Market

	Hong Kong	Singapore	South Korea	Japan
Equity market capitalization (2005/3, US$bn)	843	227	485	3,514 (Tokyo)
Equity market trading volume (2004, US$bn)	510	107	488	3,218 (Tokyo)
Number of listed companies (2004)				
Local	1,086	547	1,583	2,288 (Tokyo)
Foreign	10	100	0	30 (Tokyo)
Government bonds outstanding (2005/3, US$bn)	46	66	605	8,858
Mutual funds outstanding (open-ended funds only) (2004/12, US$bn)	344	n.a.	177	4,000
Number of foreign banks	108 (2005/8)	105 (2005/12)	39 (2004/6)	72 (2004/10)

Source: NICMR, from official data of each of the countries concerned

[1] This is a plan to help South Korea's financial markets become a distinctive financial hub for northeast Asia. Its implementation strategy (-2020), announced in December 2003, aims to (1) encourage the development of services targeted at specific regional needs such as asset management, structural adjustment loans and shipping finance, (2) establish the Korea Investment Corporation (KIC) and thereby attract international asset management companies, (3) remove all restrictions on foreign exchange transactions, and (4) overhaul the regulation of the country's financial services industry.

II. The Concept of a Northeast Asian Financial Hub: Developments to Date

The government of President Roh Moo-hyun, which was elected on a populist platform and has maintained a certain distance from the *chaebol*, has had difficulty in gaining the support of business. In September the government invited the opposition Grand National Party to form a coalition in an attempt to stem the decline in its popularity, but this was rejected. As a result, the government's future is uncertain. This raises the question whether a new government forced to change the direction of policy would honor the present government's commitment to develop a financial hub.

Although the possibility that the government's flagship policy of developing a Northeast Asian Financial Hub might be abandoned cannot be ruled out completely, most observers think it unlikely that a new government would abandon all the policies already either implemented or announced, including the recent establishment of the Korea Investment Corporation (KIC)[2] and the complete deregulation of foreign exchange transactions. It is also difficult to imagine that a new government would immediately either amend or repeal the Ad Hoc Law of National Balanced Development (2003), which has led to the devolution of a number of public corporations and been sharply criticized as being incompatible with the "functional centralization" integral to the concept of a financial hub.

However, the investigations into the activities of a number of foreign funds that have made billions of dollars in capital gains from their acquisition of distressed companies and financial institutions following the Asian Financial Crisis in 1997 and the decision to levy back taxes and penalties on them have caused a stir in financial markets.

After launching investigations into six such funds in April 2005, the National Tax Service (NTS) announced on 29 September that it was levying back taxes and

[2] The KIC was established on 1 July 2005 and is modeled on Singapore's Government Investment Corporation (GIC). Its first assignment was to manage $20 billion of the Bank of Korea's foreign exchange reserves. The KIC is only allowed to invest in foreign currency assets, such as securities, foreign exchange, financial derivatives, bank deposits and property, and is not permitted to invest in local currency products. To begin with, it plans to farm out 80-90% of its assets to external managers and to gradually increase the proportion it manages in house. The KIC can also be expected to consider increasing the range and quantity of its investments once it has established a track record. Finally, it is required to disclose to the public the details of its finances and investment performance.

penalties on five of them (Lone Star[3], the Carlyle Group, Westbrook, Goldman Sachs and AIG).[4] This is the first time that the South Korean tax authorities have carried out an investigation of this kind into several different foreign funds at the same time, and the total amount of back taxes and penalties levied (214.8 billion won) was considerably more than had originally been expected. It has also been reported that the NTS is planning to refer several high-ranking fund officials to the public prosecutor for possible violations of domestic tax law and financial transaction law, and that the Financial Supervisory Commission is planning to investigate whether any of the funds illegally remitted foreign currency to overseas affiliates.

Provided the same standards are also applied to Korean investors, the Korean authorities may be able to avoid the accusation that they are targeting foreign investors. However, there is a risk that this action may be seen as incompatible with international standards or with the government's aim of creating a financial hub. Underlying this reaction appears to be a distrust of the lack of consistency in the tax authorities' decision to apply retroactive rules to foreign funds looking for an exit from investments they had made in response to a campaign by the Korean government to attract foreign money soon after the 1998 IMF crisis.

III. What Makes a Financial Hub or Financial Center?

So what makes a financial hub or financial center? According to Kindleberger (1974),[5] "…financial centers are needed not only to balance through time the savings and investments of individual entrepreneurs and to transfer financial capital from savers to investors, but also to effect payments and to transfer savings between places." Similarly, Takahashi (1990)[6] defines financial centers as "financial markets

[3] US-based Lone Star set up a wholly owned subsidiary in South Korea in the name of a subsidiary in Belgium. In 2001 its South Korean subsidiary purchased property worth some 600 billion won and later sold shares in the company to Singapore's Government Investment Corporation for a profit of 60 billion won. In the process, according to the NTS, Lone Star took advantage of the fact that, while the US-Korean double taxation agreement taxes capital gains on property sales, the agreement between Korea and Belgium does not to sell shares in its South Korean subsidiary, which owned too much property, using the Belgian subsidiary as a conduit in order to evade tax. In the view of the NTS, the real seller was the parent company in the US. (JoongAng Daily, 29 September 2005)

[4] The back taxes and penalties were imposed for the following alleged offenses: (1) abusing South Korean double taxation agreements by investing in South Korean property in the name of a subsidiary located in a tax haven and then selling shares in the company that owned the property (147.3 billion won); (2) transferring investment gains to an overseas affiliate by means of egregiously high interest payments (30.2 billion won); and (3) evading taxes on securities transactions as well as allocating costs illegally (37.3 billion won). (JoongAng Daily, 29 September 2005)

[5] Charles P. Kindleberger, "The Formation of Financial Centers," International Finance Section Princeton University, 1974.

[6] Takuma Takahashi, "Mane Senta no Kobo — Tokyo wa Kin'yu Haken o Nigireru ka" [The Rise and Decline of Money Centers: Can Tokyo Become the Dominant Financial Center in Asia?], Nihon Keizai Shimbun, Inc., 1990.

with the key function of financing international trade and coordinating the short- and long-term flow of international capital."

We can assume that this refers to markets in which not only domestic agents but also lenders, borrowers and intermediaries from any country can participate. For this to happen, we can also assume that they have rules and infrastructure that allow capital to move freely.

If such markets are to attract enough users, providers and intermediaries of capital and goods, they will need to be cost-effective, open, well equipped, well supported in terms of business skills and free of political and social risks. We shall now look at each of these requirements in turn by comparing the situation in South Korea with that in Hong Kong, Singapore and Japan, which are also located in East Asia but either already function as financial hubs or have the potential to do so.

1. The policy stance of the authorities towards financial centers

In Singapore, the role for developing the financial centre is performed by the Monetary Authority of Singapore (MAS). In Hong Kong, various departments within the Securities and Futures Commission (SFC) are responsible for the regulatory aspects, while the Financial Services team of InvestHK, the government body responsible for attracting investment to the region, is responsible for the promotional aspects.

As for the policy stances of these authorities, an MAS spokesperson said that "MAS seeks to maintain a robust regulatory regime that safeguards investors' interests while providing adequate flexibility to facilitate and promote commercial transactions to support the sustained long-term development of Singapore's financial markets".

In Hong Kong, on the other hand, according to a spokesperson from the SFC's Intermediaries & Investment Products, "the authorities have endeavored to provide a level playing field in accordance with international standards, focusing on maintaining a robust yet flexible entry standard and monitoring the market on a risk basis." This indicates a possible desire to distance themselves from the attitude of the Singapore authorities. However, the Hong Kong authorities appear to have devoted considerable resources to enforcing a licensing system for each different type of financial institution and supervising them in accordance with global standards.

In South Korea, in 2004, a new department (the Financial Hub Planning Division) was set up within the Ministry of Finance and Economy's Financial Policy Bureau to gather information and make proposals, while a task force composed of representatives from various government departments (the Northeast Asian Hub Committee) is responsible for discussing matters related to the development of a financial hub. When the author visited South Korea in September 2005, work on fleshing out the policies announced in July was still going on and little progress appeared to have been made in developing the concept of a financial hub beyond what had already been announced. However, work does appear to be proceeding on drawing up an action plan to open up the country's financial markets as part of an effort to attract foreign asset management companies (following the establishment of the KIC in July and in anticipation of the launch of corporate pension schemes in December) and to remove all restrictions on foreign exchange transactions by 2010.

2. Restrictions on foreign exchange and capital transactions

One of the shortcomings of South Korea's financial markets frequently alluded to by representatives of foreign financial institutions is the restrictions on foreign exchange and capital transactions. Although the government has announced that all restrictions on foreign exchange transactions will be lifted by 2010, the situation as of 2005 is that the Korean authorities (like their counterparts in Singapore) have retained some controls to enable them to avoid excessive speculative transactions.

As part of its policy of "currency non-internationalization" Singapore does not permit transactions in which the Singapore dollar could come under speculative pressure. As a result, like South Korea, it does not permit local currency transactions between nonresidents.

In the case of Singapore, there is an offshore "Asian dollar" market, which, like Tokyo's offshore market, is separated from the onshore market. This enables both resident and nonresident to lend and borrow in foreign currencies, as an alternative to transactions in the domestic currency. There are no restrictions on cross-border capital flows of foreign currency funds. Since 1978, all exchange controls in Singapore have been abolished, and both residents and non-residents are free to remit S$ funds into and out of the country. They are also free to purchase or sell S$ in the foreign exchange market. The only restriction is on S$ credit facilities exceeding S$5 million to non-resident financial institutions for the purpose of speculation in the S$. The ratio of onshore to offshore transactions is reckoned to be about 2:8 or 3:7, although the ratio is based on the perception of the market participants and no official figures are published by the autority.

In Hong Kong, on the other hand, the offshore market makes no distinction between onshore and offshore transactions. As in Singapore, there are no restrictions on cross-border flows, and the ratio of resident to nonresident money is also reckoned to be similar to that in Singapore. In addition to the absence of any distinction between onshore and offshore transactions, capital flows between mainland China and the Chinese diaspora make any such distinction difficult. No official figures on this are available.

South Korea, however, still has some restrictions on capital outflows, and this has been cited as an obstacle to internationalizing the country's markets and creating a financial hub.

In June 2005 the government announced that all restrictions on foreign exchange transactions (apart from a minimal declaration requirement) would be gradually abolished by 2010. The following month, as a first step, restrictions on purchases by Korean residents of overseas property were eased. Similarly, Korean businesses are now allowed to remit up to $1,000 a day to overseas subsidiaries without having to obtain permission from the Bank of Korea.

However, there are still some restrictions on other remittances overseas. For example, although there are in theory no restrictions on remitting profits overseas, in practice companies have to give a reason for remitting more than 10 million won. Such remittances are handled on a case-by-case basis, with some reasons being found unacceptable and others leading to the kind of scrutiny mentioned above. What it means is that the authorities still have a certain degree of discretion in this matter—something that is considered by some to increase the uncertainty of doing business in the country and to act as a deterrent to foreign financial institutions.

Figure 2 A Comparison of Each Country's Rules Governing Foreign Exchange and Capital Flows

	Hong Kong	Singapore	South Korea	Japan
Exchange rate system	Currency board: a US dollar standard or a pseudo-fixed exchange rate system (dollar peg)	Managed float: based on a trade-weighted index of major trading partners (nominal effective exchange rate). The composition of the currency basket and the permitted fluctuation band are unknown, but the US dollar is the main component, followed by the euro and the yen. MAS intervenes if the rate deviates from the band.	Float	Float
Separation of onshore and offshore markets	None (integration of domestic and offshore markets)	Separation based on the policy of 'non-internationalization of the Singapore dollar' has been distilled to the basic safeguards against borrowing by nonresident financial institutions for speculating in Singapore dollars.	None	Nonresidents are free to participate. Separated from the domestic market and free of interest rate restrictions, deposit reserve ratio requirements and withholding tax. Only transactions between nonresidents free of restrictions.
Use of local currency for international transactions	Permitted	Liberalized in accordance with the above liberalization, particularly in the following areas; a) Nonresident nonfinancial issuers of Singapore dollar securities will no longer be required to swap or convert their Singapore dollar proceeds into foreign currencies before remitting abroad; and b) Temporary overdrafts of Singapore dollar vostro accounts extended to prevent settlement failures will be exempted from the policy.	Not permitted	Permitted
Repatriation	No restrictions	No restrictions (Singapore dollars borrowed for use overseas must be converted to foreign exchange before they can be taken out of the country)	Remittances of more than 1 million won must be reported and the reason given	No restrictions
Restrictions on foreign investment by residents	No restrictions	No restrictions	Institutions: amounts equivalent to more than 20% of total assets must be reported to the Bank of Korea. (In the case of funds, the figure is "more than 10%".) Individuals: only via a securities company or for investing in a mutual fund	No restrictions
Other restrictions	None	Singapore dollars may not be borrowed for speculative purposes	Individuals: the limit on investment in overseas property was raised to $500,000 in June 2005	None

Source: NICMR, from official data of each of the countries concerned.

3. Cost factors

Corporate income tax is 17.5% in Hong Kong, 20% in Singapore, 13-25%, depending on the tax base (over 15 million won) in South Korea, and 37.2% (including business tax) in Japan (see Figure 3 for details). Although the minimum rate in South Korea was lowered from 15% to 13% earlier this year (2005), there is already talk of raising it again to increase the tax revenue.[7]

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7 Although the Ministry of Finance and Economy has officially denied that it is considering increasing the rate of corporate income tax, the consensus is that an increase of 1 percentage point is inevitable. The apparent reason is that corporate investment has failed to increase in spite of the reduction earlier in 2005. (Dong-a Ilbo, 29 September 2005)

As was mentioned above, the FSI, introduced by the Singapore authorities in April 2003, brought together the various tax incentives that had existed independently until then, providing a concessionary tax rate of 5-10%, depending on their type and status. As a result, the effective tax rate in Singapore is now the lowest of the four markets we are comparing, making the country a particularly attractive location for start-ups. The move can also be seen as an attempt by Singapore to attract institutions involved in relatively new areas such as hedge fund management and private banking.

As can be seen in Figure 3, office rents are much lower in Singapore than the other three markets—another reason for the clear tendency of investment funds and other start-ups to choose to locate in Singapore. In this regard, Hong Kong, where the recent sharp rise in rents has made it more expensive than Seoul and the second most expensive location after Tokyo, is at a major disadvantage.

Figure 3 A Comparison of Each Country's Market Infrastructure and Regulatory Framework

		Hong Kong	Singapore	South Korea	Japan
Tax system					
	Corporate	17.5%	20% (a concessionary tax rate of 5-10% applies to financial service companies)	Corporate income tax: if tax base is 100mn won or less, 13%; otherwise, 10mn won + 25% of tax base Business tax: depends on assets and number of employees Residence tax: corporate income tax × 10%	Corporate income tax: 30% Business tax: 7.2% Residence tax: corporate income tax amount × 17.3%
	Individual	Maximum progressive rate of 20%, standard rate of 16%	<Residents> Maximum progressive rate of 22% (on income in excess of S$320,000/year. To be lowered to 21% in 2006, and 20% in 2007.) <Nonresidents> - Employment income: 15% - Others: 20%	Income tax: ranges from 9% (if tax base is 10mn won or less) to 17mn won + 36% (if tax base is more than 80mn won) Residence tax: 10% residence tax surcharge is levied on capital gains and income from dividends/interest	Income tax: 10~37% Residence tax: 2~10%
	VAT/consumption tax	None	5% (certain exports and financial services are exempt)	10%	5%
	Financial taxes	■ Interest and dividends: tax-free ■ Offshore income, dividends, capital gains and the tax-free portion of deposits with particular categories of financial institutions are tax-free	■ Interest: 15% ■ Dividends: tax-free ■ Particular remitted income, trade income, dividends from local companies, income from particular funds, and capital gains are tax-free	■ Interest and dividends: residents 15%, nonresidents 25% ■ Capital gains: residents are exempt from stock exchange transactions if they own less than 3%; otherwise, they are taxed at 10-30% Nonresidents are taxed at 25% of their capital gains or 10% of the amount sold ■ Share transaction tax: 0.3% ■ Certain investments by foreigners are subject to a reduced rate of corporate and income tax	■ Interest: 20% ■ Dividends: 10% (until 2008/3), 20% (from 2008/4), companies pay tax on 50% of total dividends ■ Capital gains: 10% (until 2007/12), 20% (from 2008/1) ■ Nonresidents are exempt from tax on interest on government bonds
Rents for prime commercial office space (Tokyo = 100)		95.9	29.5	77.4 (Seoul)	100.0 (Tokyo)
Average non-primary sector wage (2002, US$/month)		1,146	1,865	1,957	2,656
Accounting firms/accountants		21000 firms	15000 firms	Just under 15,000	21,284 (membership of JICPA)
Law firms/lawyers					
	Local	5455 firms	3300 firms	Just under 10,000	21,185 (membership of JFBA)
	Foreign/foreigners	663	n.a.		236 (membership of JFBA)
Average TOEFL score(2004)		216	252	213	190
R&I country risk score/ranking (2005/7)					
	Overall	8.3 / 20th	9.7 / 16th	7.9 / 24th	n.a.
	Political stability	7.7 / 27th	10.0 / 1st	6.0 / 50th	n.a.
	Continuity of policy	7.4 / 35th	9.9 / 1st	7.1 / 39th	n.a.
	International credibility	8.0 / 21st	10.0 / 1st	7.3 / 31st	n.a.
	Treatment of foreign companies	8.3 / 23rd	9.6 / 16th	7.7 / 25th	n.a.
	Risk of war, civil war, terrorism, disease	7.9 / 31st	9.6 / 11th	7.1 / 46th	n.a.

Source: NICMR, from official data of each of the countries concerned.

As far as employment costs are concerned, differences between the markets tend to be arbitraged out, as can be seen from the relatively high mobility of financial professionals between Singapore and Hong Kong. Because of this and the fact that wage levels in some financial services and jobs are already at high levels, the data in Figure 3 (average monthly wages in non-primary sectors) are a rough indication only. In the case of local staff, however, where intermarket liquidity is lower, they give some idea of the relationship between the four markets.

4. The availability of support services

The data given here (Figure 3) are for accounting firms (or accountants) and law firms (or lawyers) because of the support they offer financial services companies.

Because the data for Hong Kong and Singapore are expressed in terms of the number of firms while those for South Korea and Japan are expressed in terms of the number of accountants and lawyers, direct comparisons are not possible. Nevertheless, the data do suggest that the number of accountants in South Korea is not significantly fewer than in Hong Kong, Singapore or Tokyo—even in relation to the size of each market.

A better indicator of the extent to which a market has the infrastructure necessary for a financial hub or center than the total number of people employed in that role is perhaps the percentage of those who are familiar with US and UK law as well as international accounting standards. This is perhaps also something that applies when comparing Tokyo with Hong Kong and Singapore. It would certainly seem that this figure is higher in Hong Kong and Singapore than in either South Korea or Japan, although the author has not been able to obtain data to confirm this.

Also important are (1) the number of professionals in relation to the volume of financial transactions and the number of deals concluded, and (2) the ability to communicate professionally in English. As far as the ability to communicate in written and spoken English is concerned, it is generally agreed that Hong Kong and Singapore are in a stronger position than either South Korea or Japan.

5. Political and social risks

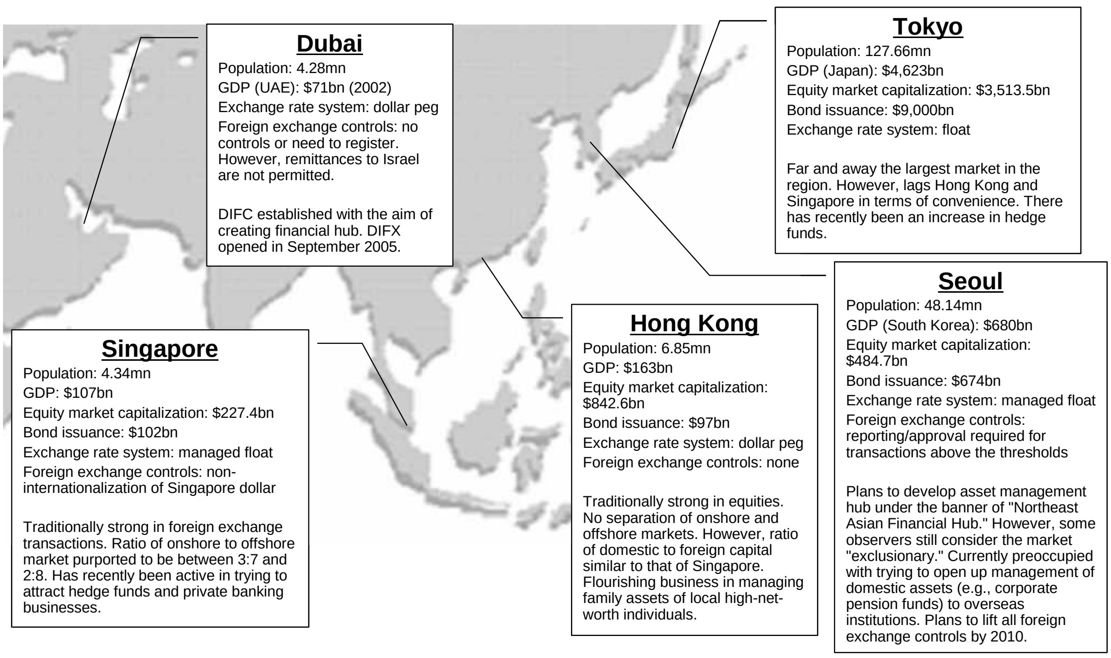
Although it is in the nature of risk that it cannot be predicted, it also needs to be considered whether, assuming that it can be predicted, it can be controlled.

When Hong Kong was returned to China in 1997, there was an exodus of both human and financial capital in an effort to avoid political risk. However, the exodus soon stopped as confidence in the region's economic performance and continuity of policy was restored. Although some still cite mainland policies as a risk factor, particularly when comparing Hong Kong with Singapore, the author's view is that Hong Kong's location should be enough to enable it to absorb any risk with regard to services related to China.

Singapore, on the other hand, owes the high degree of confidence enjoyed by its administrative and legal systems to the transparency with which its laws are enforced and its rules implemented, and this should limit any downside risk. This is very important in attracting and retaining financial institutions, which are notoriously footloose.

As a result, the more discretion that the legal and administrative authorities can still exercise, the more difficult it is to predict the outlook for business. The reaction of market participants (both residents and nonresidents) to the tax authorities' investigation of foreign investment funds and the authorities' handling of profit remittance declarations (see above) may therefore send an important message.

Figure 4 Key Market Data



Source: Bank for International Settlements, World Federation of Exchanges, World Bank, etc. Unless otherwise stated, the population and GDP data are for 2004, while the data on equity market capitalization and bond issuance are for end-March 2005.

IV. Future Prospects

In this final section, I would like to consider the future of regional financial centers in Asia by giving my personal views on two related issues: the prospects for a financial hub in South Korea and the issue of regional dominance.

1. The prospects for a Northeast Asian Financial Hub

All this raises the question whether South Korea is looking to establish the same kind of financial center as Singapore or Hong Kong. The South Korean authorities have announced their intention to lift all restrictions on foreign exchange transactions by 2010. However, South Korea is not a small open economy like Singapore that can shut itself off from overseas markets in order to defend its currency. Rather, it would appear to be following a similar route to that taken by Japan—namely, that of heading towards a freely floating currency. If so, what will count is whether its economy is big enough and robust enough to withstand the kind of shocks that such a system entails.

Even if South Korea succeeds in achieving the objective of full liberalization of foreign exchange transactions by 2010, it is too soon to say whether this market will be an offshore market like Hong Kong, seamlessly linking the domestic market to the outside world, or two separate markets like the onshore and offshore markets in Singapore and Tokyo. In either case, if the present restrictions are all lifted and the discretionary powers of the authorities curbed, foreign financial institutions (and especially asset management companies) can be expected to establish a stronger presence in the country.

The information that has been published so far, however, suggests that, when that happens, the main effect will be to open up competition for South Korean assets, such as those held by pension funds and in the form of foreign exchange reserves, to overseas competitors. Very little else has been revealed about what is planned. It is not clear to what extent the South Korean authorities are prepared to allow their markets to serve as receptacles for foreign money that might be managed by foreign asset management companies and then repatriated. Nor are there rules in place that would allow this to happen.

If the aim is simply to open up South Korean assets to overseas competition, it is perhaps inappropriate to talk about a "financial hub." Nor is it just financial professionals (both Korean and non-Korean), who have consistently viewed the proposal with skepticism, that are questioning its feasibility. Even President Roh Moo-hyun, who pledged to voters that his government would create a financial hub, has recently stated that, if the term "financial hub" is going to cause unnecessary misunderstandings, it might be better to talk about "a strategy for developing South Korea's financial services industry."[8]

Moreover, if "functional centralization" is integral to the concept of a financial hub, the question must be asked whether the policy of moving a part of the stock exchange, pension funds and other public corporations to the regions in compliance with the Ad Hoc Law of National Balanced Development does not, in fact, jeopardize the future of a financial hub by producing functional decentralization.

The South Korean government's focus from the outset on core products such as asset management, structural adjustment loans and shipping finance also makes good commercial sense in that it would create niche markets. Although it is not yet clear exactly how these various markets would function, we can expect to see a clearer picture of how the authorities intend to address the above-mentioned issues in the not too distant future.

2. The issue of regional dominance

As I have already suggested, there is no reason why the existence of markets in Hong Kong and Singapore should prevent the establishment of a Northeast Asian Financial Hub or why there should be room for only one financial center in the region. Indeed, there are good reasons (e.g., the Korean authorities' desire to focus on niche products and services) why such a hub could coexist with other financial centers.

However, prospective users, providers and intermediaries of a financial center or hub need to have a clear incentive to participate if it is to have a raison d'être. A good example of this is Singapore, which has been trying to catch up with the front-runner in the field of securities trading, Hong Kong, by offering such incentives to start-ups and trying to focus on niche areas.

Another example, albeit of a market that may not compete in all financial services, is the three Gulf states of Dubai, Qatar and Bahrain, which are seeking to establish Islamic financial centers.

Dubai, which set up an onshore capital market designated as a financial free zone (the Dubai International Financial Center or DIFC)[9] in 2002, set up the first major

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[8] Dong-a Ilbo, 4 June 2005.

exchange for foreign currency transactions in the region (the Dubai International Finance Exchange or DIFX) in September 2005. Similarly, Qatar announced in January 2005 that it was setting up a financial center[10] and began to accept license applications in May, while Bahrain is also seeking to expand as an international financial center, building on the success of its offshore market. These markets are aiming to attract money not only from the Islamic world but also from further afield, and it will be interesting to see how they develop.

As an increasing number of investors, issuers and intermediaries seek to operate internationally, financial centers, be they new or well established, have to be able to offer them an infrastructure and regulatory framework that is both attractive and reliable. The competition to do this is set to become increasingly fierce.

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9 The DIFC offers the following incentives: 100% foreign ownership; no restrictions on repatriation of profits and dividends; no taxes on companies or individuals for the first 50 years; and no restrictions on employing foreign staff. Its aim is said to be to become an onshore capital market like New York, London and Hong Kong rather than simply an offshore tax haven. Licenses have been issued since September 2004—to 60 companies so far. Regulatory responsibility for the DIFC is separated from the domestic financial market under the control of the UAE Central Bank, and borrowing in the local currency is not permitted.

10 As well as hoping that this develops into a regional center, Qatar is planning to utilize the center's services for financing domestic activities. The center's incentives include zero corporate income tax for the first three years of the center's operation and a rate of 10% from 2008.