THE NEW WORLD ORDER: KOREA'S ECONOMIC OPTIONS

Op Ed by Dr Rory Knight

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The dire aftermath of the pandemic has left the world's leading economies in a parlous state suffering a disastrous combination of high government expenditures and unprecedented levels of both government and private debt. The fallout from unstoppable inflation will tip many major economies into recession. Not only have the lockdowns inflicted major economic damage, the social consequences are now also becoming evident. As a result of productivity reductions, supply chain disruption and the spectre of inflation disruptive labour disputes are resurfacing in many economies. These issues are unlikely to be resolved within a decade - certainly long after the political leaders that inflicted this damage will have retired. While Korea is in a strong position relative to other major economies and likely to bounce back as it did after the Asian Financial Crisis at the end of the last millennium, it still needs to seriously consider its economic options. Growth will be constrained by the pace of global demand, and a new approach building on Korea's culture of innovation is required. The new administration of President Yoon is no doubt well aware of the opportunities and threats that lie ahead, and the administration's support for developing Korea as a fintech centre within a global financial centre will be one key to Korea's economic future.

Breakup of a unipolar world

After the fall of the Soviet Union Francis Fukuyama published his now infamous book The End of History, declaring ironically that the Hegelian-Marxian dream of a homogenous world order had now been achieved. However it was not to be a global world but a unipolar one dominated by US hegemony under the economic control of the US dollar. Clearly this vision is now being seriously undermined in part as a result of the pandemic, and homogeneity is being replaced by at least three separate power blocs (not unlike the Orwellian groups of Oceania, Eurasia and Eastasia). The hostility between China and the US dates back before the pandemic but is now being matched by renewed tension between the US and Russia. This major sea-change in the geopolitical world order is particularly exemplified by the war in the Ukraine. The unipolar world order under US management is rapidly disappearing, and Korea as a mid-sized country will have to carefully navigate the resultant fragmentation. Korea has a long history of managing blocs dating back to the Three Kingdoms; it will need these skills for the foreseeable future.

Lessons from Brexit

Whatever the political issues presented by the new world order, Korea as a newly significant economic player with a mid-sized population needs to carefully evaluate its economic options. Lessons could be drawn from the Brexit experiment when the United Kingdom seceded from the European Union. Although there were potential advantages for a mid-sized country with a global financial centre to be gained from new and nimble low tax rates and reduced regulation, these gains have yet to be achieved in part because the pandemic and recent geopolitical factors have hampered progress. The lesson for Korea is that going it alone is not without risk and requires a very clear focus in order to maintain competitiveness.

The miracle on the Han river

As Korea approaches the seventieth anniversary of its founding it is timely to consider what new horizons it faces. In 1953 its per capita GDP was $67 - lower than the lowest ranked African nation and a mere one-fifth that of the highest ranked African nation South Africa. Figure 1 shows Korea's current standing in the 2021 global GDP league table: an impressive tenth place with an overall GDP of $1.8 trillion. It represents an extraordinary achievement and probably the greatest economic miracle in living memory. Figure 2 reports per capita GDP for the top 10 economies. Within this top ten group Korea falls eighth with a GDP per capita of $35,000, followed by China and India in ninth and tenth positions respectively. However, the global picture is very different since many small countries tend to generate larger per capita GDPs. Korea ranks 29th by this measure while Singapore by contrast is in eighth position, enjoying a per capita GDP of around $66,000. It is instructive to consider that if Korea were able over night to achieve a per capita income of $50,000 it would enjoy an overall GDP of around $2.5 trillion - which would take it to eighth position just behind France. However in terms of the per capita metric it would soar to fourth place behind Germany within the top 10 club. Even if the economic and political challenges outlined earlier did not exist Korea could not expect to grow to a $50,000 per capita GDP in real terms any time soon. Nevertheless, this surely must be the goal.

Limits to industry-based growth

A recent UNIDO survey ranked Korea third behind Germany and China in manufacturing competitiveness. Korea's strength in technology and manufacturing is the main reason for its impressive economic success. This competitive edge must of course be maintained, but the limits to growth from this source alone are fast approaching and manufacturing competitiveness itself cannot be relied on to make the leap from $35,000 to $50,000 per capita GDP; an additional competitive advantage is required. The sector where Korea lags in world rankings is financial services. The recent Global Financial Centres Index ranks Korea twelfth. Although this represents a rise of four places from 2020, there is still room for improvement. Finance and insurance together make up a mere 5% of GDP but could conceivably grow to 25%.

A new goal: Seoul as a GFC

The Korean economy has the capacity to develop a global financial centre (GFC). Indeed this represents an imperative next step in Korea's development. Hong Kong's shrinking role as a GFC creates an opportunity for Seoul to seize the mantle as the leading financial centre in Asia. While there is strong competition from other contenders such as Singapore, Korea has not only a much deeper economic hinterland to support a GFC but a more realistic chance of doing so quickly. Korea's palli palli (hurry hurry) culture now needs to be applied to financial services.

There is certainly a demand for such a centre in Asia. Does Seoul have the wherewithal to achieve this goal? Certainly the new administration is espousing policies to innovate in fintech, and many are calling for a specific policy to create a GFC. Local rivalry to be the financial centre among Yeouido, Incheon and Busan will first have to be resolved (the US and the UK have New York and London alone respectively, not multiple sites). Seoul is a most agreeable city for expatriates and a network of excellent international schools now exists but there is much work to do in adapting existing regulations and taxes to increase the attractiveness of Seoul to foreign financial services firms.

Fintech the key

Korea needs its own distinctive USP in financial services. Blockchain technology and digital asset policy point the way forward here. Korea's prowess in technology as reflected in its flourishing digital asset trading is Korea's greatest asset in becoming a GFC. Blockchain technology and a set of flourishing digital asset exchanges could together apply the best of Korean technology and innovation to a sector that lags manufacturing in the world league tables and for which there is an urgent and burgeoning demand. Cryptocurrencies have had a bad press of late in Korea. The recent Terra Luna scandal understandably attracted regulatory attention. The Financial Intelligence Unit (FIU) naturally sought to have stronger oversight to protect the investing public. One very welcome response from the industry this week was the creation of the Digital Asset eXchange Alliance (DAXA), comprising the five registered digital assets exchanges: Bithumb, Upbit, Coinone, Korbit and Gopax. The alliance represents an excellent development, aiming to coordinate the monitoring of unusual transactions and this provides an excellent self-regulating safeguard for investors. There is a risk of regulators stifling innovation in this area to the detriment of the development of fintech and Korea's quest to create a GFC. A recent Oxford Metrica whitepaper argued for the smart regulation of blockchain and digital assets. The paper reported a survey of major Korean financial institutions which found that most were already at work on these projects beyond the conceptual phase. However it identified regulatory uncertainty as a major impediment. Cryptocurrencies provide the liquidity which is an indispensable part of the ecosystem required for fintech platforms, and it is crucial that the policy framework adopted in Korea acknowledges the importance of digital exchanges to the flourishing of fintech. In short, digital exchanges are not optional. In addition, the policy needs to develop a precise taxonomy for the different types of digital assets and apply the appropriate safeguards to each.

A smart policy framework

Smart regulation that unlocks value from financial innovation while at the same time is risk-based is eminently achievable. An agile and risk-sensitive regulatory framework for digital assets and a clear set of 'rules of the road' that enable innovation to flourish will lay a strong foundation for a vibrant digital asset ecosystem to take root. The following recommendations for developing the digital asset ecosystem in Korea which will also help provide clarity to the legal character of digital assets in Korea. (See *A policy framework for blockchain & digital assets in Korea*. Oxford Metrica, Ripple & GBCKorea)

1. *A digital asset taxonomy*

The definition of "virtual asset" under the Specified Financial Information Act is rather broad as it covers "a digital token with economic value that is digitally tradable and transferable". In line with global practices, there should be a clear distinction between payment tokens, utility tokens, and security tokens.

Payments or Exchange tokens: to describe non-fiat native digital assets that are used as means of exchange and have no rights that may be enforced against any issuer;

Utility tokens: to describe those digital assets that create access rights for availing service or a network, usually offered through a blockchain platform; and

Security tokens: to describe tokens that create rights mirroring those associated with traditional securities like shares, debentures, security- based derivatives, and collective investment schemes.

Such a taxonomy will make it very clear where digital assets and related activities lie on the risk spectrum which mitigates the potential for developing and investing in technology that is unregulated.

2. A risk-sensitive approach

The definition of "virtual asset service provider" under the Specified Financial Information Act is also similarly broad, encompassing "virtual asset trading service providers, virtual asset safekeeping and administration service providers and virtual asset digital wallet service providers engaged in the purchase and sale, exchange and transfer, safekeeping and administration, or intermediation and brokerage of virtual assets and virtual asset transactions". In practical terms, this means that any solution incorporating digital assets could be considered a virtual asset service provider and therefore be liable to register and report to KoFIU even if the solution poses minimal risk. The lack of a risk-sensitive regulatory framework may act as a disincentive to innovation in the sector. In addition to the recommended taxonomy for digital assets, policymakers and regulators in Korea should also consider an appropriate regulatory framework for digital assets in order to provide certainty and encourage innovation in the sector. The smart regulatory framework should have the following characteristics; technology agnosticism; principles-based regulation not-rules based; risk-based.

- The regulatory framework should be technology-agnostic and should not explicitly or otherwise endorse any particular technology. This means that financial services using digital assets as a solution should not be treated differently from financial services embedding legacy architectures and there should be parity in the treatment of all technology;

- Given the dynamic nature of digital assets, prescriptive regulation risks obsolescence. Prescriptive regulation could also have the unintended consequence of hindering innovation. Therefore, we recommend considering a principles-based regulatory framework which will guide market participants to regulatory and policy goals without imposing an overly prescriptive and onerous process in doing so; and

- The regulatory framework should use a risk-based approach to identify digital asset services that pose sufficient risk to warrant regulation and where such risks are crucial to address.

Such an approach will ensure a simple, secure and accessible digital assets ecosystem that will encourage investment into digital assets in Korea, while mitigating any potential risks. The recommended regulatory framework should be forward-looking and flexible while providing regulatory certainty and consumer safeguards.

3. Digital asset sandboxes

An innovation sandbox is a formal regulatory programme for market participants to test new and innovative products, services and business models with end-users in a controlled environment while being subject to regulatory oversight. However, the Korean regulators currently do not offer any opportunity for digital assets in a sandbox environment. In order to incentivise innovation and inform the development of a clear and consistent regulatory framework for digital assets, innovation sandboxes should be encouraged, at the very least for specific use cases such as cross-border payments and capital markets.

4. Public-private collaboration

Finally, any policy framework intended to regulate digital assets should promote an active dialogue between regulators and market participants.

This smart policy framework would provide legal clarity to industry, markets, and consumers on the nature of blockchain and digital assets in Korea. We believe that each of the above policy proposals – whether implemented separately or together – can succeed in achieving the policy goal of fostering innovation while ensuring sufficient safeguards.

One goal, two routes

Whereas London aims to leverage its current position as a global financial centre (GFC) by developing it's abilities in fintech, Korea conversely could use its existing technological edge in fintech to develop a GFC. As a mid-sized, post-Brexit economy striving to successfully operate independently, the UK can look to a key asset in the City of London, its global financial centre. The challenge for London will be to remain competitive while nurturing a thriving fintech sector.

Korea by contrast has yet to develop its own global financial centre. However it already has a technological advantage in Fintech and hosts the highest trading in digital assets by volume per capita in the world. A smart policy framework would allow Korea to use its leading position in fintech to develop a GFC. But this would of course demand the full commitment of government to implement the necessary regulatory changes.

We already have K-Pop flourishing - why not let us have K-Finance. Game on!

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FIGURE 1: Top 10 GDP countries ranked by nominal GDP 2021 ($ Millions)
SOURCE: IMF & Oxford Metrica

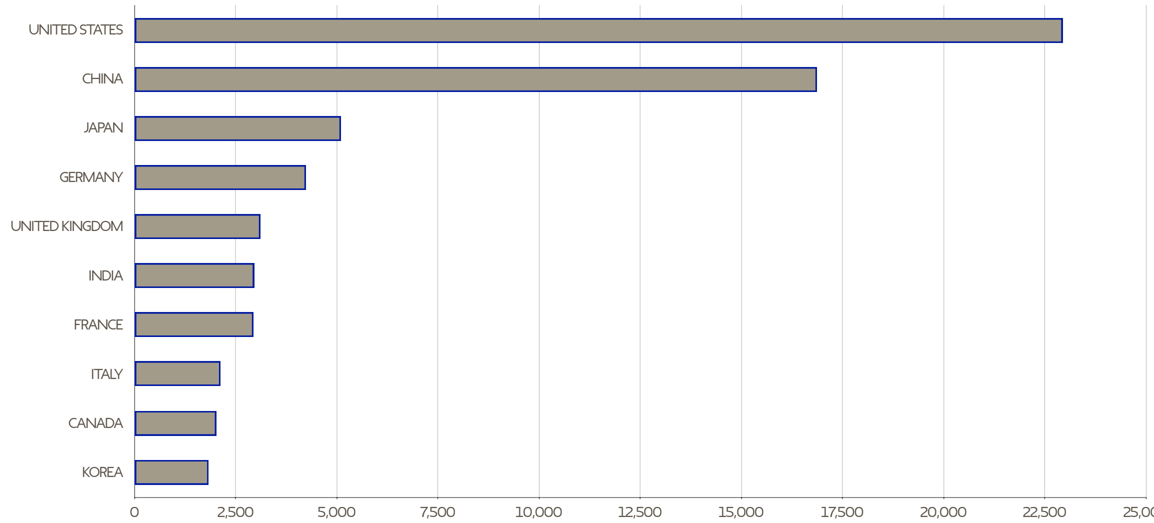

FIGURE 2: Top 10 GDP countries ranked by nominal GDP per capita 2021 ($)
SOURCE: IMF & Oxford Metrica