8 FDI as a Factor of Economic Restructuring: The Case of South Korea
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Introduction

South Korea (hereafter referred to as Korea) has long been seen as an unqualified success story, with per capita gross domestic product (GDP) rising at an average annual rate of nearly 7 per cent since the mid-1960s. Yet, the formerly successful strategy was tested to its limits, rather unexpectedly, with the outbreak of the Asian financial crisis in 1997. The resulting economic meltdown triggered a dramatic change in economic policies and, more generally, in the way Korea relates to the global economy.

A number of policies pinpointed earlier as the key to the Korean ‘miracle’ came under heavy attack in the wake of the crisis. In particular, Government interventionism was deemed to have been excessive and to be one of the major causes of the crisis because of the so-called moral hazard phenomena. As a result, Government interventions are likely to be trimmed down, and more leeway is expected to be given to market mechanisms. As an integral part of the country’s industrial policy, measures regarding direct investment have been deeply reformed and the economy is now completely open to foreign investors. At the same time, Korean investors are likely to reduce their involvement abroad.

The objectives of this chapter are two-fold. Firstly, it examines how Korea took advantage of globalization in the past to sustain its growth dynamics. Secondly, it assesses the change in the way the country participates in, and responds to, globalization in the wake of the crisis. To that purpose, the main emphasis is placed on the role of both inward and outward foreign direct investment (FDI). In other words, the chapter aims to explore how FDI has influenced the restructuring of the Korean economy in the past and how it can be expected to continue to do so in the future.
In a first section, the chapter briefly sketches the major features of the Korean economic miracle, stressing the contribution of Government interventions, and highlighting both the strengths and weaknesses of past public policies. It also highlights the 1997 Asian financial crisis and its implications for the Korean economy. The second and third sections examine the role played respectively by inward and outward FDI in the development of Korea, as well as the changes triggered by the recent financial crisis and, more generally, by the changing environment. The analysis is based on a thorough examination of policy provisions as well as of FDI trends.

The Rise and Fall of the Korean Economy

Economic Performance and the Developmental State

Changes in Korea’s industrial structure  Korea was one of the poorest countries in the world in the late-1950s and was considered at the time as a real ‘basket case’ without any positive growth prospects. Yet over the period 1960-96, its real GDP grew by 8.4 per cent on average per annum, as it transformed from a poor agricultural economy into a newly industrializing economy (NIE). In the mid-1990s, Korea’s real per capita income was nearly 9 times what it had been in the early-1960s, equal to some Organization for Economic Co-operation and Development (OECD) countries, enabling it to access the industrialized countries’ club in 1996.

This remarkable and steady growth was accompanied by drastic structural changes. The rapid contraction of the primary sector was matched in particular by a dramatic expansion of the manufacturing industry, which grew by more than 15 per cent in the 1960s and 1970s. The share of agriculture dropped from 40 per cent in 1960 to 6.3 per cent in 1996, while the share of manufacturing rose from 12 to 31 per cent. Among the manufacturing sectors, the durable goods industries showed the highest growth rate during the 1973-80 period. Eventually, labor-intensive industries, such as textiles, were gradually replaced by capital-intensive and technology-intensive industries such as electronics and automobile.

Similarly, changes in commodity trade patterns were significant. First, manufactured exports rose from less than $0.1 billion in 1961 to $100 billion in 1995, and to $172 billion in 2000. In 1961, all but one (plywood) of the largest ten exports was a primary commodity. By 1975, apparel and clothing were the largest single commodity group of exports, but it was soon
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surpassed by electrical and electronics goods by the mid-1980s (see Figure 1).

The development of the Korean economy can be said to be unusual for two reasons. First, because of its stellar export performances, which makes it an exceptionally open economy (at least from the trade perspective). A second feature is the relative importance of heavy and chemical industries in the country’s evolution.

Figure 1  Korea’s Structure of Exports, 1967-1999.

Changes in Korea’s economic policies  The impressive economic performances highlighted above can be accounted for to a large extent by the tight control of the Government over the industrialization path of the country. The successive changes in Korea’s industrial policies can be briefly summarized as follows:

- The first period (1961-1971) can be characterized as a period of ‘easy import-substitution’ of non-durable consumer goods and intermediate materials, progressively combined with a resolute outward looking strategy. The major means of implementing the government’s objectives at that time were the so-called policy loans. Export-oriented industrialization was chosen as a strategy to consolidate political power through economic development, and maximization of exports was clearly the top priority over all other policy objectives. In order to encourage exports, the Government relied heavily on financial policy tools rather than on fiscal policy or the use of public enterprises. The most important of these measures were preferential credits for exporters, tax subsidies, the establishment of free
trade zones and tariff exemptions for raw material imports earmarked for exports. By contrast to what was observed in other countries, the mix of import-substitution and export-promotion proved to be successful in Korea, certainly thanks to the highly centralized structure of the Government (Park, 1988).

- During the second period (1972-1981), export growth together with industrial deepening were maintained as priorities. Korean authorities wanted at the time to construct a self-supportive industrial structure based on heavy and chemical industries. They thus decided to launch the Heavy and Chemical Industry (HCI) drive, while reducing to some extent the wide-ranging incentives hitherto accorded to exports. This strategy imposed substantial costs on the economy. In particular, because the Korean system of industrial targeting leaned more toward foreign borrowing than FDI, the strategy led to a rapid increase in external debt (Cho, 1994). The difficulties encountered with the implementation of the HCI led to a new shift in the country’s industrial policy and the Government started to opt for an indirect rather than a direct form of control of the economy.

- The third period (1982-97) can be said to be a period of economic liberalization and globalization (Chung and Wang, 2000). During this period, the Government started to reduce its role in industrial planning and targeting in order to promote competition in domestic markets. A first round of privatization went hand in hand with various market opening measures (with respect to imports as well as FDI). Overall, there was certainly more progress in external liberalization than in internal liberalization and the Government remained heavy-handed. In particular, despite the official abandonment of targeted industrial policies, the Government continued to act directly in the financial markets through the Korea Development Bank, which provided long-term investment funds to companies (Haggard and Mo, 2000).

The state and the chaebols

A well-known characteristic of Korea’s development strategy is the Government’s tight control over all aspects of economic activity, and its decisive role in the fast industrialization process that started in the 1960s. During the initial period of Korea’s economic development, the Government assumed an active and direct role in particular through the establishment of the Economic Planning Board (in 1961), which played a key role in economic policy-making. Heavy state interventionism was particularly manifest in the financial sector. As a result of the financial reform (law for dealing with illicit wealth accumulation) in
1961, all commercial banks became in essence the property of the state and were placed under the direct control of the Ministry of Finance. This law enabled the Government to exert control over the allocation of credit, and to tightly monitor its sectoral development - rewarding companies, which fell in with its development strategy and punishing those, which did not. Through this original form of planning and of credit allocation, the Government set the objectives, which were realized by private firms (Lanzarotti, 1992). As explained above, the Government provided subsidies, financial assistance, and tax breaks to key industries to promote exports and industrial upgrading.

A major consequence of the interventionist stance of the Korean Government is the emergence of large industrial conglomerates, the chaebols. This is a major difference with the other NIEs, in particular Taiwan, and a major similarity with Japanese keiretsu (see Chapter 2). In Korea, economic policy has had a clear tendency to emphasize scale economies. For that matter, financial support was given to industries with a certain minimum scale of efficient production, especially during the HCI drive, thus fostering the expansion of large diversified conglomerates. By the same token, as a means of promoting exports, the Government established so-called General Trading Companies (GTCs), which were modeled after a Japanese institution. The GTCs, which were usually selected among the chaebols, were given special benefits and were in charge of handling export business for other exporters as well as for themselves. The creation of the chaebols system thus depended crucially on Government’s intervention in the financial system.

One major consequence of the developmental state is the existence of a close business-government relationship so characteristic of Korean chaebol capitalism.

The 1997 Asian Financial Crisis and its Implications for the Korean Economy

Until 1997, Korea seemed an unqualified success story with very short periods of economic slowdown. Yet some of the seeds of the current crisis had been sown long before, in the form of institutional deficiencies and policy mistakes. Such is the case for the practices in the banking sector as well as the collusive relationships between the Government, and the banking and the business communities. These cozy relationships together with the tradition of high indebtedness in Korean conglomerates fuelled the accumulation of imbalances and encouraged investment in excess capacities and in non-profitable activities. This nature of the business-
Government relations contributed to problems of moral hazard during the investment boom in the mid-1990s (Haggard and Mo, 2000).

The main trigger of the difficulties came from the sharp slowdown in export growth in 1996. Merchandise export growth dropped from more than 30 per cent in 1995 to a mere 4 per cent in 1996 (ADB, 1997), and the current account deficit widened from 2 per cent of GDP to 5 per cent. This development was the result of a number of factors, both internal and external. The won appreciation was one, the slump in world demand for electronic products accompanied by falling world prices was another. Yet, prices of electronic products were not the only prices to drop significantly. Such was also the case for ships, automobiles and garments, thus affecting 50 per cent of Korea’s total exports. Corporate failures (Hanbo Steel and Kia Group in particular) soon followed, raising doubts about the health of the Korean economy and the chaebols’ ability to repay their debts. The excessively high leverage of the corporate sector can be pinned down as a major weakness because rapid growth was essential to the solvency of this sector, equivalent to a corporate Ponzi game (Adelman and Nak, 1998). A combination of the setback in economic growth and the financial crisis in the rest of Asia gave a final blow to the Korean economy, unveiling the numerous weaknesses and imbalances that had accumulated over time. A major financial and currency crisis broke out in November 1997, with the won tumbling 50 per cent during a two-week span. The crisis came to a head in early-1998 when Korea was on the brink of default.

By contrast to a number of previous crises, the Asian financial crisis, with the Korean crisis as a case in point, was the result of over-investment, rather than excessive consumption. Investments in over-capacities were mainly due to the chaebols and were clearly the results of complacency on the part of public authorities. The crisis highlighted the need for a complete overhaul of Korea’s development strategy, and for a redefinition of the role of the chaebols. Other factors also call for a resolute shift in economic policy. Korea has committed to push liberalization and market opening further under the pressure of the World Trade Organization (WTO) and the OECD. As is the case for Japan, global economic conditions are likely to continue to restructure and push for a ‘normalization’ of the Korean economy, and of its regulatory environment towards more convergence with the industrial policies of other advanced industrial nations (Blomström et al, 2000).

Finally it can also be anticipated that Korea will have to face rising competition from other economies in the region, in particular China, and to adapt to another challenge, namely the rise of the knowledge-based
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Inward FDI

Inward FDI is one of the domains in which the Korean Government exerted a large influence. By contrast to other high performing Asian economies, Korea did not opt for a systematic promotion of inward FDI but chose a more selective strategy. Yet FDI was clearly used as an instrument of industrial policy. For instance, by targeting specific industries, the Government definitely helped shape the Korean industrial structure.

Pre-crisis FDI

Policies The constant Government’s desire to monitor closely any changes in the economy is also reflected in policy measures regarding FDI. A passive liberal policy with respect to FDI may only attract multinational enterprises (MNEs) into areas of static comparative advantages, while selective and functional interventions may help guide FDI into dynamic and more complex activities with higher potential for technological spillovers (Lall, 1996). Moreover, as suggested by a number of empirical studies, a minimum threshold of technological capabilities is necessary for FDI to generate benefits to the host country (Borensztein et al, 1998). All this points to the need for public intervention. The Korean approach to FDI was apparently based on such premises.

In contrast to other emerging economies, Korea has followed an extremely selective policy towards foreign investors, with restrictions being imposed in accordance with development priorities defined by domestic economic authorities. Broadly speaking, FDI was kept out unless deemed necessary for technology access or exports, while joint ventures and licensing were encouraged. Technology transfer requirements to domestic firms were also used by Korea in the 1960s so as to encourage technology transfer.

The Government took a rather favorable stance toward export-oriented foreign companies with the creation of Free Trade Zones (FTZs) based on the Free Export Zone Establishment Act of January 1970. The first zone was established in Masan in 1971, soon followed by the Iksan FTZ in 1975. These zones are specifically designated industrial areas in which foreign invested firms can manufacture, assemble or process export products using tax-free imported raw materials or semi-finished goods.
In addition to the theoretical factors presented earlier, the rationale for the rather restrictive stance towards FDI can be explained as follows. First, the Government did not encourage FDI for fear that the economy would be dominated by foreign interests preventing the development of domestic firms' competitiveness. This is in relation to Korea’s historical background in particular, to Japanese occupation and domination of Korea (Sakong, 1993). The choice has always been to favor externalized growth (i.e. through sub-contracting) rather than internalized expansion through foreign ownership (Lall, 1997). Secondly, foreign borrowing was favored over FDI because it made government’s control more effective. Finally, as priority was given at first to low-tech labor-intensive export production, FDI was not perceived as necessary.

As a result, in particular, of the difficulties raised by the HCI scheme and the rise in the nation’s debt service capability, the Government realized that FDI could play more of a role in the development strategy of the country. A first move took place in 1981 with the opening up of a large number of business categories to foreign investment. These comprised 427 business categories constituting about 50 per cent of all products in Korea’s standard industrial classification system. Yet the basic direction of FDI policy was not really changed until 1984 with the revision of the Foreign Capital Inducement Act, which reflected a less stringent Government control on FDI. In particular, there was a switch to a negative list system, and to an automatic approval system, while restrictions on the repatriation of capital and the foreign ownership ratio were abolished (Seong, 1997). The liberalization of FDI rules was seen as a possible way of helping the economy in its attempt to upgrade technologically, and to restructure the industry toward higher value-added and more sophisticated production. While licensing had proved to be an efficient channel for transferring mature technologies, new technologies were found to be better transferred through joint ventures and wholly-owned subsidiaries (Chaponnière, 1997).

In 1989, the United States of America (US) government threatened to designate Korea as a Priority Foreign Country because of its discriminatory practices. As a result, market liberalization and opening became an important objective for the Korean Government in the early-1990s. Moreover, the perspective of Korea’s accession to the OECD gave a new momentum to various market opening measures particularly, to the further liberalization of FDI policy. Local content and export level requirements were abolished, together with mandatory technology transfers. Yet the government remained cautious and opted for a gradual liberalization.
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Trends  During the first period which extended from the early-1960s to the mid-1980s, FDI inflows were minimal. The real take-off occurred in the second half of the 1980s (see Table 1 and Figure 2). FDI inflows rose from $682 million over the period 1971-80 to $5080 million over the period 1981-90, a change comparable to what was observed in Colombia (OECD, 1995). After peaking in 1988, there was a brief setback in the early 1990s, followed by a new surge in 1995.

Table 1  Inward FDI Trends ($ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Notification basis</th>
<th>Arrival basis</th>
<th>Balance of Payments basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962-81*</td>
<td>93.305</td>
<td>73.893</td>
<td>67.83</td>
</tr>
<tr>
<td>1982-86*</td>
<td>353.546</td>
<td>231.560</td>
<td>188.2</td>
</tr>
<tr>
<td>1987-88*</td>
<td>1173.542</td>
<td>759.826</td>
<td>815.2</td>
</tr>
<tr>
<td>1989</td>
<td>1090.279</td>
<td>812.315</td>
<td>1117.8</td>
</tr>
<tr>
<td>1990</td>
<td>802.635</td>
<td>895.397</td>
<td>788.5</td>
</tr>
<tr>
<td>1991</td>
<td>1395.996</td>
<td>1177.245</td>
<td>1179.8</td>
</tr>
<tr>
<td>1992</td>
<td>894.476</td>
<td>803.311</td>
<td>728.3</td>
</tr>
<tr>
<td>1993</td>
<td>1044.274</td>
<td>728.148</td>
<td>588.1</td>
</tr>
<tr>
<td>1994</td>
<td>1316.505</td>
<td>991.565</td>
<td>809.0</td>
</tr>
<tr>
<td>1995</td>
<td>1947.229</td>
<td>1361.925</td>
<td>1775.8</td>
</tr>
<tr>
<td>1996</td>
<td>3202.580</td>
<td>2309.978</td>
<td>2325.4</td>
</tr>
<tr>
<td>1997</td>
<td>6970.915</td>
<td>3088.356</td>
<td>2844.2</td>
</tr>
<tr>
<td>1998</td>
<td>8852.527</td>
<td>5221.249</td>
<td>5412.3</td>
</tr>
<tr>
<td>1999</td>
<td>15541.547</td>
<td>10597.857</td>
<td>9333.4</td>
</tr>
<tr>
<td>2000</td>
<td>15689.857</td>
<td>10185.169</td>
<td>9283.1</td>
</tr>
<tr>
<td>2001</td>
<td>11870.000</td>
<td>Not available</td>
<td>3198.3</td>
</tr>
</tbody>
</table>

Note:  * - Annual averages.

The general pattern in FDI inflows can be clearly related to changes in policy stance vis-à-vis FDI (see Nicolas, 2001 for a more detailed account of FDI inflows to Korea). As a result of the restrictive stance described above, FDI stock as a percentage of GDP (see Table 2) was lower by about half in Korea than in Argentina, Brazil and Mexico in the late-1970s (approximately 3 per cent). Similarly, the penetration ratio by foreign firms was in the 1960s and the 1970s much smaller than in Latin American or other Asian countries (Lanzarotti, 1992). Reflecting the limited openness of the domestic market, foreign presence was particularly limited in Korea in
industries (beverages and tobacco and chemicals such as soap and detergents) where international brand name consumer products are important (Hill and Johns, 1985).

The slowdown in the late-1980s to early-1990s can be accounted for by the deterioration in Korea’s locational advantages particularly, increased labor disputes and a sharp rise in real estate prices. These developments made Korea less attractive than some Southeast Asian economies. The renewed surge since the mid-1990s was certainly largely due to the government’s policy of foreign investment promotion. For instance, FDI in high-tech industries such as electronics and machinery was subsidized through tax exemptions and low rental rates in industrial parks (Kim and Wang, 1996).

Government intervention had also a clear impact on the sectoral orientation of FDI as well as on the form of participation. The prevalence of the manufacturing sector was the result of Korea’s locational advantages in the form of an abundant labor force and the lack of natural resources, as well as government’s policy favoring FDI flows into these activities (Sakong, 1993). At first, FDI flows were welcomed into light manufacturing export industries whereas they were discouraged from import-substituting industries such as pharmaceuticals and heavy industry (Koo, 1981). During the period 1962-1980, FDI into textile and clothing industries seeking to exploit low-wage labor was quite significant, contributing about 12 per cent of total manufacturing FDI. Yet FDI was even more heavily concentrated in sectors in need of technological inputs,
such as the chemical industry (26 per cent of total manufacturing FDI) or the electrical and electronics industry (18 per cent). This pattern was clearly the result of government policies rather than of locational advantages in the form of cheap labor (Lanzarotti, 1992).

Table 2  The Ratio of Inward FDI Stocks to GDP (%)

<table>
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</thead>
<tbody>
<tr>
<td>China</td>
<td>3.1</td>
<td>3.4</td>
<td>7.0</td>
<td>19.6</td>
<td>30.9</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>487.0</td>
<td>413.6</td>
<td>217.5</td>
<td>135.4</td>
<td>255.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>14.2</td>
<td>28.6</td>
<td>34.0</td>
<td>25.0</td>
<td>46.2</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>1.8</td>
<td>2.3</td>
<td>2.0</td>
<td>2.1</td>
<td>7.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>21.1</td>
<td>23.7</td>
<td>24.1</td>
<td>32.9</td>
<td>65.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.9</td>
<td>8.5</td>
<td>7.4</td>
<td>8.2</td>
<td>14.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>52.9</td>
<td>73.6</td>
<td>76.3</td>
<td>70.0</td>
<td>97.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>5.8</td>
<td>4.7</td>
<td>6.1</td>
<td>6.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>3.0</td>
<td>5.1</td>
<td>9.6</td>
<td>10.4</td>
<td>17.5</td>
</tr>
</tbody>
</table>


The impact of public policies could also be felt in the clear difference in the orientation and form of FDI to be found in FTZs, and in the rest of the country. In FTZs, MNEs tended to be concentrated in low-wage production and to be 100 per cent foreign-owned, but such was not the case in the rest of the economy where labor intensity and the level of foreign equity participation were much lower. This is in sharp contrast with the traditional view according to which all MNEs in Korea sought exclusively to take advantage of cheap local labor.

While manufacturing was the largest recipient in the early period (64 per cent during 1962-86), the service sector eventually gained importance, accounting for 60 per cent of total FDI in 1995 (see Table 3). FDI in the service sector started exceeding FDI in manufacturing from 1994 (Hong, 1998). This change reflected the relaxation of restrictions to foreign investors in this sector as well as the rise in the relative importance of these activities in the Korean economy.

Within the manufacturing sector, the chemical industry was still attracting a large share of inflows in the late-1980s, together with the electrical and electronics sector, and the transport equipment industry. The large role played by the chemical industry helped turn Korea into a net exporter of chemical products, primarily to the rest of
Asia. By contrast, textiles and clothing industries gradually lost importance (reaching 3 per cent of total manufacturing FDI in the period 1994-97) and were replaced by the transport equipment and the food industries. Textiles and clothing fell prey to the loss of competitiveness of labor-intensive and low-tech products as a result of rising wages. The shift in sectoral

Table 3  Industrial Composition of Inward FDI (%)  

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture/Fishery/Forestry</td>
<td>0.7</td>
<td>0.3</td>
<td>0.3</td>
<td>0.0</td>
<td>0.8</td>
</tr>
<tr>
<td>Mining</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>70.7</td>
<td>71.3</td>
<td>61.8</td>
<td>58.9</td>
<td>56.8</td>
</tr>
<tr>
<td>Food</td>
<td>2.0</td>
<td>5.1</td>
<td>4.5</td>
<td>3.1</td>
<td>4.8</td>
</tr>
<tr>
<td>Textile and Clothing</td>
<td>8.2</td>
<td>1.0</td>
<td>1.4</td>
<td>1.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Paper and Lumber</td>
<td>0.3</td>
<td>1.9</td>
<td>0.7</td>
<td>1.0</td>
<td>3.4</td>
</tr>
<tr>
<td>Chemical Engineering</td>
<td>18.6</td>
<td>13.7</td>
<td>11.2</td>
<td>17.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>3.6</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Medicine</td>
<td>0.8</td>
<td>5.7</td>
<td>3.7</td>
<td>3.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Petroleum</td>
<td>6.1</td>
<td>0.7</td>
<td>1.3</td>
<td>9.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Ceramics</td>
<td>1.8</td>
<td>0.4</td>
<td>1.1</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Metal</td>
<td>5.2</td>
<td>2.9</td>
<td>1.1</td>
<td>1.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Machinery</td>
<td>5.4</td>
<td>2.7</td>
<td>7.2</td>
<td>6.7</td>
<td>9.0</td>
</tr>
<tr>
<td>Electronics and Electrical Equipment</td>
<td>13.0</td>
<td>21.0</td>
<td>16.6</td>
<td>7.2</td>
<td>16.5</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>4.3</td>
<td>15.1</td>
<td>11.8</td>
<td>4.4</td>
<td>6.7</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>1.6</td>
<td>0.9</td>
<td>1.2</td>
<td>1.0</td>
<td>1.7</td>
</tr>
<tr>
<td>Service</td>
<td>28.3</td>
<td>28.3</td>
<td>37.8</td>
<td>41.1</td>
<td>42.3</td>
</tr>
<tr>
<td>Electricity and Gas</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.5</td>
<td>1.9</td>
</tr>
<tr>
<td>Construction</td>
<td>0.1</td>
<td>4.8</td>
<td>0.2</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Wholesales and Retails</td>
<td>0.0</td>
<td>1.8</td>
<td>0.1</td>
<td>2.0</td>
<td>6.6</td>
</tr>
<tr>
<td>Trade Business</td>
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<td>0.0</td>
<td>1.5</td>
<td>7.8</td>
<td>3.1</td>
</tr>
<tr>
<td>Restaurant</td>
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<td>0.0</td>
<td>0.1</td>
<td>1.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Lodging</td>
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<td>9.2</td>
<td>23.9</td>
<td>7.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Transport and Warehousing</td>
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<td>0.8</td>
<td>0.2</td>
<td>0.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Finance</td>
<td>7.7</td>
<td>9.5</td>
<td>8.5</td>
<td>14.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Insurance</td>
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<td>0.1</td>
<td>2.1</td>
<td>3.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Real Estate</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Other Service</td>
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<td>2.0</td>
<td>1.2</td>
<td>4.6</td>
<td>11.3</td>
</tr>
<tr>
<td>Total</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

composition of inward FDI away from labor-intensive to more capital-intensive sectors also possibly reflects the attainment by Korean firms of some ownership advantages.

The trends observed in the period 1984-93 were reinforced further in the latest period. The rise of FDI in the food industry probably illustrates the rise in the role played by domestic demand. This form of market-seeking FDI occurred quite late because of previously restrictive policies. The composition of FDI in the service sector has also changed accordingly with investment into wholesale and retail trade as well as in financing and insurance gaining ground relative to hotel business (Kim and Hwang, 1998).

Traditionally, the US and Japan have been the main investors in Korea (see Table 4). European countries emerged only recently as active participants in the Korean market, overtaking Japan in the 1991-96 period. This recent move suggests that European producers may be seeking to exploit the Korean as well as the Asian market (ESCAP, 1998).

Table 4 Shares of FDI from Selected Source Countries, 1962-2000

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Japan</td>
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<td>36.4</td>
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<tr>
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</tr>
<tr>
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<td>10.3</td>
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<tr>
<td>France</td>
<td>1.1</td>
<td>3.2</td>
<td>9.2</td>
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</tr>
<tr>
<td>Germany</td>
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<td>10.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.0</td>
<td>1.5</td>
<td>11.9</td>
<td>0.5</td>
</tr>
</tbody>
</table>


Assessment

A first point to stress is that foreigners’ interest in Korea as a destination for FDI was manifested in the 1970s, after a decade of strong development. Consequently, they certainly cannot be held responsible for Korea’s economic success (Lanzarotti, 1992).
In Latin American countries such as Brazil and Mexico, FDI contributed significantly to the development of their manufacturing sectors, serving large domestic markets and expanding consumer durable and intermediate goods industries (Kim and Wang, 1996). By contrast, FDI played a negligible role in the early stages of Korea’s economic development and its industrialization was realized on the basis of national enterprises (Amsden, 1989). FDI inflows remained modest first because Korea is not a natural resource-rich country, and secondly because of restrictive public policies.

Yet, as emphasized by Lanzarotti (1992), the modest volume of FDI in Korea does not mean that FDI played no role in changing the country’s productive system. To the contrary, MNEs were an important input in Korea’s industrialization and substantially contributed to the success of its export-led strategy as well as to the upgrading of local technological capacities. First, FDI contributed in shaping the Korean industrial structure. The heavy machinery, petrochemical and petrol refining industries would never have gotten off the ground in Korea in the absence of FDI. Similarly, multinational pharmaceutical firms helped the domestic pharmaceutical industry develop new drugs by boosting local research capabilities (Kim and Hwang, 1998). Finally, a number of global giants in the electronics industry established themselves in Korea as early as the mid-1970s and helped shift the country’s pattern of production away from labor-intensive activities towards more technology-intensive activities. FDI was also instrumental in starting the production of many fast-growing export lines.

**Figure 3  Electronics and Electrical Equipment: Exports, FDI and OFDI, 1961-2000**

![Graph showing Electronics and Electrical Equipment: Exports, FDI and OFDI, 1961-2000](image-url)
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such as radios (Hobday, 1995). As Figure 3 illustrates, the rise in the share of FDI in the electronics and electrical equipment industry went hand in hand with a rise in the share of exports of such products. Subsidiaries of foreign semi-conductor firms certainly contributed to the emergence of domestic firms as major players in the world market. In the late 1960s, a number of American and Japanese MNCs established assembly and test facilities in Korea, allowing Samsung and LG to enter the industry in the 1970s through joint-ventures with foreign producers, and become world class semiconductor manufacturers (for a more detailed account, see Kim, 1999). Figure 3 also suggests that domestic firms must have taken over, since exports of electronics and electrical goods continued to rise while FDI in this sector dropped in relative terms.

In the electronics industry, fully foreign-owned FDI was restricted although joint ventures were perceived favorably (Amsden, 1989). Subsequently, MNEs were used by the Government mainly to further the acquisition of technology by local firms and help them develop new ownership advantages (Lall, 1996). In other words, FDI was not the major engine of technological development, but it was used in such a way as to strengthen the local technological capacities. During the first period, there was no real problem of ownership because FDI helped develop local skills and local firms.

There are a number of different channels through which positive spillovers may affect a host economy. Linkages can be enhanced through information and matchmaking, technological upgrading, training, and financing. Various measures can encourage technology transfer from foreign affiliates to their local suppliers and facilitate technological upgrading. In Korea, technology transfer requirements to domestic firms were used in the 1960s but were eventually discontinued as the measure merely encouraged the transfer of obsolete technologies (UNCTAD, 2001). Further measures can help bring suppliers and foreign affiliates together and strengthen their linkages. They can be of a general nature or may be more proactive through specific linkage promotion programs usually focused on a limited number of industries and firms. In Korea, local content requirements contributed to the development of supplier industries. In addition, the 1984 Act on Fair Transactions and Subcontracting gave the Government supervisory authority to monitor buyer-supplier transactions (UNCTAD, 2001). In addition, foreign firms also contributed to establishing supporting industries either by founding suppliers themselves or by helping former employees to establish their start-up suppliers (Kim, 1999).
The contribution of foreign firms may be in the sphere of technology as well as in the sphere of management techniques. Also, the presence of foreign firms in highly dynamic sectors, such as the electronics industry, contributed to the good trade performance of the economy. In 1972, foreign firms accounted for 55 per cent of Korea’s exports of electronics products.

On the downside of foreign presence, Yun and Lee (2001) have examined how FDI has impacted on market structure and competition in Korean manufacturing industries during the 1990s (before the crisis), and found that FDI had an upward influence on concentration and led to higher price cost margin. More generally, the efficiency of Korea’s pre-crisis FDI policy appears questionable. While FDI turned out to be positive for the sectors in which it was allowed because it helped develop and upgrade Korea’s industrial structure, the lack of competition also proved harmful. In particular, the restrictive stance taken by the Government vis-à-vis foreign investors in its attempt to protect domestic producers gave rise to an oligopolistic market structure dominated by large and excessively-leveraged conglomerates engaging in risky behaviors. These various imbalances and excesses can be said to be the deep-rooted causes of the recent crisis.

Post-crisis FDI

Reforms With the outbreak of the Asian financial crisis, Korean authorities, as well as firms, had to change course. As far as FDI is concerned, the liberalization move, which was already under way, gained renewed momentum as of 1998, and FDI was prioritized as a key component of the country’s revival strategy. In the wake of the crisis, Korea was sorely in need of inflows of foreign capital, whether in the form of portfolio or FDI. As a result, the country resolutely embarked on an active FDI-promoting strategy. FDI is now clearly favored over borrowing because it provides a more stable way of financing development. In addition, it has been shown to lower the odds of currency crashes (Park and Rhee, 1998; and Kim and Hwang, 1998).

The Korean Government revised acts related to foreign investment and proposed a new Foreign Investment Promotion Act (in November 1998), which strongly emphasizes the liberalization of foreign investment, improvement of the investment incentive system, introduction of the ombudsman system, streamlining foreign investment notification procedure, and the establishment of one-stop service. The Korea Trade-Investment Promotion Agency (KOTRA) established the Korea Investment
Service Center in July 1998, a one-stop service institution for foreign investors, which provides administrative support for investment as well as counseling services and post investment services. Virtually all business sectors are now open to foreign investors and FDI is subject to no specific restrictions provided it does not violate national security, public health and conservation of the environment. Out of a total of 1,121 industries of activity under the Korea Standard Industry Classification, 63 including public administration, diplomatic affairs and national defense are closed to foreign investment. Out of the 1,058 business areas, which are subject to foreign investment, two remain prohibited (radio, television and satellite broadcasting) and 24 are partially open to foreign investment. Different degrees of limitation on foreign equity participation or the exclusion of some business lines to foreign investment are the most common types of restriction found in these partially opened business sectors.

While foreign investors and foreign-invested companies enjoy the same rights as local residents or locally-owned companies, unless otherwise legally specified, in some cases they enjoy even greater privileges in the form of tax incentives. Such is the case in particular, in the so-called FTZs. Gimpo, Songdo, and Youngjong Island have been given the status of such special economic zones. In July 2002, five additional special economic zones were created as part of a package of incentives to attract foreign companies to Korea.

Finally, restrictions on shareholdings by foreign investors in some public enterprises have been abolished or significantly reduced. Ceilings on foreign equity ownership in the stock market have also been eliminated. More importantly perhaps, cross border mergers and acquisitions (M&As) and even hostile takeovers are now allowed, and foreign land ownership has been fully liberalized. Consequently, as of end-2001, foreign investors owned 36.6 per cent of equities listed on the main KSE, up from 30.1 per cent at the start of the year. The top ten blue chip companies are now over 50 per cent foreign-invested, including SK Telecom, Posco, LG Electronics and Kookmin Bank (EIU, 2002).

In brief, all the following types of FDI are now permitted:

- establishing a new business.
- acquiring shares from capital increases from an existing business.
- acquiring existing shares in a business.
- mergers and acquisitions.
- long-term loans investments, (including investment in privately-owned business).
Since the crisis broke, FDI flows into Korea have increased sharply. This can be attributed to a combination of positive factors including a substantial depreciation of the local currency and asset values, an increased number of company offerings as a result of corporate restructuring and privatization of state-owned companies, and a more favorable investment environment as a result of the Government’s deregulation and liberalization drive.

As Table 1 demonstrates, during the four years from 1998 to 2001, FDI flows into Korea totaled more than $27 billion (BoP data), or $52 billion (notification basis). A slowdown was however, observed in 2001 for the first time since 1992 (or 1993, depending on the series), suggesting that the post-crisis euphoria may be short-lived. It remains to be seen whether this is a turning point resulting from the slowdown in corporate and financial restructuring or simply the result of a temporarily less positive global environment. The rising competition from China, as an alternative location for FDI, is also perceived as a major matter of concern and a potential cause of the observed slowdown. Yet the rebound observed in early 2002 is an encouraging sign.

With respect to industrial distribution, although the service sector has maintained a strong momentum, the manufacturing sector is still dominant. As Table 3 illustrates, finance and insurance excel in the services sector, while electric and electronics makes up the largest share among manufacturing industries. This can be attributed to the Government’s will to attract FDI to help maintain the competitiveness of these sectors. A good example is the joint venture between Philips and LG Electronics in 1999.

The surge of FDI in manufacturing has been sustained since the crisis, with rather contrasting evolutions across industries. FDI is no doubt increasingly used as an instrument for restructuring. The government ascribes the continuing robust nature of inbound capital to the recovery of the international credibility of the Korean economy, the progress of its ongoing corporate restructuring program, and the new environment of opportunity in the investment regime created by the Foreign Investment Promotion Act. According to a study by KPMG, foreign companies, which initially exported to Korea through local agents or engaged in joint ventures with local companies, were found to have expanded their FDI during the crisis, probably because their Korean partners hoped to boost their liquidity this way.

The rising share of the finance and insurance industries is related to the strong progress in the restructuring of the financial sector and to the Government’s easing of foreign investment restrictions in financial services.
and insurance industries. An increased foreign presence can clearly be found in the financial sector and foreign financial institutions advancing into Korea’s market are now placing more emphasis on capital investment and acquisition of existing institutions rather than on establishment of branches. While the financial sector is particularly attractive thanks to the sweeping clean-up drive to remove insolvency, other sectors such as construction and transport were particularly severely hit by the crisis. The increase in domestic demand has also brought about an increase in FDI flows into wholesale and retail trade industries.

The post-crisis surge in FDI involves a different mix of foreign investors, with a larger diversification in the sources of FDI than was the case in the past. Although US investors are still dominant, European investors account for a relatively large share, while Japanese investors lost ground as a result, most probably, of the country’s persistent economic and financial crisis (see Table 4).

With regard to the size of investment projects, the proportion of investments of less than $5 million has steadily increased, suggesting that FDI is much more diffuse than was the case in the past. Cross-border M&As (mostly involving buying out joint venture partners, existing investors expanding through acquisitions, and creation of new establishments in collaboration with Korean partners to acquire existing business units) rose dramatically in Korea in the wake of the financial crisis from $836 million in 1997 to $3973, $10062 and $6448 million in 1998, 1999, and 2000 respectively (UNCTAD, 2001). Korea was the most targeted economy for cross-border M&A in Asia (excluding Japan and China) in 2001, attracting $13.83 billion worth of foreign investment from 79 deals (South China Morning Post, January, 2nd, 2002). Prominent transactions included the $2.77 billion purchase of SK Telecom by Signum IX. This evolution is due to the deregulation of hostile M&As, and also to lower asset prices and to the sharp depreciation of the won. Target enterprises have been accepting foreign capital participation in order to secure ready cash. Selling off even lucrative and core business divisions over their more marginal ones has proved an effective means of tackling the financial crunch resulting from a loss of creditworthiness. Such was the case of BASF’s purchase of a new lysine-manufacturing unit from Daesang group (Kim, 1999).

The rise in FDI in services described earlier is also driven by the opening up of industries such as telecommunications and electricity, which were traditionally in the hands of the public sector. Among the 11 public enterprises designated for privatization, 6 (including POSCO) have already
been successfully privatized, while the remaining 5 are in the process of being privatized. Yet so far, these firms have attracted more portfolio than FDI, with the exception of KEPCO, which sold two generation plants to an international consortium (Yun 2001).

Assessment

**Expected benefits and potential risks** The recent surge of FDI into Korea is largely due to the more positive policy stance towards foreign investors. Opening up the economy to FDI may serve different purposes. First, FDI is a source of finance. Second, FDI can help firms streamline their activities. Third, FDI can contribute to the restructuring process to the extent that the presence of foreign firms can encourage the adoption of international best practice and promote better corporate governance, in particular by reducing the degree of public interventionism (Yun and Lee, 2001). In the case of Korea, the rationale for attracting more FDI is to be found at the microeconomic level rather than at the macroeconomic level.

The dramatic change in Korea’s policies and attitudes toward FDI will definitely affect the way the Korean economy operates and interacts with the rest of the world economy. In particular the lifting of a number of restrictions on the participation of foreign firms will expose the chaebols to fiercer competition, while enhancing a more transparent business environment.

Of course, next to these opportunities, the surge of FDI may also generate a number of risks. The first major concern is that domestic firms may be acquired at low price (fire-sale). Second, is the fear of dominance by foreigners (ownership issue). Third, is the potential for domestic monopolies to be substituted by foreign monopolies.

**Where does Korea stand?** Despite the dramatic rise in FDI inflows, Korea still does not attract a large amount of FDI relative to the size of its economy and lags very much behind other comparable economies. According to UNCTAD (2001), Korea is among under-performers in terms of attracting FDI. In 2000, its proportion of FDI stock (on arrival basis) to GDP was just 8.9 per cent, which is quite low compared to the average of 23.3 per cent in East Asia and 13.7 per cent for the world average. There is thus still scope for further expansion of FDI if Korea is to reach the degree of internationalization observed in comparable economies. An important point to note is that the different capital inflows to Korea are now better balanced, with non debt-creating flows now clearly dominant.
Yet FDI inflows have no doubt already deeply affected the Korean economy, and should continue to do so in the future, in the following way:

- FDI helped firms to survive while they were on the brink of collapse in the wake of the crisis. When cash-rich companies took over ailing Korean firms, hundreds of jobs that might otherwise have disappeared were salvaged, not only at the firms concerned but also at their subcontractors and suppliers. Critics may perceive some acquisitions negatively because foreigners may acquire a large market share. This is probably the case for the seeds industry, with Seminis controlling about 45 per cent of the Korean vegetable seed market. But the important point is to compare the current situation with the counterfactual. Acquisition by foreigners ensured the survival of firms that would otherwise exit the market, and as a result these acquisitions exert a competition-enhancing effect.

- Beyond this first short-term impact, major changes already took place and reflect a real change of mindset. As FDI is expected to favor structural change, a self-reinforcing mechanism may come into play through which structural change stimulates FDI to Korea, and FDI to Korea accelerates the speed of structural changes. As a result, the Korean economy is likely to be increasingly in line with other OECD economies. Structural changes include (i) changing the safety net mechanism in the financial system; (ii) changes in corporate governance of Korean companies triggered by changes in the financial system (increasing share of foreign equity holders, hence a rise in the required rate of return for the firms, and a shift to the globally accepted level playing field); (iii) recent focus on business restructuring for the purpose of improving profitability; (iv) increasing transparency of Korean companies as a result of reinforced disclosure requirements; and (v) a series of deregulation initiatives lowering or eliminating barriers to new entrants.

- As was the case in the past, FDI continues to make a significant contribution to export growth. Research undertaken by KIET (2002) suggests that exports of foreign manufacturing companies in Korea accounted for about 15 per cent of the country’s total exports in 1999. The trade surplus generated by these companies reached 20.3 per cent of Korea’s total trade surplus. All this means that these firms’ contribution to export performance is much larger than what their share of total production would suggest (Korea Times 17.01.02). As one of the top-selling foreign companies in Korea, Nokia (which became the 10th largest exporting company in the country in 1999) more than doubled its exports of mobile phones from 1995 to 1998 (to $1 billion) and again in 2000 (to $2.4 billion).
• FDI also increasingly helps in developing the components industry and in reducing the dependence on imports from Japan. Investment by an Italian consortium (Ultratec) aimed at producing printed circuit boards (PCB) and PCB manufacturing equipment is a good example of such a new trend. This move should help reduce the country’s dependence on imports. Active Government policies seek to promote the creation and deepening of linkages between MNEs and local suppliers (so as to raise the efficiency of production and contribute to the diffusion of knowledge and skills from MNEs to the local enterprise sector). Specific measures were put in place in order to maximize the potential benefits of FDI inflows. For instance, the Government encourages big companies (including foreign affiliates) to help organize small and medium sized enterprises’ (SMEs) supplier associations and participate in their training and other programs (UNCTAD, 2001).

• FDI may also play an important role in the privatization process. Through this channel, it can have a number of positive impacts. First, by providing the much needed financial means for the privatization of State-Owned Enterprises. Second, by ensuring continued steady influx of foreign exchange in the form of follow-up investments for maintenance and expansion. Third, by highlighting the government’s openness policy to foreigners. Also, privatization-related FDI can act as a catalyst and induce additional foreign investment in non-privatized industries. Finally the inclusion of foreign investors in the bidding process may push up the price of the entity being privatized. Yet, the success of the privatization process is mixed so far. In order to attract foreign investors to participate in privatization, Korea has to ensure coherent principles and enhanced transparency of regulations (Korea Times, 13.9.01).

• The contribution of FDI is also substantial in transferring not so much technology but organizational skills and managerial know-how. Volvo Korea (as a result of Sweden’s Volvo take over of Samsung’s construction-equipment division in February 1998) is a good example where an MNC helped change the management system of a Korean firm. Under Volvo’s influence, the administrative process of the Korean subsidiary has been rationalized and transparency has been enhanced (see Kim, 1999). Generally, changes in strategy from growth orientation to profit orientation can be observed under the pressure of foreign investors (Rhee 1999). Large firms are increasingly withdrawing from diversified activities, while they tend to focus on the business in which they have a competitive advantage. Changes of a similar nature can be observed in the financial sector. As a result of the change in the form of foreign involvement in the financial sector, foreigners are now participating actively in the management of
banks, leading to substantial changes in lending practices in particular. The refusal of the new foreign management of Korea First Bank to participate in the government-organized bailout of Hyundai and other large Korean corporations in January 2001 may be seen as a promising development. Similarly, since the takeover by Germany’s Commerzbank, Korea Exchange Bank has reduced its exposure to high-risk corporate giants like Daewoo, improved its lending practices and strengthened the credit analysis by its staff (Park, 2000). For more details on the impact of foreign involvement in the Korean banking and financial sectors, see Nicolas (2002).

- There is still inconclusive evidence on the pro- or anti-competitive impact of FDI (Yun, 2001). On the one hand, the rise in FDI inflows led to substantial concentration in some industries such as the paper industry (Yun and Lee, 2001). On the other hand, thanks to increased foreign penetration, there is a likely erosion of the power of the chaebols in a number of industries including the retail trade industry. Korea has traditionally had a manufacturer-dominated structure in retail industry in which manufacturing firms not only produce but also participate in retail sales as dominant players (Kim 1999). As a result of the liberalization drive that gained momentum after the crisis, the market structure has been changed and large-sized discount stores or hyper-markets established by foreign retailers (Makro, Carrefour, Wal-Mart) are now competing with the chaebol manufacturers. More generally, the number of industries in which foreign companies have more than 50 per cent of the total market share is consistently on the rise. As a result, the nature of competition has changed, shifting from competition among domestic companies to competition between MNEs and domestic companies.

- Finally, FDI may be helping turn Korea into a regional hub. Korea is perceived by a number of foreign investors as the gateway to the East Asian market. For instance, most French firms perceive Korea in such a way and try to take advantage of the regional market, in the fine chemicals industry.

In a nutshell, rising FDI is having two major types of impacts on the Korean economy. First, FDI helped economic recovery in the short-run by providing cash and maintaining competitiveness and keeping some firms afloat. Second, FDI is having a longer-lasting contribution to economic efficiency through demonstration effects, through adoption of international standards in business practices and promotion of better corporate governance, and through enhanced competition. FDI helps industrial restructuring and changes the way the Korean economy operates, in particular by modifying the nature of competition and the relationship
between business and government. As a result, rationalization can be observed in many respects, primarily in the financial sphere. The contribution of FDI is different than in the past. The impact is no longer on the pattern of specialization of the economy but rather on the way the Korean economy is working. In other words, FDI can be said to have today more of an impact on the ‘software’ than on the ‘hardware’ of the Korean economy.

Outward FDI

Pre-crisis OFDI

Policies In the 1970s exports were the favored means of internationalization for the Korean manufacturing sector. Moreover, because it was considered as a capital outflow, outward FDI (OFDI) was discouraged by the Government except in special cases for facilitating export or securing a stable supply of important raw materials (ESCAP 1998). Until the 1980s OFDI was thus restricted to a limited number of activities. During the late-1980s, however there was a change of direction in the country’s OFDI policy not only as a result of the emergence of a current account surplus but also in the wake of the liberalization of foreign exchange transactions. Aggressive measures were put in place in order to help declining industries regain competitiveness by relocating overseas in low-wage countries or to help more high-tech industries jump over the protectionist barriers imposed by industrial countries or get access to foreign technology.

Some initial steps were taken as early as 1981. For instance, restrictions on investor qualifications were eased, prior authorization of investment projects was abolished, the requirement of recovering the invested principal within 10 years was removed, and the approval procedure was widely simplified. Yet genuine liberalization did not materialize before 1987. In particular, the adoption of the notification system allowed firms to invest abroad simply by notifying the Bank of Korea. Investor qualifications were also further simplified. As a result of the liberalization only 14 business categories remained restricted for outward investment. The government even allowed overseas real estate investments, which had so far been regarded as proscribed practice (Kim and Kim, 1997).

The return of the deficit in 1990 did not stall the OFDI liberalization move and the promotion of OFDI stood as one of the objectives of the
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Seventh Five-Year plan (1992-97). Liberalization was still getting ahead, with relaxed conditions for approval and a shift in February 1994 to a negative list system (as a result OFDI was possible in all business categories except for those on the negative list). OFDI liberalization as part of the segyehwa policy encapsulated in the Seventh Five-year plan represents the government’s recognition of the need for greater integration into the world economy and continues the strong tradition of close collaboration between the government and the private sector (in particular the chaebols). An important strategic objective of the segyhewa policy is to enhance independent technological capability, and OFDI is seen as a way of improving competitiveness. Perhaps, this is in recognition that Korea’s technological dependency remains a major structural weakness (Dent and Randerson 1996).

At the same time, the Government grew increasingly worried about possible negative impacts of booming OFDI on the home economy. Prudential regulations were thus introduced in 1995 as an allegedly precautionary measure to induce more careful planning and healthy management of OFDI and thereby prevent any adverse side-effects arising from its liberalization. Among other things, the Government introduced a minimum self-funding requirement of 10 per cent of the OFDI amount for the local subsidiaries with financial assistance of less than $100 million. This ratio rises to 20 per cent if the investment exceeds $100 million. This regulation, which is paralleled by similar provisions at the domestic level, reflects the willingness of the Government to tightly monitor the economy. Rather than restricting investment abroad, it is aimed at preventing firm managers from taking undue risks, which would ultimately be at the expense of shareholders and creditors, particularly domestic banks. These measures were supposedly taken in response to poor performance of OFDI in some countries and the sharp increase in large-scale OFDI projects (Kim and Wang, 1996). It is also worthwhile noting that it has been typical of the Korean economy that such an initiative should be taken by the Government and not left to the private sector through enhancement of good corporate governance.

Trends OFDI from Korea started in the late-1950s in the service sector (with a mining company investing in New York real estate), in 1968 with a forestry development project in Indonesia, and in 1974 in manufacturing. Yet OFDI did not experience strong rates of growth until the second half of the 1980s when Korea gradually gained economic clout (see Figure 2). The total value of stock investment abroad rose from $0.65 billion in 1986 to
$10.2 billion in 1995.

In the early stages, OFDI was oriented towards Asia, North America, and the Middle East. In terms of industries, OFDI was mainly concentrated in agriculture, manufacturing, trade, and construction. Within the manufacturing sector, the large share devoted to the petrochemical industry (see Table 5) reflects the country’s dependence on such resources. Within Asia, OFDI was primarily directed to Indonesia to gain access to timber supplies for the Korean plywood industries. In the Middle East by contrast, the bulk of OFDI was directed to Saudi Arabia and sought to take advantage of the construction boom.

Over the period 1981-90 OFDI in mining gained importance, next to manufacturing and trade. This is because as a resource-poor country, Korea is totally dependent on raw material and energy imports. Within manufacturing, electronics emerged (with 7 per cent) while textiles and transport equipment started to loom large (next to petrochemicals), with about 15 per cent each of total manufacturing OFDI. Yet, basic metals commanded the largest share (about 24 per cent). The rise in OFDI in basic metals products resulted primarily from a large investment of POSCO in the US. In terms of destination, North America was a privileged destination in the 1980s, ahead of Asia. The real take off of OFDI in the late-1980s (with an average annual growth of 77 per cent) was accompanied by a shift in the destination, with neighboring Asian economies becoming major targets.

In the immediate pre-crisis period, OFDI was overwhelmingly concentrated in manufacturing, with close to 60 per cent of the total for the period 1991-97 up from less than 20 per cent in the period 1968-80. In terms of stock, manufacturing accounted for 53 per cent of OFDI position in 1997 compared to 33 per cent ten years earlier. This suggests that restructuring of the domestic industry is gaining importance over access to natural resources as a motive for OFDI. According to Lee and Plummer (1992), OFDI, both to developing and industrialized countries, is found to originate largely from those sectors in which Korea has proven its competitive advantages in world markets. The primary goal of OFDI is to maintain export dynamism be it through relocation of export production or through export-preserving in OECD countries. This results again from the heavy emphasis initially placed on export-oriented production in Korea. OFDI in trading activities is also particularly large in the US and the EU, while it is relatively unimportant in Asia, underlining the importance of Asia as a production location rather than a target market (Hoesel, 1999).
Table 5  Industrial Distribution of OFDI, 1968-2001 (%)

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<tr>
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</thead>
<tbody>
<tr>
<td>Agriculture/Fishery/Forestry</td>
<td>24.7</td>
<td>6.8</td>
<td>0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Mining</td>
<td>1.1</td>
<td>20.5</td>
<td>4.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>19.1</td>
<td>47.9</td>
<td>59.6</td>
<td>45.3</td>
</tr>
<tr>
<td>Food</td>
<td>2.1</td>
<td>3.2</td>
<td>2.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Textile and Clothing</td>
<td>0.9</td>
<td>7.4</td>
<td>7.7</td>
<td>3.9</td>
</tr>
<tr>
<td>Shoes and Leather</td>
<td>1.1</td>
<td>2.0</td>
<td>1.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Wood and Furniture</td>
<td>0.2</td>
<td>1.2</td>
<td>1.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Paper and Printing</td>
<td>1.1</td>
<td>1.8</td>
<td>1.1</td>
<td>0.5</td>
</tr>
<tr>
<td>Petrochemicals</td>
<td>5.9</td>
<td>4.8</td>
<td>4.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Non-metallic Minerals</td>
<td>1.9</td>
<td>1.8</td>
<td>2.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Primary Metals</td>
<td>2.6</td>
<td>11.3</td>
<td>4.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Fabricated Metals</td>
<td>0.0</td>
<td>1.6</td>
<td>1.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>0.0</td>
<td>0.6</td>
<td>5.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Electronic Communication Equipment</td>
<td>0.0</td>
<td>3.5</td>
<td>18.8</td>
<td>20.3</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>0.0</td>
<td>7.0</td>
<td>6.5</td>
<td>5.6</td>
</tr>
<tr>
<td>Others</td>
<td>3.2</td>
<td>1.8</td>
<td>2.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Service</td>
<td>55.1</td>
<td>24.9</td>
<td>35.4</td>
<td>51.8</td>
</tr>
<tr>
<td>Construction</td>
<td>18.9</td>
<td>1.2</td>
<td>2.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Wholesale and Retail</td>
<td>22.6</td>
<td>18.1</td>
<td>17.5</td>
<td>28.4</td>
</tr>
<tr>
<td>Transport and Warehousing</td>
<td>1.8</td>
<td>0.2</td>
<td>0.9</td>
<td>0.5</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>0.0</td>
<td>0.0</td>
<td>5.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Barking and Insurance</td>
<td>0.0</td>
<td>0.1</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Hotels and Restaurants</td>
<td>1.7</td>
<td>3.6</td>
<td>3.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Real Estate Service</td>
<td>10.1</td>
<td>1.6</td>
<td>5.5</td>
<td>20.2</td>
</tr>
<tr>
<td>Others</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: The calculations are based on net invested amounts.

Within manufacturing, a breakdown by industry shows that transport equipment, together with electronics and telecommunications equipment account for the largest share (more than 40 per cent) of OFDI, while textiles and clothing simply account for about 13 per cent, and basic metal products dropped below 8 per cent. Leading Korean electric and electronics firms generated the recent surge in the machinery sector OFDI, investing
initially in the US and eventually in other countries.
In terms of location, OFDI is primarily concentrated in Asia and in the
US, these two regions accounted for more than 75 per cent share during the
period 1991-97 (see Table 6). Yet Europe’s share has been strongly on the
rise lately, up to almost 15 per cent for the period 1991-97 from 4 per cent
in 1968-80. Europe was ahead of the US as a destination for Korean OFDI
in 1995.

Table 6 Destination of Korean OFDI, 1968-2001 (%)

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Asia</td>
<td>29.4</td>
<td>29.5</td>
<td>48.8</td>
<td>28.8</td>
</tr>
<tr>
<td>Middle East</td>
<td>16.6</td>
<td>1.6</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>North America</td>
<td>24.4</td>
<td>69.6</td>
<td>27.1</td>
<td>31.0</td>
</tr>
<tr>
<td>Latin America</td>
<td>3.5</td>
<td>6.8</td>
<td>4.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Europe</td>
<td>3.9</td>
<td>5.1</td>
<td>14.4</td>
<td>30.8</td>
</tr>
<tr>
<td>Africa</td>
<td>18.9</td>
<td>1.0</td>
<td>2.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Oceania</td>
<td>3.3</td>
<td>6.8</td>
<td>2.1</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Note: For this period, the calculation is done excluding investments in Bermuda.
The calculations are based on net invested amounts.

Assessment
During the period 1960-80, Korean enterprises cannot be said to have
generated ownership specific advantages to make OFDI possible. The only
exception may be with Korean investments in the construction industry in
the Middle-East. In this case, Korean firms were exporting technology,
labor and management (Dunning, 1981). In general, until the early 1980s,
Korean OFDI can be said to have been primarily of the resource-seeking
kind (Lee and Plummer, 1992) and to a limited extent of the market-
seeking kind. The deliberate limitation to the growth of the home market
created an additional incentive for Korean firms to move abroad.

The major push in OFDI in the mid-1980s was perhaps partly fuelled by
the chaebols’ desire to reduce their reliance on domestic sales to enable
them to service their debts, the heavy debt burden being a legacy of Park
Chung-Hee’s soft loan policies. Korean OFDI is also related to structural
FDI as a factor of economic restructuring: The case of South Korea

changes (rising domestic wages, appreciating won and strong business interests to enhance market share and increase profits) taking place in the Korean economy as well as to changes in policy (liberalization after the current account surplus). The high degree of OFDI from Korea in the recent period is to be linked to the active home government encouragement of firms with limited international experience (Narula, 1996). Extensive support is given to potential overseas investors by means of financial help and tax incentives. Moreover, the traditional rivalry among the chaebols probably also strengthened the trend.

Depending on the location of OFDI, there are basically four major motives for OFDI by Korean firms: to relocate industries in order to gain cost advantages or to circumvent trade barriers; to secure stable supplies of industrial resources; to facilitate trade or promote exports; and to accommodate the need for global networking. The motives for OFDI vary across destinations and their relative importance has changed over time as Korea’s industrial structure changed. Also, as can be seen in figures 3 and 4, the situation is different for declining and growing industries: OFDI may substitute for exports in the former case and complement them in the latter.

Korean OFDI in Asia as a response to eroding comparative advantages

A particular feature of Korean OFDI in Asia is the radical transition in terms of its pattern, turning away from the resource-seeking of the 1970s and mid-1980s to small-scale, export-oriented, labor-intensive profit-maximizing, particularly in such industries as textiles, footwear, garments and chemical industries (Lee, 1997). The erosion of Korea’s comparative advantages was no doubt the primary driver of Korean OFDI in developing Asia. The high export dependency of the major Korean manufacturing industries led domestic firms to seek overseas investments as a means to survive the various threats to their export markets (Lee, 1997). Moreover the loss of the Generalized System of Preferences (GSP) status further induced Korean firms to relocate in neighboring less advanced countries such as Malaysia, Thailand, Vietnam and eventually China to take advantage of these countries’ quotas in industrialized countries’ imports. As income levels in Korea rose and approached those of industrial countries, the latter began abolishing special treatment granted to Korean exports in their markets under the GSP. Korea was knocked off the list eligible for inclusion in the GSP by the US in 1988 and by the EU in 1989 as part of a wide array of measures aimed at reducing their trade deficits with Korea. In Korea, because economic growth had been export-driven so far, the only way to maintain the production momentum was through OFDI
expansion in lower-wage economies. Such investments can be said to result from strong ownership advantages in the form of management techniques and production processes adapted to third world conditions.

In this respect Korean OFDI fits rather well with the standard explanation of the shift from export activities to overseas production in the framework of the product cycle model. This is confirmed by Figure 4, which shows a substitution between exports and production abroad in the textiles and clothing industry. As was the case in Japan, the success of export-led industrialization in Korean economic development, made the next stage, capital export, inevitable (Lee, 1997), in particular in countries further down the line.

Figure 4  Textiles and Clothing: Exports, FDI, OFDI, 1961-2000.

While Korean OFDI in developing Asia tended to be single factor dominated, namely seeking cheap labor for export-oriented production in the 1980s, local market-motivated investments have been on the rise since the early 1990s, in particular in the Association of Southeast Asian Nations (ASEAN) countries such as Malaysia. This is reflected in a sectoral shift in the composition of OFDI away from apparel, leather goods, footwear and miscellaneous manufacturing to fabricated metal products or machinery and equipment industries.

The re-emergence of Asia as the major host region for Korean OFDI in the 1990s also reflects the growing importance of export-oriented manufacturing investment in outward-oriented second-tier exporting economies in Asia. In this respect the surge of Korean OFDI in the region is the result of strong pull factors and not exclusively of the push factors
highlighted above. Within Asia, while Indonesia remains a privileged destination for Korean OFDI, China has recently risen as the primary target of Korean investors, accounting for as much as 20 per cent of total OFDI over the period 1992-98. There is little doubt that state policies and institutional conditions in these host countries played a large role. In particular, it is important to recognize that the rapid increase of Korean OFDI in manufacturing in Indonesia or China coincides with massive economic reforms aimed at securing and attracting foreign capital (Lee, 1997; and OECD, 1999). As shown by Park and Lee (2001), Korean firms in China aimed at using this country as an export-processing base and not at targeting the local market. Also they focused on labor-intensive sectors over which they had some ownership advantages exploiting cheap labor and raw materials. The pattern of Korean OFDI in Eastern and Central European economies (such as Poland or Romania), in former USSR Republics (such as Uzbekistan), in Mediterranean countries (such as Turkey), or in Mexico closely resembles what was observed in developing Asia. In these countries, the primary motive of Korean ODI is clearly seeking cheap-labor so as to improve price competitiveness.

**Korean OFDI in OECD countries as a means of preserving market shares and upgrading** A major characteristic of recent Korean OFDI is its heavy involvement in OECD countries, relative to what can be observed in comparable NIEs such as Taiwan. By contrast to what was observed for Korean OFDI into Asia, shifting comparative advantages cannot possibly account for Korean OFDI into OECD countries. The bulk of Korean OFDI in OECD countries is concentrated in manufacturing (about 50 per cent), with trading activities as the second largest sector (30-35 per cent). Within manufacturing, more than half of Korean OFDI in OECD countries is in the machinery and equipment sector (including electronics), definitely not seeking cheap labor in these countries. In an empirical analysis of the Korean electronics industry, Hoesel (1999) highlights the differences in the determinants of Korean OFDI in Asia and in OECD countries. Protectionism and the overall quality of human capital embodied in a firm are shown to play a role in the latter case but not in the former. In the same vein, Lee (2002) also stresses the different motives for Korean OFDI in Asia and in OECD countries and finds that expansion of local sales is a particularly important motive in the latter case.

Korean OFDI in OECD countries appears to seek two things. First it is purported to defend export market shares and cope with import restrictions. Second, it seeks advanced technology from developed countries, as
International trade, capital flows and economic development in East Asia

The surge of OFDI to OECD countries may be partly attributed to rising protectionism against Korean products in these economies. Apparently, the increase in trade barriers in OECD markets tended to raise internalization advantages sufficiently to more than compensate for locational disadvantages or lack of locational advantages in OECD economies and thus induce the Korean firms to invest in OECD countries (Lee and Plummer, 1992). For instance about 80 per cent of the total Korean OFDI stock in the EU is concentrated in the electronics industry, and more precisely in those products where Korean chaebols have a strong advantage in the world market, namely brown goods (TV sets, VTRs), some white goods (micro-wave ovens, AC), components (semi-conductors, cathode tubes), and office equipment. This high concentration reflects the attempt by Korean firms to respond to protectionist threats or measures, which are greatest for consumer electronics products. Another factor tends to confirm this hypothesis. Many Korean OFDI cases in electrical and electronic goods are for the production of intermediate goods, which would increase the local contents of Korean products in foreign markets.

Because Korea’s efforts to spend more on R&D may not suffice to make its firms more innovative, Korean MNEs also resorted to M&A in industrial economies to gain access to cutting-edge technologies. Hyundai has been the most aggressive investor of this kind with its acquisition of Axil computer for instance (Woo 1999). OFDI perceived as a means of acquiring assets through strategic asset seeking investments is clearly less a function of home country advantages and more of host country advantages. These investments are to some extent complementary to market-retaining investments to the extent that they are expected to help enhance the competitiveness of the investing firm. The stake taken by Samsung Electronics in US computer firm AST was obviously aimed at strengthening its position in information systems, as well as at improving its brand name and distribution systems (Dunning et al, 1998). Other examples include the acquisition by LG Electronics of Zenith Electronics, the last TV producer in the US. The failed attempt by Daewoo to take over the consumer electronics part of Thomson France had exactly the same objective.

An additional reason for the expansion of Korean OFDI in the Triad has to do with the need to develop marketing capabilities. If non-manufacturing OFDI is included into the analysis, the largest number of Korean projects in OECD regions was to set up foreign trading companies. The combination of locally-made intermediate goods and expanded marketing channels is
expected to contribute to defend or increase Korean products’ shares in OECD markets. This situation has to do with the prevalence of original equipment manufacture arrangements in the past: Under such agreements, Korean firms were not induced to develop global brand names or distribution channels.

As a result, Korean OFDI in advanced countries cannot be said to be systematically based on any strong ownership advantage of Korean producers. Rather, it seeks to defend Korean shares in local markets in response to rising protectionism or to learn from foreign partners. A number of authors (Lee and Lee, 1992; and Lee, 1994) argue that most of these OFDI flows into OECD countries result from a ‘premature strategic move’. This OFDI also does not result from economic restructuring or industrial upgrading. To the contrary it can be interpreted as a means of reaching such goals. In other words, far from being the result of Korea’s industrial upgrading, OFDI is partly used to help and ease industrial upgrading.

**Excessive or problematic OFDI** The pace of Korean OFDI expansion was perceived by some authors as the sign that these investments may be excessive. The failure of a number of large ventures, such as Hyundai’s failed investment experience in Canada followed by the closure of its facility in 1993, confirm these concerns. Further signs suggest that some of these investments may not have been fully sound. First, the returns on investment by foreign subsidiaries are often found to be quite weak. Of course, such a result may be related to the asset-seeking orientation of these investments, as well as to the immaturity of Korean OFDI. Yet, the financial soundness of Korean ODI is also questionable, with excessive foreign borrowings as standard practice. As reported in Lee (2000), the financial stability of the foreign subsidiaries of Korean firms was found to be extremely weak in a study conducted by KIEP in 1997. Because of the guarantees provided by parent companies or member companies, the vulnerability of the subsidiaries may also threaten the whole group, as was clearly demonstrated in the case of Daewoo.

Public policies can probably account for the apparently excessive extent of some Korean OFDI, with the worldwide expansion of Daewoo as a case in point. Under a ‘global management’ strategy launched in 1990, Daewoo has been pursuing a daring international expansion at a breakneck speed, with investments ranging from textiles to electronics and components, heavy industries, autos, and natural resources, in locations such as China, Vietnam, Russia, Hong Kong, Britain, Poland, Uzbekistan, Libya, Sudan or
Angola. As a result, in 1998 Daewoo was included in the world’s 100 largest transnational corporations. Public policies certainly played a role in this expansion in many ways. First, Korean authorities provided financial support to potential outward investors. Moreover the bulk of these investments is due to the chaebols, whose emergence was the clear result of former public policies. In their foreign ventures, the chaebols simply reproduced the type of strategy they followed at home. And there can be little doubt that they adopted riskier strategies than they would do in the absence of helping hands in the form of rescue loans from the Government. Moreover, because of the traditional race among the chaebols, there is a clear risk that the chaebols may overstretch themselves.

Post-crisis OFDI

Policies and trends  Although OFDI is again perceived nowadays as a possible drain on Korea’s resources, there was no major change in policy provisions to restrict its scope. To the contrary, certain requirements on self-financing were relaxed in August 1997, while the prior approval system was finally abolished in October 1997. Yet, in the wake of the crisis, policies imposing restructuring measures to the chaebols, as well as various regulatory restrictions in terms of indebtedness and diversification of activities may have a negative impact on OFDI flows. The bankruptcies of a number of large industrial groups account for the divestments or the scaling down of projects. In particular Daewoo Motor and Daewoo Electronics closed down a large number of their overseas production units over the past two years.

As could be expected, since 1997, the financial crisis has taken its toll on the wave of Korean OFDI, which had assumed such a high profile in recent years. As a result, Korean OFDI has slowed down since 1998, as can be seen in the consistent drop in the OFDI to GDP ratio (Figure 2). In absolute terms, the upward trend which had started in the late 80s stopped abruptly in 1997 but there was only a slight fall in the amount of investment. This initially limited drop can be explained by the rise in additional investment by parent companies in their foreign subsidiaries in order to compensate for their inability to roll over their short-term borrowings or access new funds in the local financial markets. According to the Exim Bank, however, there is as yet no clear trend beyond the initial stagnation: OFDI recovered in 2000, before slowing down again in 2001. In spite of the dramatic improvement in Korea’s economic situation, divestments have been quite large, and a number of foreign ventures have
been closed down. In 2001, these negative flows totaled $1.3 billion, leading to a sharp drop in the net total investments from $3.7 billion to $1.9 billion (Exim Bank, 2002).

New OFDI patterns Since the crisis, the share of the service sector has been on the rise at the expense of manufacturing. While wholesale trade and retail, as well as the real estate industry have been major beneficiaries within the tertiary sector, textiles and clothing, as well as wood and furniture or basic metal industries have been major victims of the drop in the share of manufacturing OFDI. By contrast, electronics and telecom equipment, and petroleum and chemicals proved resilient. Active overseas investment in the R&D and software areas also account for the rise in the share of the service industry in the recent period (Ha, 2002).

Also, the relative erosion in the weight of the chaebols may help reduce the rivalry which fuelled some excessive investments in the past, and also lead to a better balance between OFDI by the chaebols and by SMEs.

More importantly perhaps, there has been to a large extent a geographical redistribution in OFDI, away from Asia, towards the US and to some extent Europe. In fact, Europe managed to improve its position mainly thanks to a large investment realized jointly by LG Electronics and Philips in 2001. Within Europe, Central and Eastern European countries such as Poland or Hungary loom large by contrast to Western European countries, with the exception of the UK and the Netherlands. The drop in the share of Asia needs to be qualified however. First, in terms of accepted investments, Asia remains the main destination of Korean OFDI (if the year 2001 is excluded). Second, the observed relative decline does not mean that Korean OFDI dropped in all countries. To the contrary, China is attracting increasing amounts of investments, at the expense of other Asian countries such as Indonesia. Yet, even if China overtook the US as the main magnet for Korean OFDI in 1998, over the period 1997-2001, it only managed to attract about $1 billion (less than 10 per cent of total Korean OFDI), compared to the US’ $3 billion (about 30 per cent).

Obviously, one of the motivations of Korean OFDI into China is resource-seeking. Both large, and small- and medium-sized Korean firms rushed into China, primarily in order to take advantage of cheap labor and maintain their price competitiveness on export markets. According to the Exim Bank of Korea, SMEs account for 54 per cent of total Korean investment in China. Moreover, the bulk of these investments is taking place in manufacturing. Yet, Korean firms may also be attracted by the potential growth of the Chinese market. Such is probably the case in
industries where Korean producers are competitive, such as mobile telecommunications, automobile or electronic communication equipment. By contrast, in the case of Korean OFDI to the US, the major motivation is to circumvent various trade barriers such as anti-dumping measures.

Assessment

*Temporary slowdown or permanent change?* A key question is whether the drop in Korean OFDI is a temporary phenomenon related to the crisis-induced financial difficulties of the chaebols or a longer-lasting feature resulting from deep structural changes in the Korean economy.

The observed slowdown in Korean OFDI expansion is probably mainly due to financial difficulties. As stressed by Lee (2000), it is only natural that Korean companies facing a liquidity crisis and strong pressure to restructure are reducing the scale of their overseas investment. Despite this immediate impact, there is no reason to expect this trend to continue over time. Far to the contrary, the long-term trend is towards more OFDI, if Korea is to follow the path of all other industrial economies. OFDI was found in the past to help growing industries improve or maintain their competitiveness and declining industries restructure through the relocation of their production overseas. This certainly still holds true, and OFDI will no doubt continue to play such a role in the future. Two categories of investment can be expected to persist, on the one hand investments that may help restructuring due to an erosion of comparative advantages at home, and investments aimed at pioneering new markets, maintaining acquired markets, or acquiring technology. OFDI should continue to help in restructuring the Korean economy through these two channels.

Yet in the wake of the crisis, fundamental changes in the pattern of OFDI can certainly be expected. Even if OFDI is likely to resume its interrupted upward trend, it will no doubt take place in different conditions. Restructuring efforts at home will necessarily reverberate on Korean firms’ overseas activities in the direction of sounder and more rational OFDI. As explained earlier, changes in the Korean context will favor market-orientation and lead to a relative erosion in the role of the chaebols. If such is indeed the case, overambitious overseas ventures are likely to come to an end, and OFDI will be more in line with economic logic. Streamlining of existing investments, as well as expansion of new sounder investments should be the rule in the years to come. In this respect, the financial crisis may come as a blessing in disguise and help restructure the Korean economy and avoid recurrent problems related to excessive diversification,
There is thus a strong presumption that Korean OFDI will be gradually rationalized in the wake of the crisis, with higher priority given to strengthening existing positions and reinforcing the commercial network rather than to further expansion of production capacities. It should be a priority of the Government to create the appropriate conditions for such necessary changes to materialize, yet this strategy is fraught with difficulties.

**Risks and challenges** A first risk has to do with the fact that financial constraints may hinder desirable new investments. A number of firms may have difficulties in finding adequate funding for their overseas projects for instance. Government assistance may be warranted in such circumstances but should be kept to a minimum and awarded under strict conditions and after a thorough assessment of the project under consideration.

As recalled earlier, the priority today is to make sure that OFDI is based on different and sounder grounds, in particular that it can contribute to enhancing the competitiveness of Korean firms and stimulating economic growth without giving rise to excessively risky ventures that may threaten the well-being and stability of the national economy as a whole. To this end, a number of measures can be imposed regarding the form of financing in order to avoid excessive foreign borrowing in particular. Yet, beyond these financing issues, a major difficulty pertains to the identification of the investments that should be encouraged and those that need to be streamlined. The assessment is all the more complicated since some investments may appear unprofitable in the short run but may turn out to be useful in the longer-term from the point of view of technology acquisition for instance. The challenge is to manage to strike a (tricky) balance between short-term objectives (currently dominated by financial profitability) and longer-term considerations (related to the preservation of Korean firms’ competitiveness).

From the perspective of firms, withdrawal decisions should be limited to cases when performance is really poor, while OFDI projects should be maintained for competitiveness preservation purposes, even in the absence of immediate visible results. In the latter case, public help may be again warranted.

From the point of view of the Government, the problem has really to do with the scope of its industrial policy. The promotion of OFDI is rather necessary for the improvement of international competitiveness, yet the difficulty is to determine which industries should be helped, under which
circumstances and where to set the limits for this assistance.

**Conclusion**

A salient feature of the Korean experience is the limited, but effective, role of FDI in the country’s economic development and restructuring. Until the Asian financial crisis, FDI into Korea remained minimal because of the lack of natural resources, the limited size of the local market (the growth of which was also held in check by Government policies), as well as because of the restrictive policy stance vis-à-vis foreign investors. Restrictions were imposed according to the priorities set by the Government rather than according to locational advantages. Although FDI has systematically been constrained, it played a non negligible role in changing the productive structure in Korea. In this respect, inward FDI has contributed very selectively to the development of Korea’s technological capabilities and contributed to the success of the country’s export-oriented strategy. More importantly, by channeling FDI into specific industries, public policies contributed to the enhancement of the competitive advantages of Korean manufacturers, thereby enabling them to eventually launch their OFDI. It is important to note at this stage that the real influence FDI could exert on the Korean economy has little to do with its magnitude in absolute terms.

The liberalization drive initiated in the mid-1980s remained modest, first because there was no perceived need to go ahead with such a move and second because of the pressure exerted by the chaebols. As a result, FDI was not fully used as an instrument of industrial restructuring and as a means of enhancing the economy’s overall efficiency, with the financial sector as a case in point. The recent crisis gave a renewed momentum to the liberalization move, with both friendly and hostile M&As being allowed. More than additional capacities in the form of greenfield investments, Korea needed more efficient capacities and more competition. The new surge of FDI is expected to help Korea develop new competitive advantages and be instrumental in enhancing economic efficiency. Again, even if FDI remains modest in absolute terms, its possible impact on the Korean economy should not be under-estimated. The mere presence of foreign agents matters, to the extent that they bring with them not only technological know-how but also new business practices and can contribute to stimulate competition. The crisis probably ushered in an entirely new era characterized by more openness and a larger role for market mechanisms. In this respect, FDI is likely to be more fully used as an instrument of restructuring and of promotion of transparency. For this change to
materialize, however, the momentum must be maintained over a long enough period of time. While it is still too early to make a definite assessment, the opportunity is there, and Korea should seize it. But it remains to be seen whether resistance to change will prevail or give in.

With respect to OFDI, Korea exhibits again specific characteristics. As a result of the emphasis on export orientation, Korean OFDI shifted rapidly from being of the resource-seeking kind to being primarily market-seeking and export-preserving. Korean OFDI took off in the mid-1980s as a result both of a change in public policy following the emergence of a current account surplus, and of various structural changes prompting both the chaebols and the SMEs to relocate part of their activities in less advanced neighboring economies. Korean OFDI in developing countries can be said to result primarily from the erosion in competitive advantages due to structural changes related to the level of development.

Since the early-1990s, there has been a new surge in Korean OFDI, which responds to more diversified and complex motivations. Korean OFDI in OECD countries in particular cannot be fully explained by the possession of strong ownership advantages, and may be better accounted for by other factors, such as the need to circumvent protectionist barriers or to acquire technological assets, as well as the traditional rivalry among the chaebols and their tendency to overstretch themselves. These ‘new’ investments also reflect a complex interactive relation between OFDI and structural change. In Korea, structural change may lead OFDI as much as it may be eased or fuelled by it. Yet the expansion of OFDI in the pre-crisis period was deemed by many to be to some extent excessive and premature. The crisis suggested that a number of policy options may have been flawed or, at least, that they may have reached their limits. It also revealed the inadequacy of some of the chaebols’ strategies (in particular their strategy of worldwide expansion was seriously put into question).

Since then, there has been a drop and a reorientation in OFDI flows, which are now likely to be more in line with Korea’s level of technological development. In other words, corporate restructuring efforts go hand in hand with streamlining of overseas projects. The challenge is, however, to make sure that rationalization only concerns those projects which are not economically warranted.

While Korean OFDI is likely to be trimmed down and restricted to sounder projects, IFDI is gaining more importance and helping change the way the Korean economy works domestically. An entirely revamped Korean economy is likely to emerge as a result of these post-crisis policy changes. Preliminary evidence suggests that these changes are likely to
erode the intimate relationship between the State and family-owned business groups, the economy is likely to open further to external influences, while the conglomerates’ involvement abroad is likely to be scaled down, or at least to proceed at a more reasonable pace. All this will lead to a more balanced internationalization of the Korean economy, as well as perhaps to a new form of economic governance, if, however, resistance to change does not prevail.

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