FDI INTO KOREA: REACHING THE NEXT PLATEAU

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on

Raising the Bar: Korea as a Global Economic Player

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I. Introduction

There are two types of foreign investments: foreign portfolio investment and foreign direct investment (FDI). The former consists in foreign investment flows into stock, bonds, money market instruments such as Treasury bills, commercial paper, etc. In such a case, foreign investors are not interested in participating in the management of the investee company and their primary objective is to realize higher investment returns in terms of dividends, interest income and capital gains through buying low and selling high. Such foreign portfolio investments are in essence the same as domestic assets management except that international portfolio investments involve foreign exchange risk due to exchange rate fluctuation in the investee country currency vis-à-vis the domestic or home country currency as well as the risk of capital blockage imposed by the host country government. The main motivation of foreign portfolio investments is to achieve investment diversification, so that you don't put all your investment nest eggs only in one basket, in this country, one national financial market. Various studies have demonstrated that portfolio diversification on a global basis tends to reduce the volatility of returns. Another reason for foreign portfolio investment is to search for higher returns that are sometimes available in foreign financial markets.

On the other hand, FDI is defined as those foreign investments acquiring 10 percent or more of the equity stake in the investee company in statistical terms but, in practical terms, those foreign investments not so much interested in immediate investment returns (like portfolio investments) in stock dividends and interest income but more interested in long-term gains through management involvement and strategic alliance with the investee company in a foreign country. Scholars have identified several reasons for a company to make FDIs in a foreign country. The company may be a raw materials seeker. This type of FDIs can be those by oil companies in search of oil fields, mining companies in coal, aluminum, copper and other mineral resources, and large agri-business firms in search of banana and tea plantations, etc. Some FDIs are in the form of efficiency seekers, when a company looks for lower manufacturing costs due to lower wages available abroad or closer markets for their products to save in transportation costs. Another type of FDIs is that of market seekers, when a company wants to penetrate a foreign market protected by high tariff walls and/or other non-tariff barriers such as textile quotas.

In the history of Korea's modern economic development from the early 1960s, FDI did not figure prominently in its development paradigm. The accepted wisdom of Korean economic policy makers during the early period was that FDI was a form of exploitation of cheap land, labor and raw materials by global MNCs (multinational corporations) from industrialized countries. The economic elites in Korea thought that MNCs continued through FDI the old colonial pattern of exploitation that left the developing countries selling raw materials to and buying consumer goods from the industrialized countries. MNCs controlled technology and global marketing channels and formed alliances with their host governments to exploit the people and keep them down. Such line of thought among Korean government elites reflects the prevailing view of Third World policy makers in those years, due to the early history of FDI in developing countries. Unlike FDI between industrialized countries where MNCs take advantage of their comparative strengths in management and product mix for mutual benefits of both MNCs and host country consumers, the early FDI from industrialized countries into their colonies was in most cases for the explicit purpose of exploiting the raw material base of these colonies.

Such pattern of FDI was especially pronounced in the cases of mining and plantation projects that were popular forms of colonial FDI. For example, Western oil companies would invest in new oil fields discovered in the jungles of South America or in the deserts of Arabia in order to supply crude oil to the modern oil refineries constructed back home. FDI in oil fields, copper mines, and plantations for tea, coffee and bananas in developing countries was mostly managed by Western expatriate staff that used to live with their families in enclaves carved out of their colonies. These enclaves had their own schools, stores, clubhouses and other recreational facilities for the exclusive use of the expatriate families and their friends, while local populations provided cheap source of manual labor as miners, field laborers, cooks, gardeners and nannies. This early pattern of FDI provided little positive spillover effects on the local economies of host countries, except for fattening the bank accounts of local rulers or tribal leaders who were paid handsomely by MNCs for the foreign investment concessions. It is not surprising, therefore, that newly independent countries in the developing world in the post World War II period did not look kindly toward both FDI and MNCs, and early Korean economic elites also succumbed to this naïve view of FDI.

Consequently, the Korean government used to restrict FDI rather tightly through a variety of regulations including complicated foreign investment procedures and numerous sectors of the economy designated off limits or severely restricted to foreign investments. As a result, Korea was one of the least hospitable countries for FDI for many decades of its modern development history. As late as 1996, the cumulative inward FDI stock as a percentage of GDP was the lowest among Asian tiger countries at only 2.6% for Korea while the average for all developing countries stood at 15.6%. The comparable figures were 7.3% for Taiwan, 15.7% for Hong Kong, 22.3% for China, 48.6% for Malaysia and 72.4% for Singapore. In fact, Singapore was the first among developing countries in the 1960s to realize that the traditional view of FDI was outdated in the post-colonial period and that MNCs could bring in much needed capital, management know-how, technology, marketing skills and, most importantly, new jobs for host countries. To encourage FDI actively, Singapore established in 1961 the Economic Development Board, which provided a one-stop service for investors including MNCs. This enlightened view of FDI among Singaporean leaders was further solidified during Prime Minister Lee Kuan Yew's sabbatical at Harvard, where, as recounted in his autobiography, he was most impressed among many illustrative professors there including Henry Kissinger, by the late Raymond Vernon of Harvard Business School. Lee Kuan Yew says that Prof. Vernon taught him the modern and more realistic view of MNCs, which seek out FDI opportunities abroad as part of their global strategy of synergy, resulting in a positive win-win game for both host countries and MNCs.1

Unlike Singapore and other Asian economies such as Hong Kong and Malaysia, Korea is a very late and reluctant converter to finally recognize the many virtues of FDI in the postcolonial era. And such conversion took place not so much as a result of deliberate policy deliberation inside Korea but almost forced to open up to FDI by external economic factors. Only when Korea joined OECD in 1966, the government had to realign its FDI regime in line with international norms by updating its laws and regulations. Thereafter, when the Asian financial crisis hit Korea in 1997, policy makers in Korea finally realized the importance of FDI to secure long-term foreign capital on a more stable basis as compared to short-term bank loans and other traditional sources of foreign borrowings.

II. Overview of the Changing FDI Regime in Korea

The Asian economic development model has often been described as that of the flying geese, wherein Japan, the lead goose, blazes the trail of uniquely Asian development patterns by a combination of active government guidance, selection of key industry sectors for priority development, and neo-mercantilist export promotion, all of which are then imitated more or less

1 Raymond Vernon developed the famous theory of product life cycle and he was a leading scholar in the field of MNCs and foreign investments. When Lee Kuan Yew was at Harvard for one semester on his sabbatical as a sitting prime minister, I was a doctoral student at Harvard Business School where Prof. Vernon was one of my mentors and later I arranged for his visit to Korea to give a series of lectures to senior business executives.

by other Asian tiger and tiger cub countries. During the past decade, however, the Asian flying geese formation increasingly resembled a flock of sick ducks, with Japan's lost decade and the tremor of the 1997-98 Asian financial crisis. Many have blamed the crisis on the "crony capitalism" practiced in Asia, where a cozy and murky relationship among the government, large businesses and banks led to a host of dubious investments financed by reckless bank loans, creating moral hazard problems. In the meanwhile, for better or worse the world economy has been increasingly integrated and synchronized. Thus, a serious policy debate has been raging in many Asian countries including Korea on the need for a new paradigm for economic development in the 21st century, leading to a changed view on the role of FDI in economic development.

In the early period of Korea's economic modernization starting from the 1960s, the government encouraged the inflow of foreign capital in order to make up for the shortage of domestic savings and foreign exchange reserves. However, the government preferred foreign borrowing to FDI because of its fear of Korean industries being dominated by foreign entities in the case of FDI. Such xenophobic suspicion of foreign economic domination was deeply rooted in Korea's bitter experience of Japanese colonization from 1910 to 1945. The government felt that foreign borrowing could bring in external capital but still under its own control. When two Free Export Zones were established at Masan in 1970 and Iri in 1974, the government allowed FDI in the light manufacturing export sector but with stringent performance requirements such as mandatory export quotas and technology transfer. Another factor working against FDI in Korea during this period was the relative cost structure of capital. During the period of inflation and high domestic interest rates, foreign borrowing at much lower nominal interest rates seemed far preferable for the Korean economy to foreign equity capital infusion through FDI. It is a basic financial truth that the nominal cost of equity financing is always much higher than the cost of debt financing, but a high financial leverage (or a high debt to equity ratio) has its own hidden cost in terms of greater volatility of profits, often leading to bankruptcies during an economic recession and declining revenues. For this reason, Western firms try to maintain a proper debt to equity ratio in order to minimize the bankruptcy risk. However, Korean businesses were generally both ignorant and dismissive of such leverage risks, believing in the government's bailout during a time of crisis in the environment of crony capitalism. The bigger the size of a firm, the more audacious its management became in ignoring the leverage risk, firmly trusting its government to bail it out during a financial crisis. Such a mentality of "too-big-to-fail" syndrome was prevalent especially among large Korean conglomerates known as chaebol, which naturally relied more on foreign borrowing than on foreign equity investments.[2]

A minor crack appeared in the Korean government's anti-FDI stance during the 1980s as a result of the dismal failure of the ambitious Heavy and Chemical Industry Promotion Plan launched in the 1970s, which relied on large chaebol firms to embark on reckless investments in heavy and chemical industries without adequate technology and equity capital base and instead relying on excessive policy loans arranged through the government. The government finally realized that FDI could be a key channel to introduce not only the essential equity capital but also the management know-how and technological base essential to modern business ventures. Linkages with MNCs could also provide the crucial marketing channel through their global network. In 1984, therefore, the government replaced the positive list system of restricting foreign investments with a negative list system, and it further liberalized the FDI regime in 1989 by abolishing various FDI performance requirements such as export, local content, and technology transfer. The government also lifted the universal requirement that foreign ownership ratio must be less than 50% for all FDI projects.

In the 1990s the government continued to liberalize its FDI policy, introducing for the first time in 1991 the system of foreign investment notification for certain FDI projects in lieu of the mandatory investment approval system for all FDI projects. By 1992, the notification system became the rule and the approval system the exception for foreign investments. In 1993, the government launched a 5-year plan to promote FDI in 132 sectors out of the previously restricted 224 sectors. In 1994, foreign investors were allowed to notify new investments not just at the

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2 The too-big-to-fail (TBTF) concept also exists in the Western developed countries but it is mostly limited to large financial institutions, whose failures might lead to the widespread systemic risk far outweighing any moral hazard problem inherent in a government bailout.

central government or the Bank of Korea but also at other commercial banks licensed to handle foreign exchange business. When Korea joined OECD in 1996, the government launched a major effort to realign its FDI regime in line with international norms and standards. In January 1997, the existing Foreign Capital Inducement Act was amended into the Act on Foreign Direct Investment and Foreign Capital Inducement and the government made a commitment to OECD to liberalize in three years 47 out of 81 sectors still restricted at that time. Also starting from February 1997, FDI was allowed not just in greenfield investments but also in existing projects through friendly M&As, defined as receiving consent of the board of directors of the investee company. Nevertheless, the basic government posture toward FDI during this period was that of tolerance rather than active promotion a la Singapore or Malaysia.

It was the Asian financial crisis of 1997-98 that caused a sea change in Korea's FDI regime. The new Kim Dae-jung government that took office in February 1998 embarked upon a major economic reform, including the promotion of FDI in Korea with the aim of overcoming the financial crisis and strengthening the international competitiveness of the Korean economy. Of course, the economic reform was a major condition of the $58.4 billion rescue financing package provided by multilateral institutions such as the IMF as well as a secondary line of credit from G-7 countries. One of the major objectives of the reform was to drastically improve Korea's foreign investment climate in the recognition, belated but still laudable, that increased inflows of FDI are essential to rebuilding the economy's competitive strength, because FDI brings with it new technology, advanced management know-how and strategic alliances with foreign partners. Thus, the Asian financial crisis changed the government stance regarding FDI from that of passive liberalization to one of active promotion.

The new government's adoption of sweeping measures to actively promote FDI is demonstrated by the enactment of the Foreign Investment Promotion Act (FIPA) of 1998, which focuses on creating an investor-friendly environment in Korea. With the passage of FIPA, Korea's FDI regime was effectively liberalized. Currently, 99.8% of Korea's economy is open to foreign investment, a level on par with that of other OECD countries. Only two out of a total of 1,060 sectors, radio broadcasting and television broadcasting, are closed to FDI, while 27 sectors such as some agricultural sectors and electricity business are partially restricted to FDI and they are scheduled to be further liberalized in the near future. Also, the amendment to the Foreigner's Land Acquisition Act in 1998 completely removed any restriction on foreign ownership of land, property and dwellings. Thus, foreign-invested companies are being accorded the same rights and treatment as domestic companies.

In addition to encouraging new business formation through FDI, Korea has now paved the way for FDI in existing businesses through both friendly and hostile M&As. With the passage of a bill in May 1998, even hostile M&As are now allowed in Korea in parallel with the global trend. During the 1990s the value of cross-border M&As globally rose by more than sevenfold from $151 billion in 1990 to $1.14 trillion in 2000. As of 2000, M&As comprised some 90% of total FDI in the world. In the case of Korea also, M&As have increased their share in total FDI inflows, exceeding greenfield FDI by a wide margin.

III. Factors Influencing FDI Inflows

There is a fierce competition among many countries around the world to attract FDI to their own countries. The locational decision for any FDI is a crucial one to an MNC for the success of its foreign investment. In this process, a company evaluates numerous aspects of doing business in a particular country in terms of its investment environment whose main components are political, government, economic and business. The first component deals with the degree of political stability, including the possibility of social and political unrest, riot, coup, revolution, and war. The second is concerned with the government policies regarding laws and regulations on FDI, investment restrictions, investment incentives, trade restrictions, intellectual property rights, investment advisory process, and foreign exchange regulation on currency conversion and profit remittances. The third focuses on the size and growth rate of the economy and the macro-economic and industrial policies pursued by the host government. Finally, the business environment is determined by the degree of social infrastructure development such as power and transportation, wage levels and the degree of labor skills and labor mobility as well as labor militancy, and the cost of land and office buildings.

Many MNCs have developed elaborate in-house grading systems to evaluate various countries before deciding on the location of an FDI project. The type of a project also influences the location decision. For example, mining projects involve less elaborate decision criteria due to the company's need to develop a particular mine at a particular country. On the other hand, various manufacturing FDIs for serving primarily world export markets could be more flexible in the location decision and consequently the evaluation of various factors should be more thorough in order to pick the most advantageous location for FDI. Therefore, a country that wants to attract FDI has to structure its incentive package considering the types of FDI that it wants or is likely to attract. Korea is not endowed with abundant raw material resources such as oil fields or mineral deposits to be developed through FDI. Instead, it has a plentiful supply of industrious and high-skill labor as well as a significant technology base and a well-developed social infrastructure. Korea also has the thirteenth largest economy with a relatively broad and sophisticated consumer market. These factors imply that Korea would be attractive to both manufacturing and services FDI aimed at both local and world markets.

IV. Investment Incentives and Pro-FDI Institutional Reforms in Korea

The tax incentives granted to FDI under FIPA and the Special Tax Treatment Control Act are primarily aimed at attracting high technology and large-scale manufacturing investment that creates jobs and generates increased tax revenues. New FDI businesses are eligible for special tax incentives if they are connected with high technology, service businesses that support the international competitiveness of domestic industries, and businesses located in a Foreign Investment Zone (FIZ). They are eligible for corporate and income tax exemption for the first seven years and are entitled to a 50% tax reduction for the following three years. Corporate income tax on royalties for induced high technologies is exempted for five years. Also exempted are customs duties, special excise tax, and value added tax (10%) on capital goods imported within three years from the date of investment notification. Foreign investors are also free from double taxation if their home country is a signatory to a tax convention with Korea, which has signed such conventions with 53 countries as of early 2002. FIPA also encourages local governments to promote FDI. At the provincial level, foreign investors are exempt from local taxes for a period of eight to fifteen years.

The FIZ program allows foreign investors to designate their preferred site for their business operations and to receive all the tax incentives and other benefits available to eligible investors. In order to qualify for a FIZ, new FDI manufacturing businesses should generate foreign investment of over $50 million, over 50% foreign ownership and creating over 1,000 new jobs, or over $30 million new investment and creation of over 300 new jobs in the Industrial Parks which are located in pre-designated areas in an effort to attract large-scale foreign investment in manufacturing industries. Currently, there are four national industrial parks, and the government plans to expand the existing areas as well as construct a new complex. Industrial parks offer factory sites at low prices, and rental fees there are reduced. Since the government purchases land for building an industrial park before renting it to foreign-invested enterprises, the initial costs for starting business there are reduced and the period for establishing a factory is shortened. In addition, a one-stop service is provided for establishment of factories. But a major shortcoming in the industrial park system is that foreign investors have no say concerning the specific business location. To overcome this shortcoming, the government has introduced the FIZ system. With approval from the Foreign Investment Committee, chaired by the Minister of Finance and Economy, local governments can designate certain areas as FIZs upon the request of foreign investors.

As a testament to Korea's new commitment to FDI promotion, two administrative vehicles were established to support foreign investment. The Korea Investment Service Center (KISC) was founded in April 1998 within the Korea Trade-Investment Promotion Agency (KOTRA) to provide one-stop service system for foreign investors with administrative services ranging from initial consultation to factory move-in. Foreign investors do not, in principle, have to obtain government approval prior to their investment in Korea. The first step is simply to notify the government of a foreign direct investment. KISC is authorized to accept the notification along with designated foreign and domestic banks. A KISC official operates as a proxy for the investor, taking care of the entire approval procedure involving relevant administrative institutions until a decision on the application is made.

In order to address grievances and difficulties of foreign investors and foreign invested enterprises, the Office of the Investment Ombudsman (OIO) was established in October 1999, also within KOTRA. The word ombudsman is used in many fields to describe people who monitor sectors such as the media and politics. Japan set up the Office of Trade and Investment Ombudsman in 1982 to handle complaints from foreign and local firms concerning government regulations. The objective of the OIO is to address and resolve any difficulties pertaining to business and daily living conditions experienced by foreign-invested companies in Korea through prompt aftercare service in collaboration with KOTRA and relevant government ministries. Along with the Ombudsman, an “Investment Home Doctor” program was also introduced. Each “Home Doctor” is assigned to a foreign-invested company to provide the company with various services such as solving grievances, providing business information, and obtaining business permits.

V. Evaluation of Recent FDI Performance

The results of Korea’s liberalized FDI regime during the past four years have been rather impressive. According to one estimate, the total amount of FDI inflows into Korea during the four-year period of 1997-2001 was $52 billion, far exceeding the amount of $25 billion accumulated over the previous 35-year period of 1962-1996. While such statistics are impressive indeed, we have to be careful in interpreting the data, as there are three different estimates of FDI inflows: notification basis, arrival basis, and balance of payment (BOP) basis. FDI is defined as foreign equity investments of more than 10% of equity capital of foreign-invested companies in Korea as well as intra-company loans with maturities of five years or more. Notification and arrival basis measures are from the administrative records of the Ministry of Commerce, Industry and Energy (MOCIE), while the BOP measure is collected by the Bank of Korea (BOK) using both foreign exchange receipts and payments statistics maintained by the BOK and the MOCIE data. This BOP measure combines three elements: purchase of equity, retained earnings, and net lending from parents to subsidiaries. It is close to the arrival basis measure for most years and it is used broadly including the official IMF statistics contained in such IMF publications as the *International Financial Statistics.* Both the arrival and BOP basis measures are more realistic than the notification measure since some FDI projects are subsequently cancelled and withdrawn after their initial notification.

Table 1: FDI Inflows into Korea
(Unit: $ millions)

Year	Notification Basis	Arrival Basis	BOP Basis
1962-1981*	93	74	68
1982-1986*	354	232	188
1987-1988*	1,174	760	815
1989	1,090	812	1,118
1990	803	895	789
1991	1,396	1,177	1,180
1992	894	803	728
1993	1,044	728	588
1994	1,317	992	809
1995	1,947	1,362	1,776
1996	3,203	2,310	2,325
1997	6,971	3,088	2,844
1998	8,853	5,221	5,412
1999	15,542	10,598	9,333
2000	15,690	10,185	9,283
2001	11,870	NA	3,198

Source: Ministry of Commerce, Industry and Energy, *Trends in Foreign Direct Investment*, 2002, and Bank of Korea, *Balance of Payment Statistics*, 2002.

On the BOP basis, the amount of FDI inflows into Korea reached the peak during 1999 and 2000, matching those heading for Japan, a far larger market with its GDP almost ten times that of Korea. However, FDI inflows into Korea sharply declined in 2001, reflecting a marked slowdown in corporate restructuring and thus much less opportunities for cross-border M&As. In terms of geographical origin of FDI inflows into Korea, the Japanese share experienced a precipitous decline from 16% of the total in 2000 to only 6% in 2001, while the U.S. share increased from 19% to 33% during the same period. The slowdown in FDI inflows has continued in 2002, especially with an 18% year-on-year decline during the third quarter. In comparison, the lion's share of FDI inflows is destined for China and Hong Kong, while Singapore and Malaysia attract also a far bigger share of FDI per capita than Korea.

Table 2: Annual FDI Inflows into Selected Asian Countries, Actual and Forecast
(Balance of Payment Basis)
(Unit: $ billions)

	1999	2000	2001	2002	2003	2004	2005	
Korea	9.3	9.3	4.7	5.6	5.6	6.0	6.8	
China	38.8	38.4	46.8	50.0	55.0	60.0	65.0	
Hong Kong	24.6	61.9	27.0	26.0	27.5	28.2	28.5	
Japan	12.3	8.2	5.1	5.2	5.4	5.9	6.9	
Singapore	7.2	6.4	5.9	6.6	6.2	6.8	7.2	
Taiwan		2.9	4.9	4.3	4.5	4.7	5.4	5.9
Malaysia	1.6	3.4	2.4	3.2	4.5	4.6	4.7	

Source: *World Investment Prospects 2002.*

With China's entry into WTO in 2001, FDI flows into China are likely to accelerate still further.

In the early years, many foreign investments in China were made with the main objective of penetrating the potentially large Chinese market with 1.2 billion people. However, foreign companies have quickly discovered that manufacturing plants in China can produce high quality products at much lower costs for global export markets as well due to the highly efficient work force with much lower labor costs. Thus, China has gradually become an important manufacturing base for many MNCs from around the world as a vital part of their global supply chain management. In recent years, China has become not only the major production center for labor-intensive goods but also for a growing array of high tech products as well.[3] China has attracted FDI flows not only from American and European firms but also from Japan and increasingly in recent years from Korean firms that are in desperate search of lower labor costs with less labor militancy. Thus, China has become a major threat to Korea in attracting FDI inflows. How to compete with China in the fight to win FDI flows has become a major challenge for Korea.

It is interesting to note that in the third quarter of 2002 FDI in services accounted for three-quarters of the total FDI in Korea, while the manufacturing FDI took up only one quarter. In fact, the share of services in total FDI inflows into Korea has experienced a steady and notable increase over the past several years, from 54% in 1999 to 69% in 2001, while the share of manufacturing sector FDI decreased from 46% to 31% during the same period. The increasing importance of FDI in services reflects the changed business patterns in many post-industrial economies of the developed world. Combined with the globalization of businesses and Internet-based technology platforms, FDI in services has caused the emergence of vast multinational service industries spanning the globe in such fields as telecommunications, finance, transportation, and retail distribution. FDI allows MNCs to engage in outsourcing strategies in services. An increasingly wide array of service functions is now being performed offshore in places such as India, Ireland and China, which can provide low-cost, high-quality, English-speaking labor pools that are now easily connected to multinational corporate networks through the Internet. These services are no longer limited to low-value-added remote call centers or document processing centers. The outsourcing of services is now involving increasingly high-

3 “High Tech in China: Is It a Threat to Silicon Valley?” *Business Week*, October 28, 2002.

value-added activities such as software development, remote e-mail help desks, accounting, production layout design, logistics tracking, network management, telemarketing, remote billing and subscriber management, transcription and translating services, engineering services, systems integration, etc.

VI. Economic Costs and Benefits of FDI

Along with the robust expansion of international trade in goods and services as well as the technological developments such as the Internet and other modern telecommunication services, international investments have always played an important role in the globalization of the world economy. International investments are composed of portfolio investments in search of higher effective yields in dividends and interest income on the one hand and direct investments involving management and strategic alliances through equity stakes on the other. Both scholars and policy makers have debated for many decades the economic costs and benefits of FDI. Of course, such a debate has to clarify first of all the type of FDI in order to engage in meaningful discussions. Unlike the earlier FDI during the colonial period in the eighteenth and nineteenth century when many FDI projects were so structured as to maximize the exploitation of local raw material resources by foreign colonial companies without much spillover effects on the local economy, the new breed of FDI is based on the more benign model of synergistic collaboration maximizing the comparative advantages of both investors and investees for mutual benefits.

The paradigm change in the FDI regime in Korea was occasioned by the twin events of Korea's accession to OECD in 1996 and the Asian financial crisis of 1997-98. Since then, the domestic debate on the costs and benefits of FDI has been intense, sometimes with a political overtone and finger pointing among vested interests. As was mentioned earlier in connection with the case of Singapore, the modern consensus among scholars and policy makers has affirmed the positive aspects of FDI far outweighing any potential negative impact on a host country. In the case of Korea in the aftermath of the 1997-98 financial crisis, the majority in the government and the scholarly community seems to have concluded that both inward and outward FDI in the regime of a more liberalized economy tends to bring about more benefits than costs. Such benefits of FDI can be summarized in six major categories.

First, FDI brings in long-term capital without requiring mandatory debt service such as principal repayments and interest costs, thus constituting a more stable source of foreign capital, unlike bank loans and portfolio investments which are comparatively more volatile and risky. In this case, Korea remembers well the lessons of the 1997 financial crisis which was triggered by the excessive reliance on foreign bank loans, especially loans with short-term maturities, in order to bridge the savings gap, rather than through more stable FDI inflows. As the volatility of international capital flows in recent years has increased dramatically in a more synchronized stock market movement and as trading volumes on various financial markets exploded astronomically across the globe, the risk of relying on bank loans and portfolio investment flows for external capital has dramatically risen as well.[4]

Second, FDI enhances the economic efficiency globally through a more optimal allocation of investment resources by matching capital, labor, technology and management without the limitation of national borders. Such efficiency gains lead to enhanced economic growth. For example, an econometric study by Korea Institute for Industrial Economics and Trade (KIET) shows that annual one percent increase in FDI over 5 years would result in 0.056% growth in GDP. Another similar empirical study finds that firms and sectors with high levels of FDI in Korea have greater average labor productivity, pay higher wages, and record larger R&D expenditures.

Third, greenfield FDI creates jobs and thus generates new tax revenues through new investments. This will trigger rising consumption and investment, generating a continuous cycle for reinforcing national wealth. FDI also has a positive effect on labor quality, as many MNCs have developed advanced training programs for their employees both on the job and off site. Fourth,

4 For example, the daily trading volume in the global foreign exchange market is over $1 trillion and the daily fund transfers handled by the global SWIFT (Society for Worldwide Inter-bank Financial Telecommunications) network alone exceeds $5 trillion, which is half the size of the annual GDP of the United States. In addition, major banking institutions such as the Bank of America and Citibank operate their own global fund transfer networks.

FDI opens up more export markets for Korea-made products by benefiting from the strong existing global distribution channels maintained by MNCs, thereby favoring the balance of payments for Korea. During the initial operation of foreign affiliates, their imports may be more significant due to the need for importing capital equipment and other investment goods as well as some raw materials not sourced locally, but over time, the net trade effect would be positive after the initial capital investment is finished and as more raw materials are sourced locally. According to an analysis by KIET, the exports of foreign-invested firms in the manufacturing sector in 1999 contributed to a $4.8 billion net trade surplus. Fifth, foreign companies' introduction of new management know-how and technology has a positive spillover effect on the economy. Successful global MNCs introduce advanced management and technology to a host country such as Korea, and local companies in turn acquire modern management, marketing and other important business skills, thereby enhancing their own international competitiveness. Finally, FDI in the form of M&As facilitates economic restructuring by providing the needed capital to buy out the business line or assets of poorly performing local companies.

On the other hand, FDI has also generated a fierce opposition and backlash against the so-called "foreign invasion." While market liberalization and promotion of FDI generates net gains to the economy as a whole, critics contend that such net benefits are not evenly distributed across various groups of workers, businesses, regions or countries. Main opponents of FDI have cited other negative aspects such as outflows of national wealth and loss of sovereignty or discrimination against domestic producers. Some have claimed that the government is "selling out" to foreign investors through fire sale of Korea's hard-earned corporate assets. However, such "fair value" criticism is based on misunderstanding the concept of a fair value, which is not related to the net book value of an asset but the present value of future expected income streams to be generated by that asset. In Korea, however, the fair value used to be estimated by a static accounting concept of the net asset value. The "foreign domination" criticism also ignores the reality of today's corporate citizenship, which is practically a legal convenience as many MNCs, including American and European firms, elect to locate their legal headquarters in offshore tax shelters to maximize their after-tax profits for their shareholders. There are in reality no “foreign” firms as long as they conduct their business operations locally by hiring local workers and paying local taxes and sourcing raw materials locally, etc. The trepidation that raising the ceilings on foreigners’ equity ownership would invite hostile takeovers of Korean companies has proven largely groundless, as friendly M&As have constituted the mainstream rather than hostile ones.

VII. Views of Foreign Investors in Korea

Foreign invested companies over 50% foreign owned play an important role in the Korean economy. According to a recent Bank of Korea study of 149 such firms out of a total of 2,046 manufacturing companies, they contribute to 18.5% of total revenues, 21.2% of total value added and 9.7% of total employment. As of 2000, global giants such as Nokia, Motorola, Hewlett Packard, IBM and BASF have all realized sales revenues of over one trillion won, including significant amounts of exports, through their affiliates in Korea. KPMG Consulting conducted in 2001 a series of interviews with senior executives of foreign invested companies in order to obtain their views on various topics related to their operations in Korea. The interviews revealed that the main reasons for their FDI in Korea were economic factors such as market-seeking, where companies establish production facilities locally to avoid trade barriers like tariffs and quotas, as well as efficiency-seeking, where companies seek to gain competitiveness by utilizing low-cost production inputs from the local market.

In the case of foreign companies that had already been exporting to the Korean market through local agencies, the decision to invest in Korea was to benefit from market opportunities offered by rising domestic consumption and to boost their market shares. In addition, Korea’s convenient export location due to its proximity to other major Asian countries such as Japan and China and well-established infrastructure were also seen as positive factors in encouraging investment. Many foreign companies chose to invest in Korea as a production base in the Asian region due to Korea’s cost competitiveness in production as compared with other Asian countries. Consequently, they were able to benefit from economies of scale by concentrating on the production of only a few products for broader regional and even global markets. Some foreign companies that initially exported to Korea through local agents or engaged in joint ventures with local companies were found to have expanded their direct investment during the 1997 Asian financial crisis. In such cases, their Korean partners requested that the foreign partners buy them out as a means of boosting the Korean partners' liquidity.

As for the positive factors encouraging FDI in Korea, the country has a well-balanced industrial structure, which makes it relatively easy to acquire basic raw materials for production, and a well-developed basic infrastructure in fields such as telecommunications, electricity, gas and transportation. In addition, there is a more than adequate supply of well-educated and skilled personnel such as engineers, accountants and technicians across a wide range of industries and Korean workers have a proven high level of diligence and dedication. On the negative side, foreign businessmen focused on the labor militancy such as the demand for excessive pay raises and frequent demonstrations and strikes rather than engaging in an ongoing labor-management discussion process. They felt that the government should take a more active role in easing illegal and unfair labor practices. The image of Korean labor unions conveyed through the global media has a negative impact on attracting potential foreign investors, and foreign businessmen felt that the government should become more active in labor issues and enhance the labor market flexibility.

In addition, Korean consumers have tendencies to purchase products based on relations with counterparts rather than assessing the quality of the products themselves. In the case of laws and regulations pertaining to their business operations in Korea, the central and local governments sometimes have different interpretations of how they should be applied and this often causes confusion for businesses. In terms of daily living conditions, they cited as negative factors traffic congestion, pollution, inadequate education facilities for foreign children, and language barriers. Foreign schools in Korea are mostly based on American standards, which may not always be appropriate for foreign children from many different nationalities.

In the case of joint ventures, finding a good Korean partner was seen to be an important factor and having a majority share in the company and management control was viewed desirable as well. Foreign companies should also seek to prevent management and labor tensions by educating their staffs in the new corporate culture, respecting the employees and investing in them to help develop a sense of pride and loyalty to the company. It is also desirable for foreign firms contemplating FDI in Korea to seek the advice of foreign invested companies that have had extensive business experience in Korea.

VIII. Conclusions

The FDI regime in Korea has undergone a sea change within the past decade. The traditional government stance of suspicion and doubt about FDI has been replaced by that of active promotion due to two seminal events in the late 1990s. The first one was Korea's accession to OECD in 1996, which required the Korean government to liberalize its outdated and restrictive FDI regime in line with international norms and standards. The second was the 1997-98 Asian financial crisis, which pushed the Korean economy into the worst disaster since the end of the Korean War of 1950-53. While the Korean financial crisis was rooted in a variety of structural and systemic causes occasioned by the crony capitalism and the excessive government regulations, the immediate trigger of the crisis was Korea's heavy reliance on short-term foreign bank loans for meeting the savings gap. Both the government and the business community in Korea did not realize that excessive financial leverage, despite its short-term cost advantage, always carries a serious liquidity risk, a risk that has been amplified in recent years in an environment of synchronized financial market movements and global economic integration. In the aftermath of the crisis, there has developed a belated recognition in Korea that FDI can provide a more stable source of external capital as well as modern management know-how and technology that can enhance the international competitiveness of the Korean economy. Furthermore, FDI can provide other economic benefits in the areas of job creation, exports, corporate restructuring, and economic efficiency.

As a result of the paradigm change in Korea's FDI regime, the past several years have witnessed bursts of FDI inflows into Korea. However, one has to be careful in interpreting the FDI flow data, due to the fact that there are three distinct measures of FDI flows. The most misleading measure is the one based on notification basis, because many foreign investors can withdraw their previous investment commitments before actual fund disbursements as a result of changed business circumstances, both internal and external. The most realistic measure is the one on BOP basis, which estimates the FDI flows on the basis of actual investment receipts. On this measure, FDI inflows into Korea peaked in 1999 and 2000, and the trend in the past one and a half years is sharply downward.

It is true that the government has taken a variety of positive steps in recent years including legislative, regulatory and institutional reforms in order to promote FDI. However, there is a fierce competition for FDI among countries, especially Korea's neighbors such as China and Hong Kong, which have taken a lion's share of FDI inflows into Asia. Therefore, both the government and the business community in Korea need to redouble their efforts in a creative way to attract FDI. In this endeavor, the most constructive one is to improve the business and investment environment in Korea through further deregulation, labor market reforms, and modernization of corporate governance in line with international best practices. Furthermore, Koreans in general need to overcome the "hermit kingdom" mentality in order to survive and flourish in the globalized economy. It is encouraging to observe, however, that the lingering suspicion of FDI by Koreans is gradually being eroded with the growing recognition that FDI has played a vital role in helping to revitalize the economy following the 1997 financial crisis. Still, one has to admit that there are large pockets of resistance inside Korea against FDI, which is misunderstood as a form of fire sale of the nation's valuable assets rather than a creative force for economic growth in a win-win proposition. There remains a huge challenge to educate the Korean public of the positive effects of FDI for the country in this era of globalization.

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