

FDI and the Economic Status of Korea: The Hub Strategy in Perspective

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Introduction

Since the 1980s, multinational companies, which have emerged as major actors in the globalization context, have experienced a quite remarkable reversal of fortune. After decades of skepticism or even hostility, a belief has developed that multinationals can substantially contribute to a country's development strategy. As a consequence, governments around the world—in both advanced and developing countries—have been wooing multinationals. This evolution may be related to the broader context of liberalization in which most developing and transition countries have moved to market-oriented strategies. The changing attitude of governments toward multinationals may nevertheless be considered as a striking policy change in developing and emerging countries.

Korea has followed a specific path in this evolution. Korean state policies toward multinationals remained restrictive and selective until the 1980s and were hesitant until the late 1990s. The situation has evolved more clearly after the Asian crisis, and Korea now actively tries to stimulate inward investment, which has nevertheless dramatically decreased since the 1999–2000 peak. Attraction of multinational companies has now become a central component of Korea's business-hub strategy.

This paper studies the changes in Korea's foreign direct investment (FDI) policies and examines the recent evolution of foreign investment in order to discuss the current hub-based development strategy. It

argues that the focus on the needs of foreign companies and the promotion of exclusive economic zones may not contribute to Korea's much-needed broader reforms. After decades of hostility to multinationals, Korea may overreact to the successes of other Asian countries in attracting FDI.

A Progressive Paradigm Change

From the 1960s to the 1980s, restrictions on foreign ownership and activities in host developing countries were related to broader policies, which tended to promote local companies as part of import substitution strategies. These policies have logically limited foreign ownership but have also slowed technological transfers and restricted opportunities to integrate export networks for a number of countries.¹ Korea generally followed an export promotion strategy, but it also promoted import substitution in specific sectors and has been keen to nurture national industrial groups. In the early 1960s, Korea established powerful institutions such as the Economic Planning Board to design and implement five-year plans that sequentially targeted development of different industrial sectors.² FDI and technology imports have been closely coordinated with these plans. In particular, foreign investment was allowed in sectors in which Korea needed technical assistance. The state developed elaborate bureaucratic mechanisms to steer foreign investment in the targeted sectors and to facilitate technology transfer as a basis for the development of domestic enterprises.³ As a result, foreign control was rare and closely monitored.

1. For a recent survey of the literature on developing and emerging countries, see Sachwald, F., and Perrin, S., "Foreign Direct Investment in Developing Countries: Leveraging the Role of Multinationals," TIK working paper no. 14 (Oslo, University of Oslo, 2002).

2. Amsden, A. H., *Asia's Next Giant* (Oxford University Press, 1989); and Noland, M., and M. Pack, *Industrial Policy in an Era of Globalization: Lessons from Asia* (Washington D.C.: Institute for International Economics, 2003) have proposed quite different assessments of the role of the developmental state. This paper focuses on FDI policies.

3. Mardon, R., "The State and the Effective Control of Foreign Capital: The Case of Korea," *World Politics* (October 1990).

Korea had started to open to FDI during the 1960s but reversed this policy in the 1970s, in particular to encourage joint ventures rather than fully foreign-owned units. Foreign investors had first been welcome to enter light-manufacturing export sectors, but the Korean government then wanted to promote large or high-tech projects. Moreover, the government supported the acquisition of the share of joint ventures owned by foreigners once the Korean partner had benefited from a technology transfer. Such a pattern was observed, for example, in petroleum refining and in some advanced construction technologies, which Korean firms needed to win large-scale contracts with Middle Eastern countries in the late 1970s.⁴ Similarly, while foreign investment in the financial sector had previously been severely restricted, the government encouraged leading banks to enter joint ventures in the late 1970s with the objective of accessing advanced financial technologies and upgrading services in Korea.

Although elaborate restrictions and specific incentives resulted in technology transfers with minimum foreign control in a number of sectors,⁵ Korean policies have not encouraged FDI in sectors requiring sophisticated technology. As the Korean groups came nearer to the technological frontier in a number of sectors, they continued to invest in learning and established internal research and development (R&D) operations, but they nevertheless needed a closer contact with frontier technology. In the 1980s the new Korean industrial strategy, which constituted an attempt to upgrade the industrial structure by moving into more technology-intensive activities, thus made FDI a priority again.⁶ This outward turn was an attempt to

stimulate technology transfer. One objective was to simplify administrative procedures and reduce discrimination against foreign companies. Various measures also allowed more foreign ownership and increased the number of industries open to FDI. The trend was thus favorable to FDI, but slow or incomplete implementation suggests that Korea was still caught in the attraction-aversion dilemma vis-à-vis multinationals.⁷

The persistence of the dilemma in Korea results from the long-lasting influence of the developmental state, which has continued to play a strong planning and monitoring role. Administrative guidance aimed at steering investment in desired industries and at promoting exports created costs, delays, and opportunities for corruption. As a result, the business environment was more uncertain and risky for foreign investors, and the government tried to compensate for these disincentives with incentives such as tax exemptions and subsidies. But again, such incentives may not have been sufficient to attract high-quality investment, in particular in high-tech sectors. As a consequence, during the 1990s, the liberalization process was stimulated by both the desire to attract foreign investment in high-tech activities and external pressures, in particular from Organization for Economic Cooperation and Development (OECD) members that demanded that Korea reduce barriers to FDI and match the practices of other developed countries before it could join the organization.⁸

Even though the Korean government made efforts to liberalize FDI in the 1990s, effective progress remained slow and uncertain until the end of the decade.⁹ Ko-

4. Ibid.

5. In 1980, foreign-owned firms made up 14 percent and majority foreign-owned firms made up 12 percent of foreign-invested firms in Korea (Ibid.). Foreign ownership was thus very low in comparison with other host countries; see Desai, M., J. Foley, and J. Hines, "International Joint Ventures and the Boundaries of the Firm," working paper (Boston: Harvard Business School, July 2002).

6. Kim, J-d., and Wang Y., "Toward Liberalization of International Direct Investment in Korea: Retrospects and Prospects," working paper no. 96-02 (Seoul: Korea Institute for International Economic Policy, April 1996).

7. Stoeber, W. A., "Attempting to Resolve the Attraction-Aversion Dilemma: A Study of FDI Policy in the Republic of Korea," *Transnational Corporations* 11, no. 1 (April 2002).

8. Ibid.

9. Nicolas, F., "A Case of Government-Led Integration into the World Economy," in *Going Multinational: The Korean Experience of Direct Investment*, ed. F. Sachwald (London: Routledge, 2001).

rea allowed FDI into a larger number of activities, eased policies on approvals, and created incentives especially for high-tech investments, but various impediments remained and implementation was only partial, notably because of resistance among lower-level bureaucrats. Foreign companies kept complaining about bureaucratic procedures and controls. In 1996–97, with Korea’s accession to the OECD,¹⁰ a new set of measures—including the liberalization of policies on friendly mergers and acquisitions (M&As) by foreigners—was put into place. The real turning point toward Korea’s active promotion of FDI came with the 1997 financial crisis.

In early 1998, the administration named by newly elected President Kim Dae-jung was pressed to carry out massive structural reforms in many segments of the economy as a condition for the rescue financing package.¹¹ The liberalization of Korea’s investment regime was one of the key reform areas since previous measures had been insufficiently effective. At the same time, Korean researchers and policymakers identified weakened competitiveness as a fundamental cause of the financial crisis and considered that FDI was one way to strengthen Korea’s technological capability.¹² One of the top economic policy priorities of the new administration was centered on attracting FDI with the aims of, first, overcoming the currency crisis and, second, stimulating industrial upgrades. The first motivation was very strong because of the acute financial crisis, but it was short-lived. The second motivation, which constitutes an internal rather than an external pressure to promote FDI, should have long-term effects. It constitutes yet another pressure in

favor of a paradigm change in terms of development policies, with less support for indigenous groups and stronger promotion of an open and cosmopolitan economy.

At the end of the 1990s, the combination of external and internal pressures to stimulate FDI led indeed to a truly more favorable regime, based on a combination of further liberalization and new incentives. The Foreign Investment Promotion Act (FIPA), passed in November 1998, created an investor-oriented environment by streamlining procedures, including a new one-stop service to assist foreign investors.¹³ The 1998 FIPA also expanded incentives in order to make Korean incentives competitive enough with those of other Southeast Asian countries. Complementary measures have also contributed to open Korea to foreign investment. The government has eliminated ceilings on foreign equity ownership in the stock market and allowed hostile cross-border takeovers. In July 1998, the full liberalization of foreign land ownership has also been considered as an important change. Finally, one important step in these recent evolutions was the October 1999 establishment, within the Korean Trade-Investment Promotion Agency (KOTRA), of the Office of the Investment Ombudsman.

As a result of this set of measures, by 2000 Korea’s level of FDI restriction was much more comparable with that of other OECD member countries. According to a composite indicator of FDI restrictions, that level nevertheless remained relatively high in comparison with European countries and the United States.¹⁴ For the period 1998–2000, most OECD countries had

10. Accession occurred in December 1996.

11. Provided by the IMF in cooperation with the World Bank, the Asian Development Bank, and the G-7 countries.

12. See for example, Hong, Y-s., “Technology-Related FDI Climate in Korea,” working paper no. 98-15 (Seoul: KIEP, December 1998); and Kim, J-d., “Inward FDI Regime and Some Evidence of Spillover Effects in Korea,” working paper no. 99-09 (Seoul: KIEP, June 1999).

13. Korea had previously attempted to simplify procedures with such a one-stop service in 1972, and again in 1997. Stoeber, “Attempting to Resolve the Attraction-Aversion Dilemma” considers these repeated attempts as a sign of the implementation problems met by FDI liberalization in Korea.

14. The indicator focuses on statutory barriers to FDI and ignores most other direct or indirect obstacles. It includes three sets of restrictions: limitations on foreign ownership, screening or notification procedures, and management or operational restrictions; see Golub, Stephen S., “Measures of Restrictions on Inward Foreign Direct Investment,” Economics Department working paper no. 357 (Paris: OECD, 2003).

a lower level of restrictions; Austria, Australia, and Mexico had a similar level; and only Turkey, Canada, and Iceland had a higher level than Korea.

This brief review of the evolution of FDI policy shows that internal pressures in favor of liberalization mounted each time Korea wanted to stimulate the transfer of resources such as capital and, increasingly, technologies and managerial competencies. Korea has consistently tried to stimulate technology transfers from leading countries while it has tried to minimize foreign control, but, as the country has needed access to more sophisticated resources, it has accepted larger foreign ownership.

It is interesting that outward direct investment (ODI) has also been liberalized in Korea in order to ease the evolution of the industrial structure and access to foreign technology. At the end of the 1980s, the liberalization of ODI helped the traditional labor-intensive industries, which were losing competitiveness, to relocate in less-developed countries. Korean groups also resorted to ODI to surmount protectionist barriers in the United States and Europe, in particular in the electronics and automobile sectors.¹⁵ Finally, a small share of the mounting ODI in the 1990s was aimed at technology sourcing by the Korean groups, in particular through acquisitions and participation in U.S. high-tech companies. The most ambitious of these strategic moves met with managerial difficulties and had mixed results, however.¹⁶ With hindsight, it is apparent that a number of these technology sourcing investments were highly risky operations.

After ODI and FDI Bubbles

During the 1970s and 1980s, as a result of restrictive policies, FDI was very low in Korea. In particular, it represented a substantially lower share of gross do-

mestic capital formation than in other East Asian countries.¹⁷ *Table 1* shows that openness to FDI in Korea has remained low relative to both developed and developing economies.¹⁸ Korea ranks closer to Japan and India than to other Asian countries—even after the 1997 crisis, which lowered the attractiveness of some emerging countries.

Table 1: Inward FDI Flows as a Percentage of GDP

Countries/ areas	1980–81	1990–91	2000–01	2001	2002
World	0.6	0.8	3.6	2.4	2.0
Developed countries					
EU	0.6	1.2	7.2	4.1	4.4
Ireland	1.2	2.1	17.1	9.5	15.9
France	0.5	1.0	3.7	4.0	3.6
Germany	0.0	0.2	6.1	1.7	1.9
UK	1.5	2.2	6.0	3.8	1.6
US	0.7	0.6	2.1	1.2	0.3
Japan	0.0	0.0	0.2	0.1	0.2
Developing countries					
China	0.1	1.1	3.9	4.0	4.3
Brazil	0.9	0.2	5.0	4.5	3.7
Malaysia	4.4	7.1	2.4	0.6	3.4
Poland	—	0.3	5.4	5.0	2.2
Mexico	1.2	1.6	3.3	4.0	2.1
Hungary	0.0	2.7	4.1	4.6	1.3
Thailand	0.7	2.5	2.8	3.3	0.8
India	0.0	0.1	0.6	0.7	0.7
Korea	0.1	0.4	1.4	0.8	0.4

Source: Calculations based on United Nations Conference on Trade and Development (UNCTAD) and World Bank data.

Figure 1 suggests that the closest match with Korea is Japan because ODI started to increase first and was higher than FDI until 1997. This pattern is of course to be related to the evolution of public policies discussed in the previous section. The government that took office in 1993 initiated a broad globalization policy (*segyehwa*) aimed at lifting Korea to interna-

15. Perrin, S., “The Internationalization of Korean Electronics Firms: Domestic Rivalry and Tariff-Jumping,” in *Going Multinational: The Korean Experience of Direct Investment*, ed. F. Sachwald (London: Routledge, 2001); and Lautier, M., “The International Development of the Korean Automobile Industry,” in *Going Multinational*.

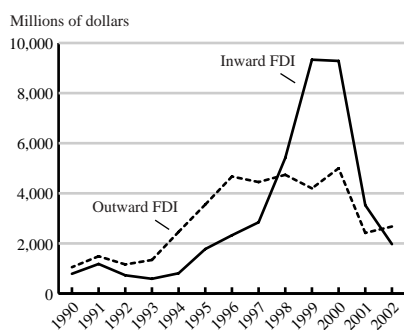
16. Miotti, L., and F. Sachwald, “Korean Multinationals’ Strategies and International Learning,” in *Going International: The Korean Experience of Direct Investment*, ed. F. Sachwald (London: Routledge, 2001).

17. Malaysia and Singapore have been much more open to FDI, but in the 1980s the ratio was even lower in Korea than in Taiwan or China; see Kim and Wang, “Toward Liberalization of International Direct Investment in Korea.”

18. Data for 2002 do not modify the trend.

tional standards in a number of areas; this policy included a pledge to increase openness to foreign investment. During the following years, however, Korea's integration into the world economy remained unbalanced, with outward investment growing more rapidly than FDI. This evolution reflected both continued impediments to FDI and Korean groups' ambitious strategies to shed their status of latecomer competitors to become world leaders.¹⁹ Korea's FDI profile was certainly unusual for a middle-income country.

Figure 1: Korea's Inward and Outward FDI, 1990–2002, millions of U.S. dollars



Source: Statistics database, Bank of Korea, 2003

This situation was brutally reversed in 1998 as a consequence of the financial crisis. Korean groups had taken large risks abroad, and some of the more reck-

less foreign investments, which fed the ODI bubble, contributed to their mounting debt.²⁰ At the same time, the government strongly encouraged FDI. ODI thus leveled off before it decreased substantially in 2001, while FDI shot up in 1998 and 1999. A large share of this sudden flow was due to acquisitions by foreign companies.²¹ Cross-border M&A flows into Korea were \$7.3 billion in 1998, \$19.6 billion in 1999, \$9.7 billion in 2000, and \$11.4 billion in 2001.²² At the end of the 1990s, cross-border M&As increased worldwide, but the trend was particularly strong in Korea in comparison with other Asian countries and with OECD as a whole.²³

Acquisitions by foreigners stirred a national debate in Korea about assets being sold to foreigners at giveaway prices.²⁴ Right after the crisis, the economist Paul Krugman argued that multinationals had taken advantage of the financial crisis to buy Asian companies at fire-sale prices.²⁵ He noticed that, because acquisitions took place in many different sectors, they may not have reflected technological or managerial advantages from acquirers and may have resulted instead from the dire financial situation of the targets. He calculated that quoted Korean corporations had lost 70 percent of their value in dollars by the end of 1997, and undervaluation probably lasted until the *won* began to recover. Krugman nevertheless offered a first explanation for these low market values by suggesting that pre-crisis asset prices may have been inflated

19. Sachwald, F., ed., *Going Multinational. Korea's Experience of Foreign Direct Investment* (London: Routledge, 2001).

20. In 1995, foreign investment by Korean firms of \$50 million or over had an average debt-to-equity ratio of more than 927 percent; see Kim, Eun-mee, "Globalization of the South Korean *Chaebol*," in *Korea's Globalization*, ed. Kim, Samuel S. (Cambridge: Cambridge University Press, 2000).

21. FDI and cross-border M&As are related, but they constitute two different sets of transactions. M&A data are compiled in a less harmonized way; see *World Investment Report 1999* (Geneva: UNCTAD, 1999), www.unctad.org/en/docs/wir99_en.pdf; and *International Investment Perspectives*, no. 1 (Paris: OECD, 2002). On Korea's record of FDI and M&As, see Kim, June-dong, "Foreign Direct Investment into Korea: Recent Performance and Future Tasks," *Joint U.S.-Korea Academic Studies* 13 (Washington D.C.: Korea Economic Institute, 2003), 195.

22. *International Investment Perspectives*, no. 1 (Paris: OECD, 2002).

23. For data on other countries, see *World Investment Report 1999*, and *Ibid.*

24. Kim, W-s., and Choo M-j., *Managing the Road to Globalization: The Korean Experience* (Seoul: KOTRA, 2002); and Kim, "Foreign Direct Investment into Korea."

25. Krugman, Paul, "Fire-Sale FDI," in *Capital Flows and the Emerging Economies: Theory, Evidence and Controversies*, ed. Sebastian Edwards (Chicago: University of Chicago Press, 2000).

by moral hazard–driven lending. This hypothesis has since been supported by studies of the Korean financial system and analyses of the perverse consequences of the relationships among the government, banks, and the *chaebol*.²⁶

The evolution of FDI policy, which resulted in substantial liberalization, constitutes a complementary explanation for the surge of FDI and particularly foreign acquisitions. In such a context, foreign companies have been able to acquire local assets, not only because they had suddenly become cheaper but also because foreigners were allowed to and could anticipate a more favorable business environment. This can explain in particular the acquisition of full ownership by foreign joint venture partners that had been operating in Korea for years but were initially not allowed to control their Korean units. Such cases, which represented a substantial share of FDI in various sectors, resulted in foreign companies wanting to acquire full control for managerial reasons, while their local partners were eager to sell in order to boost their liquidity during the crisis. Besides, the explanation in terms of technological or managerial advantages, which Krugman dismissed,²⁷ actually seems adequate in a number of cases in which the foreign acquirers have proved efficient and innovative owners.

Volvo Construction Equipment, which acquired Samsung's excavator business, is one such example. Volvo has worked with its subsidiary to upgrade the

Korean products to "Volvo's standards" in terms of ergonomics and safety. The overall strategy has been to switch from a follower position to becoming a world leader.²⁸ Volvo has also started an active program to enhance the capabilities of its suppliers. Other examples have been observed in the automobile sector and in banking, in particular.²⁹

Observations from case studies on the positive role of FDI have not yet been confirmed by thorough empirical analysis, for which firm data are missing.³⁰ Recent statistical evidence indicates that firms and sectors with high levels of FDI tend to exhibit greater labor productivity, higher wages, and larger R&D expenditures.³¹ These observations do not, however, establish a causal link between FDI or foreign acquisition and better performance.³² The influence of foreign ownership may be clearer in the case of financial issues. In 2000, foreign-invested firms in the manufacturing sector had a lower debt-to-equity ratio and higher profitability than domestic firms. Foreign firms certainly had sounder financial and managerial practices than Korean firms in the 1990s, but they have also tended to acquire not too highly indebted Korean companies after the financial crisis.³³ In other words, foreign companies carefully chose their Korean acquisitions. Financial issues have actually led to tough negotiations between potential acquirers and Korean sellers. The protracted negotiation between Daewoo Motors and GM is a case in point. In other cases, negotiations broke down because no agreement was

26. See, for example, Graham, E., *Reforming Korea's Industrial Conglomerates* (Washington, D.C.: Institute for International Economics, January 2003); and Noland and Pack, *Industrial Policy in an Era of Globalization*.

27. Krugman, "Fire-Sale FDI."

28. E. Nielsen, Volvo's CEO in Korea, interview with author, August 2003.

29. Yun, M., "FDI and Corporate Restructuring in Post Crisis Korea" (Seoul: KIEP, 2001), mimeo.

30. For an early attempt with sectoral data, see Kim, June-dong and Hwang Sang-in, "The Role of FDI in Korea's Economic Development," working paper no. 98-04 (Seoul: KIEP, 1998).

31. These results are quoted in Kim and Choo, *Managing the Road to Globalization*, and are based on studies from the Bank of Korea and the Korea Institute for Industrial Economics and Trade (KIET).

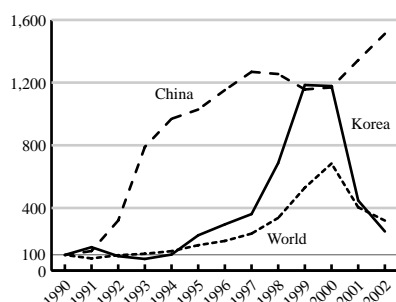
32. This causality issue is one major problem in empirical studies of the influence of FDI; for a discussion, see Sachwald and Perrin, "Foreign Direct Investment in Developing Countries."

33. Freund, C., and S. Djankov, "Which Firms Do Foreigners Buy? Evidence from Korea," working paper no. 2450 (Washington, D.C.: World Bank, September 2000).

found on the price or on debt issues. This suggests that, despite substantial progress since the financial crisis, corporate governance, including transparency issues in particular, have contributed to Korea's recent poor performance in FDI.

The FDI bubble can thus be explained by the combination of two factors, the evolution of firms' valuation and the liberalization of FDI. It is interesting to note that FDI in Korea started to increase more rapidly than world FDI precisely after the 1993 set of liberalization measures (*Figure 2*). *Figure 2* further shows that flows to Korea dropped dramatically in 2001, and in 2002 the decrease has again been greater for Korea than for world FDI. FDI to China has continued to increase, however. In 2002, FDI flows to Korea are a little more than twice as large as flows in 1990, while FDI to China is 15 times as large.

Figure 2: Comparative Evolution of FDI Flows into Korea, 1990=100



Source: United Nations Conference on Trade and Development (UNCTAD) database, 2003.

These observations suggest that the 1998–99 FDI bubble obscures the upward trend that started in the first half of the 1990s. The bubble itself and the sudden increase in the stock of FDI will have lasting effects on Korea's openness, even if flows remain moderate.

As FDI has increased, its sectoral composition has changed. *Table 2* shows that, within manufacturing, the share of electronics has increased while the share

of chemicals has steadily decreased. As important, the share of services has increased and is close to half Korea's total FDI. Among services, banking and distribution are particularly interesting. Foreign institutions first focused on commercial banking, where they possessed some technical advantages. As Korean banks progressively offered similar financial products and services, however, foreign banks have shifted to retail banking. This activity has long been underdeveloped in Korea and constitutes a growing and attractive market for foreign banks, which have adequate saving and insurance products for a more affluent and aging population. BNP Paribas, which has been in Korea for 30 years, is a good example of this strategic evolution. The French bank now focuses on the most sophisticated commercial banking activities and expands its retail activities through its alliance with Shinhan.³⁴

Table 2: Sectoral Distribution of FDI, main sectors as a percentage of total flows

Sectors	1990–1991	1995–1996	2000–2001
Manufacturing	74.2	51.4	55.5
Electricity & electronics	9.4	11.4	19.1
Machinery	9.5	6.1	11.4
Transport equipment	7.9	8.2	8.0
Chemicals	15.7	10.1	3.3
Services	25.6	48.5	44.5
Financing	11.1	14.6	15.4
Wholesale and retail	0.3	10.6	5.3

Source: Ministry of Commerce, Industry, and Energy (MOCIE), database, www.mocie.go.kr/english/statistics/default.asp. Note: Calculated from data on actual investment (in U.S. dollars) rather than notified cases.

Wholesale and retail distribution also received increasing FDI flows during the 1990s. The trend has been strongly influenced by the liberalization of distribution during the first half of the 1990s,³⁵ which triggered stronger competition and the introduction of new distribution methods. In both banking and distribution, foreign firms have been attracted by more

34. P. Reynieix, country head, BNP Paribas, interview with author, August 2003; see also Reynieix, P., "Le marché bancaire s'est sophistiqué depuis le début des années 90," *Corée Affaires* 50 (July–September 2003).

35. Liberalization of ownership for retail stores and supermarkets was progressively extended during the first half of the 1990s.

affluent consumers with more sophisticated needs and liberalized access to the Korean market. More generally, foreign companies consistently mention the size of the local market (48 million people) as a major reason to invest or expand activities in Korea.³⁶ Foreign carmakers and component suppliers, for example, may be attracted by the possibility of using the world's fifth-biggest automobile producer as a platform from which to sell to the wider region, but they are also attracted by an expanding local market.

Korea is now classified as a high-income country by the World Bank. In addition, its growth prospects are quite good, and the Korean market should keep expanding and the Korean consumer become more sophisticated. Liberalization of FDI in the 1990s was substantial, and Korea is now much more open to foreign business. Also, the general business environment has evolved more favorably in Korea than in other countries after the Asian financial crisis. In this context, the strong attraction of China may not be so alarming.

The Hub Strategy and Korean Development

At the beginning of the 1990s, Korea wanted to build upon its successful development to upgrade from the status of an emerging country to that of an advanced economy. During the 1980s, the country and companies had started to invest heavily in R&D and aimed at graduating “from imitation to innovation.”³⁷ At the same time, Korean firms faced strong competition on world markets while wages were increasing rapidly.

This is the context in which President Kim Youngsam chose *seggyewha* as the mobilizing slogan for Korea. The *seggyewha* policy was originally intended to promote a new economic structure, better suited to sustain growth and innovation. This implied a liberalization of the Korean economy, not only in terms of trade but also in the fields of foreign investment and fi-

nance. In turn, these policy steps meant that the developmental state had to transform itself into a regulatory state and that more open competition would lessen the central role of the *chaebol*. Finally, a consistent set of reforms would have included a broadening of the social safety net and investment in human development. This ambitious reform program was not fulfilled before the Asian crisis. Liberalization of direct investment, for example, supported the international expansion of the *chaebol* before opening to inward investment. More generally, Korea's globalization drive has been unbalanced in favor of local companies.

Korean political leaders are now convinced that more FDI can contribute to meeting the twin challenges of innovation-based competition and the emergence of China as a manufacturing powerhouse. They have nevertheless been disappointed by the lack of attractiveness of Korea over the past few years and are increasingly worried about the hollowing-out syndrome.³⁸ The hub strategy that was launched by President Kim Dae-jung has objectives similar to those of the *seggyewha* strategy, but the hub strategy focuses on the attraction of foreign firms as a lever for reform.

In April 2002, the government unveiled its ambition to turn Korea into the next business hub of Northeast Asia. This vision has been transformed into an official policy, and the concept of a business hub for Northeast Asia has been made more precise. The concept first referred to a logistics hub but has since been extended to finance, R&D, and multinationals' regional headquarters. The project has also become broader than in the original conception, as it now emphasizes Northeast Asia cooperation as a means to reinforce Korea's connectedness. From an operational perspective, the designation of several economic free zones is a major building block of the project. These zones are being designed to attract foreign companies not only with up-to-date infrastructures but also

36. For recent surveys, see *Foreign Direct Investment in Korea*, KPMG Consulting, September 2001; and Lee, You-il, and Michael Hobday, “Korea's New Globalization Strategy: Can Korea Become a Business Hub in Northeast Asia?” *Management Decision* 41, no. 5 (2003): 498–510.

37. Kim, Linsu, *Imitation to Innovation: The Dynamics of Korea's Technological Learning* (Boston: Harvard Business School Press, 1997).

38. The share of China in Korean ODI has been increasing, while the share of developed countries decreased.

through tax incentives and various special provisions regarding labor laws and the possibility of setting up foreign education institutions.³⁹ Ideally, these free zones would constitute a much better business environment for foreign firms and offer good living conditions to expatriates. These features are meant to answer frequent criticisms by foreign investors, whatever their country of origin, about red tape, poor industrial relations, labor militancy, lack of communication skills in English among Korean workers, and inadequate living conditions for expatriates.⁴⁰

The central role of the free zones comes from the fact that the hub strategy has been modeled after Hong Kong's and Singapore's experiences as hubs for international trade, business, and transportation that link Asia to other parts of the globe. The Netherlands and Ireland have also been used as benchmarks in discussions of the hub strategy. All these countries are small, open economies. Hong Kong and Singapore in particular may be considered as special economic zones themselves. Korea could not reach that level of openness and internal liberalization rapidly, and the hub strategy necessarily implies setting up specific economic zones where rules and infrastructures would be tailored to attract foreign investors and international traffic. The idea is to create in the economic free zones an efficient and attractive environment that would become an example for Korea as a whole, thus easing the reform process.

A number of commentators have noticed that the administration has seized on the project to make Korea the new hub of Northeast Asia as a means to create a new economic paradigm for the country. In this perspective, the free zones would both attract high-quality foreign investment and expedite the reform process in Korea. This shortcut may actually be quite risky.

Exclusive economic zones have been used by a number of countries, typically developing countries, to attract foreign companies when their business environment is unfavorable. Such zones may, however, be more adequate for export platforms in manufacturing labor-intensive goods than for more sophisticated and R&D-intensive activities. Foreign R&D activities are attracted by a dense scientific and technological environment as well as by easy access to various academic institutions and firms. Foreign technical centers and R&D laboratories tend to focus first on adapting products and processes to local conditions and thus depend on the existence of large subsidiaries. An attractive environment for foreign R&D builds up progressively and has to be well connected to the rest of the economy as well as to international networks. A special economic zone may enforce specific regulations but may not easily nurture the right environment for R&D activities.⁴¹ Exclusive economic zones are also ill adapted for market-oriented FDI. In the case of Korea, for example, foreign banks that are attracted by the development of retail activities would find themselves isolated from their clients in a separate economic zone. The free zones may thus develop as enclaves, attracting few new multinationals and generating little spillover.

The literature on export processing zones and other special economic zones shows that such schemes are second-best solutions compared with countrywide reforms, but that they can nevertheless be a useful weapon in the development arsenal when more general reforms are difficult to implement. In the case of Korea, free zones may also generate perverse effects on the process of reform.⁴² First, these zones will not be fully operational for some time. Second, the existence of these zones could slow down rather than accelerate nationwide reforms. This may be the case in

39. The area near Incheon airport is expected to become a business hub, and the ports of Busan and Gwangyang would focus on logistics.

40. For recent surveys, see *Dynamic Korea Hub of Asia* (Seoul: American Chamber of Commerce in Korea (AMCHAM), 2002), www.amchamkorea.org; *Magnet or Morass? South Korea's Prospects for Foreign Investment* (London: Economist Intelligence Unit, 2002); and Lee and Hobday, "Korea's New Globalization Strategy."

41. The experience of some countries even suggests that the creation of innovation clusters is very difficult when a number of conditions are not met.

42. See, for example, "Export Processing Zones in Sub-Saharan Africa," World Bank *Findings* no. 193 (October 2001), www.worldbank.org/afr/findings/english/find193.pdf.

the important area of industrial relations in particular. Poor labor-management relations and militant unions are constantly mentioned as major problems by foreign companies operating in Korea.⁴³ The roots of traditional labor's hostility to multinationals lie in its experience of repression under Japanese colonial rule and during the 1960s and 1970s when the few foreign firms that ventured into Korea had the reputation of exploiting labor.⁴⁴ During the late 1960s, strikes over unionization and working conditions erupted in plants located in export-processing zones. Labor unrest and opposition to multinationals in export-processing zones lasted until the late 1970s, and criticism of multinationals remained high until the late 1980s. Tension became lower when higher wages eroded the advantage of export-processing foreign activities in Korea.

Today, labor-management problems are not confined to multinationals, and it could be counterproductive to establish new, differential treatment in the free zones. Labor-management and industrial relations are one of Korea's major institutional weaknesses. A benchmarking exercise⁴⁵ conducted in 2001 shows that, in comparison with high-income countries, Korea's major weak areas are industrial relations, property rights and contracts, and competition-related issues. It may thus be much sounder to launch a nationwide effort to build clear procedural rules for the conduct of industrial relations and promote a culture of cooperation instead of confrontation.⁴⁶

Two other criticisms may be addressed to the business-hub project as a strategy to develop FDI and promote a new economic paradigm for Korea. First,

such a strategy focuses on attracting investment to promote Korea as a production site and contribute to upgrading Korea's technological capability. In so doing, the project neglects the fact that the primary attraction of Korea for the majority of foreign investors lies in the size and the strength of the domestic economy. A recent report states:

[A]s a burgeoning market of 48 million avid consumers, fond of gadgets and brands, yet also ageing and seeking better service in everything from pensions and personal finance to healthcare and insurance, there is no shortage of opportunity for foreign companies to invest and sell to South Koreans.⁴⁷

The focus on supply rather than demand determinants of FDI suggests that the business-hub strategy may not represent much of a departure from the mercantilism of the export-oriented strategy, which some observers have underscored.⁴⁸ Second, the tradition of the developmental state is still quite alive in the business-hub project. Broader economic reform and the promotion of a more open and effective business environment across the board would represent a clearer departure from this planning approach.

Concluding Remarks

During the first decades of its industrialization, Korea tightly monitored FDI with the aims of simultaneously accessing relevant technology and promoting the development of local companies. Over the past decade, Korea has become much more open to FDI, but public policies, local firms, and labor are still influenced

43. Labor grievances are the grievances most frequently filed at the Office of the Investment Ombudsman (Kim, "Foreign Direct Investment into Korea.").

44. Guillen, M., "Organized Labor's Images of Multinational Enterprise: Divergent Foreign Investment Ideologies in Argentina, South Korea, and Spain," *Industrial and Labor Relations Review* 5:419–42.

45. *Profils institutionnels des pays émergents* (Paris: DREE, Ministère de l'Économie des Finances et de l'Industrie, 2001).

46. In September 2003, the government issued draft plan for a new labor policy, which could represent a first step in this direction, but it is too early to assess this initiative.

47. *Magnet or Morass? South Korea's Prospects for Foreign Investment*.

48. See for example, Lee, G-j., "A Hub in the Making," *KT&I* (July–August 2003).

by the experience of the developmental state. In an attempt to promote innovation-based growth, Korea now has a strategy to emulate small, open economies and become the next Northeast Asia hub. Singapore, Hong Kong, and Ireland may not, however, be the right models for Korea. Rather, Korea should take advantage of the attractiveness of its internal market and promote a better business environment for all firms, domestic and foreign alike, so as to stimulate synergies between local firms and multinationals. Korea's industrial relations problems illustrate the importance of nationwide reforms as opposed to more liberal rules in specific enclaves. The argument can certainly be extended to the reform of education in order to promote creativity, not only in specific schools and universities but across the board.

This alternative approach to the promotion of FDI depends however on a change of attitude toward foreign competition. Many foreign managers consider that Korea is still hostile to foreign competition on the local market. More broadly, one obstacle to further collaboration between Korean firms and foreign partners is the absence of the notion of win-win situations. This may more particularly hinder R&D alliances and foreign R&D activities, which Korea precisely wants to encourage.

Korea now belongs to the high-income group of countries and should generally adapt its economic and social policies to this status in order to keep moving up the development ladder. This means pursuing reforms to improve corporate governance and promoting competition and better industrial relations, for example. With respect to FDI, it means accepting a balanced approach to foreign investment, with both higher levels of outward flows (including to China) and higher levels of inward flows. FDI will be mostly attracted by the opportunities offered by Korea's market, but expanding foreign business should progressively nurture positive spillovers, which cannot be imposed or even specified beforehand.

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