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Reduction of Regulatory Restrictiveness in Services Sectors and Its Impact on FDI Inflows

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I. Overview

As the development of global value chains has intertwined production networks across countries, the nature of international trade has evolved along with it. The weight of intermediate goods in gross trade has been growing fast and greater attention has been paid to the importance of foreign direct investment and related services in trade. Trade cannot be understood as an independent economic phenomenon and is becoming ever more involved with services and investment.

In conjunction with the changes in the global economic environment, recent trade agreements have become more comprehensive, dealing with more issues and subjects bearing relation to services and investment. Efforts toward tariff reduction across countries have gained traction, and liberalization in services has moved forward slowly yet steadily. Such comprehensive development in trade agreements naturally leads to the question of what relationship there is between goods trade, services liberalization and FDI flows. In particular, the effect that services liberalization has on investment flows across countries is still in need of further clarification. In terms of homogenous final goods trade, tariff reduction is understood to present substitution effects on foreign direct investment. As trade costs decrease, the necessity for foreign direct investment also wanes. However, as the global economic environment evolves with the development of global value chains, such a prediction is no longer obvious. Furthermore, it is even more obscure whether services liberalization attracts more FDI inflows or not.

Korea reached its first free trade agreement deal with Chile in 2004. Since then Korea has struck FTA deals with 52 economies up to now. In particular, the Korea-EU FTA in 2011 and Korea-US FTA in 2012 have included high-level liberalization commitments in extensive services sectors, and most of the following FTAs Korea has signed by and large have the same level of commitments in services.[1]

In order to answer the questions raised about the relationship between services liberalization

[1] These FTA partner economies are Australia (2014), New Zealand (2015), and Canada (2015).

and FDI flows, Kim et al. (2016) investigated how the increased liberalization in services sectors via free trade agreements has affected the inflow of foreign direct investment, using data from Korea's recent experiences in services liberalization.

II. Stylized Facts of Korea's FDI Inflows

Stylized facts about global FDI flows have been documented well. Kim et al. summarize such stylized facts based on Markusen (2002) and Antras and Yeaple (2013), and also compare global stylized facts with Korean stylized facts with regard to FDI inflows.

The stylized characteristics of global FDI flows are as follows. First, foreign direct investment has expanded dramatically since the 1980s. Reduction of trade costs including tariff and transportation cost, and the fast-evolving information and communication technologies (ICT), have contributed to the development of global value chains and a corresponding surge in FDI flows. Second, FDI is an intra-industry phenomenon. Multinational corporations have played a crucial role in such an intra-industry FDI surge among advanced economies. It is worthwhile to note that FDI flows among advanced economies account for a major share of global FDI flows. Third, gravity characteristics in trade are also found in FDI flows. While larger GDP attracts more FDI flows, greater distances tend to be a discouraging factor to investment decisions. Fourth, multinational corporations tend to have higher R&D and capital intensities. Fifth, due to increasing FDI flows and production fragmentation, intra-firm trade has risen fast as well. Sixth, mergers and acquisitions are the dominant form of FDI rather than greenfield investment.

FDI flows in Korea share most of the characteristics of global ones, but there are differences. These similarities and differences, especially in terms of inflows, can be compared as follows. First, Korea experienced a rise in FDI inflows in the late 1990s during the process of further integration into the global economy. Its accession to the WTO in 1995 and OECD membership in 1996 were important developments in these changes in FDI inflow. The East Asian financial crisis in 1998 and the following IMF bail-out were also economic events that further exposed the Korean economy to foreign capital. Second, industries with high capital intensity tend to experience larger inflows of FDI. Electronics, chemicals, machinery in manufacturing and finance, retail, business services are among such industries. Third, another notable characteristic is that FDI inflows in services industries have accounted for a much larger share than in manufacturing since the late 2010s. Fourth, FDI inflows through mergers and acquisitions (M&A) have not been very active. When considering that M&A is the dominant form of FDI flows in most advanced economies, the reason why M&A is not active in Korea remains a quite controversial issue.

III. Services Liberalization in Korea

Korea made its first commitment to liberalization in services with the Uruguay Round and has gradually liberalized its services markets, mainly through FTAs. The progress Korea has made in this area with FTAs can be analyzed using the services trade restrictiveness index (STRI) devised by the OECD. Kim et al. (2016) have updated STRI scores reflecting all the FTAs Korea has concluded with OECD members. Their findings are as follows. First, the six recent FTAs with the U.S., EU, Australia, New Zealand, Canada, and EFTA are the ones that indicate preferential improvement from the MFN commitments in services. Second, services sectors further liberalized from the MFN commitments are limited to legal, accounting and auditing, and telecommunication services. The STRI scores of other services sectors have not shown notable changes. Third, even though FTAs with the U.S. and EU have contributed to Korea's liberalization in services industries, their levels of liberalization are not the highest in terms of STRI score. This is because they do not include Mode 4 (movement of natural persons) in the agreements. Korea's FTAs with Australia and Canada score rather higher because they include provisions for Mode 4 commitment.

IV. Services Liberalization and FDI

Investment in another country is not just a matter of building a production facility; it demands various enabling and operating services. For instance, investing firms have to familiarize themselves with the legal system and regulations of the destination country. These services as indirect production inputs are part of overall operating costs, and hence multinational firms invest more in a country where such costs could be spent efficiently. In this light, liberalization in services could be one of the factors that attract FDI. Kim et al. (2016) investigate the relationship between services liberalization and FDI inflows in Korea. Their empirical analysis studies the changes in Korea's FDI inflows from 38 other OECD members with regard to the liberalization in eight services sectors from 2010 to 2015. Data for services liberalization reflect the schedule of commitments over time. For example, in accordance with the KORUS FTA, legal services were liberalized in three stages and a differentiated STRI score was calculated for each stage and reflected in the data analyzed. The empirical analysis confirms that services liberalization indeed promotes FDI inflows in Korea. However, it should be noted what matters is the overall level of liberalization, not the liberalization in an individual sector. Another point to make is that statistical significances indicate that an FTA in itself does not effectively attract foreign investors; it should be committed to high-level service liberalization.

V. Implications and Policy Suggestions

The level of FDI inflows in Korea has been much lower than other countries with similar size of GDP. Therefore, the Korean government has shown keen interest in how to boost FDI inflows. In this regard, the analysis conducted in Kim et al. (2016) implies three possible policy suggestions. First, overall liberalization in services is more important than liberalization in an individual service. Second, in order to attract more investment from other countries and multinational corporations, FTAs with a high level of services liberalization are critical. Third, it is necessary to create a non-discriminatory social and economic environment for multinational corporations and their legally legitimate business activities. KIEP