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Inward Foreign Direct Investment Regime and Some Evidences of Spillover Effects in Korea

June - Dong Kim

KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY

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Executive Summary

This paper seeks to document Korea's inward foreign direct investment regime and some evidences of its spillover effects. Since the financial crisis of the late 1997, the Korean government started to actively promote inward foreign direct investment (FDI). In November 1998, the Korean government enacted the Foreign Investment Promotion Act. This new legislation focuses on creating an investor-oriented policy environment by streamlining foreign investment procedures, strengthening investment incentives and establishing an institutional framework for investor relations, including a one-stop service. The Korean government also undertook full-fledged liberalization in the area of hostile cross-border M&A and foreign land ownership.

As of July 1998, the government liberalized medium-term foreign loans in order to reduce the burdens on businesses seeking foreign capital. The requirement that commercial borrowing from abroad should exceed $1 million was eliminated. In April 1999, Korea abolished the restrictive Foreign Exchange Management Act and replaced it with the Foreign Exchange Transaction Act. With the Foreign Exchange Transaction Act in place, most of the restrictions on foreign exchange transactions and domestic transactions in foreign currencies have been eliminated. Remaining restrictions are now classified under a negative rather than a positive listing system.

Thanks to these policy changes, the FDI inflow has increased remarkably in 1998, reaching a record amount of US$ 5.1 billion. The pace of foreign direct investment through cross-border M&A has picked up markedly. Compared to US$ 698 million or only 10% of

total foreign direct investment in 1997, foreign acquisitions of outstanding Korean stocks have increased to US$ 1,241 million or 14% of total FDI in 1998. If the acquisitions of assets were included in the statistics of cross-border M&A, the amount of cross-border M&A would be more than half of the total FDI inflow in 1998.

The case studies on some selected industries including semiconductor and chemical show that foreign invested firms raised domestic productivity by spinning out skilled workers; providing technical guidance to subcontractors; bringing in new capital goods and technology; introducing advanced management know-how; conducting in-house R&D; enhancing competition.

Considering the benefits of FDI in raising productivity through spillover effects, it is needed to attract more FDI by removing remaining barriers. As entry barriers have been almost completely ended, most remaining obstacles are the same as faced by domestic investors. Although the government is making some progress by streamlining investment procedures, Korea's markets and industries are still bogged down with regulations that are as complicated as they are vague. In particular, the ambiguous tax laws as well as cumbersome regulations on customs and import procedures are regarded as the most serious impediment to foreign investors.

Another important area which has not been adequately addressed is labor market inflexibility. Layoffs are still difficult to execute on a large scale and are allowed only in the case of emergency. Efforts to enhance labor market flexibility is limited by the lack of a social safety net.

Anti-foreign public sentiment remains at the top of lists of perceived weaknesses of the Korean culture from the point of view of foreign investors. Other weaknesses pointed out by foreign investors include a lack of rationality due to personal decision-making or emotional reactions, relationships based on school or locality, lack of flexibility or resistance to change, militant labor unions, poor dissemination of information, and the lack of internationalization.

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Inward Foreign Direct Investment Regime and Some Evidences of Spillover Effects in Korea

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I. Historical Overview of Korea's Inward Foreign Direct Investment Policy

Early Institutionalization (1960~1983)

From the late 1950s, the Korean government began shifting its basic development strategy from import substitution to export promotion. This emphasis on an export–led growth strategy was accompanied by allowing foreign direct investment (FDI) through the enactment of the Foreign Capital Inducement Act in 1960.

In the 1960~70s, foreign investors were welcomed into the light manufacturing export sector, especially in the two Free Export Zones at Masan and Iri, which were established in 1970 and 1974, respectively. However, the overall stance of the Korean government was to keep FDI to a minimum. This predominantly anti–FDI stance was based on the Korean government's desire to take control of the available capital resources (both domestic and foreign). A preference for foreign borrowing rather than FDI also stemmed from the fear of foreign domination, a fear which originated from Korea's colonization by Japan. Even in the light–manufacturing sector where foreign investment was welcomed, performance requirements, such as export or technology transfer requirements, were imposed in order to raise foreign exchange earnings and induce advanced technology.

Passive Liberalization (Pre-Crisis: 1984~1997)

The negative effects of the Heavy and Chemical Industry Promotion Plan of the 1970s led the government to adopt a new industrial strategy in the early 1980s in an attempt to upgrade Korea's industrial structure into one that increasingly consisted of technology-intensive industries. The government recognized FDI as a key channel of gaining technological improvement. In 1984, the Korean government replaced the positive list system of restricting foreign investment with a negative list system. Various performance requirements imposed on foreign invested firms, such as export, local content, and technology transfer requirements, were also abolished in December 1989.

In December 1996 when Korea acceded to the OECD, the Korean government realigned its foreign direct investment regime in line with international norms and standards by amending the Foreign Capital Inducement Act into the Act on Foreign Direct Investment and Foreign Capital Inducement. For example, the concept of FDI was expanded to encompass long-term (five years or more) loans.[1] Also, starting from February 1997, foreign investors were allowed to pursue "friendly" mergers and acquisitions (M&A), which was defined as receiving consent of the board of directors of the targeted company.

Even though the Korean government made efforts to liberalize foreign direct investment, its basic position towards FDI remained a

1) The long-term (five years or more) loans from the parent company or its related companies were added to the definition of FDI since these loans are regarded to influence the managerial control of the firm.

passive one. In other words, the government allowed foreign direct investment into a number of business categories and activities but was not interested in removing various impediments or promoting foreign direct investment in general. This stance differed from the active pursuit of FDI by many Southeast Asian countries.

Active Promotion (Post Crisis: 1998 afterwards)

At the end of 1997, Korea went through a currency crisis as a loss of foreign reserves and a refusal by foreign lenders to rollover Korean bank debt brought Korea to the brink of default. To overcome the crisis as quickly and as painlessly as possible, the Korean government has ended its passive stance and began actively promoting FDI.

In November 1998, the Korean government enacted the Foreign Investment Promotion Act. This new legislation focuses on creating an investor-oriented policy environment by streamlining foreign investment procedures, expanding investment incentives and establishing an institutional framework for investor relations, including a one-stop

〈Historical Overview of Korea's Inward FDI Policy〉

Period	Main contents
Early Institutionalization (1960~1983)	· Enacted the Foreign Capital Inducement Act (1960) · Established two Free Export Zones (1970, 1974)
Passive Liberalization (Pre-Crisis: 1984~1997)	· Adopted the negative list system (1984) · Abolished performance requirements (1989) · Allowed friendly cross-border M&A (1997)
Active Promotion (Post-Crisis: 1998 afterwards)	· Allowed hostile cross-border M&A (1998) · Enacted the Foreign Investment Promotion Act (1998) · Ended most restrictions on foreign land ownership (1998)

service. The Korean government also undertook full–fledged liberalization in the area of hostile cross border M&A and foreign land ownership.

Ⅱ. Patterns of Inward FDI

Foreign direct investment into Korea was minimal during the initial liberalization that lasted from the 1960s until the mid-1980s (Table 1). In the 1980s, however, annual average FDI into Korea increased from US$ 100 million to over US$ 800 million. Following a contraction that lasted until 1993, FDI resumed an upward trend, reaching US$ 3 billion in 1997 and a record amount of US$ 5.1 billion in 1998. This is in part explained by the fall in stock market and real estate prices and the depreciation of currency. It also reflects the Korean government's new policy measures to promote FDI and restructuring progress in the financial and corporate sectors.

FDI statistics based on notifications indicate a more significant increase in recent years, from US$ 1 billion in 1993 to US$ 8.8 billion in 1998. While many of these committed investment projects are expected to be realized eventually, the gap between notifications and actual flows widened in 1997 and 1998 (Table 1).[2)]

Although FDI has increased significantly in recent years, Korea does not attract a large amount of FDI relative to the size of its economy. The ratio of FDI inflow to total fixed capital and the ratio of inward FDI stock to GDP in 1996 (1.3% and 2.6%, respectively) are quite low in comparison with the average of Southeast Asian countries (7.4% and 14.6% on average) and the world average (5.6% and 10.6%-UNCTAD, 1998).[3)]

2) Some of the investment projects, especially those from overseas subsidiaries of domestic firms have been cancelled due to the financial crisis.

3) These ratios are expected to increase in 1998 as FDI amounts have significantly increased, whereas the GDP decreased sharply.

〈Table 1〉 Trends of FDI in Korea (1962∼1998)

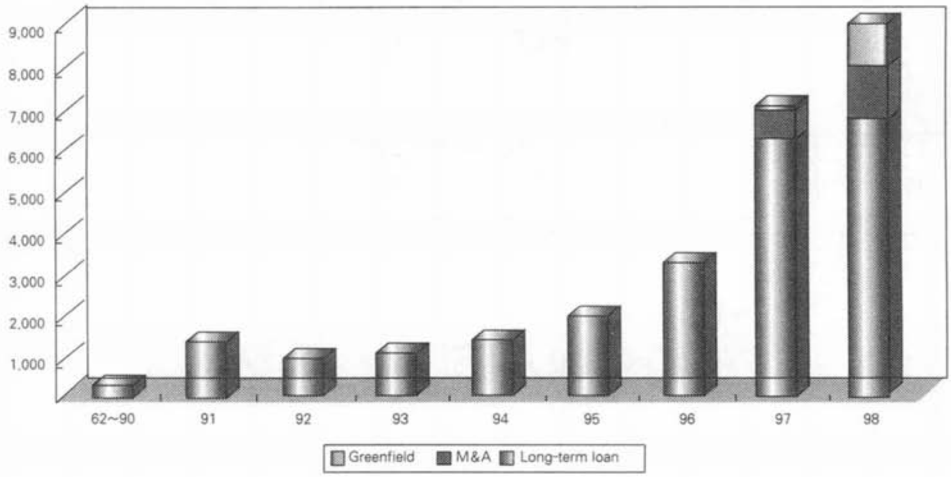
(Unit: US$ million)

	Notified	Actual
1962∼81	1,886.1	1,477.8
1982∼86	1,767.7	1,157.8
1987∼88	2,347.1	1,519.7
1989	1,090.3	812.3
1990	802.6	895.4
1991	1,396.0	1,177.2
1992	894.5	803.3
1993	1,044.3	728.1
1994	1,316.5	991.5
1995	1,941.4	1,357.1
1996	3,202.6	2,308.3
1997	6,970.9	3,085.9
1998	8,852.4	5,155.6

Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement*.

〈Figure 1〉 Trends of FDI in Korea, By Type, 1962∼1998

(unit: million U.S. dollars)

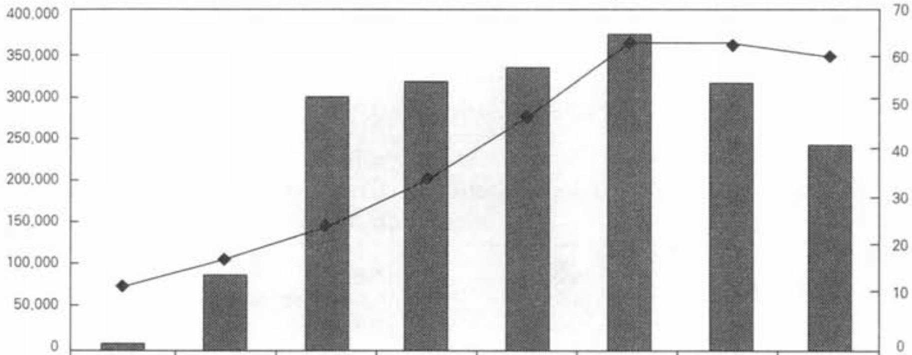


Note: Based on notifications. M&A refers to acquisitions of outstanding stocks only. For 1962–90, figures are annual averages.

Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement*.

〈Figure 2〉 **Trends of Cross-border M&A in Korea, 1997~1998**

(unit: thousand U.S. dollars)



	97Q1	97Q2	97Q3	97Q4	98Q1	98Q2	98Q3	98Q4
AMOUNT	3,180	82,840	297,967	314,877	329,464	368,965	309,932	233,158
CASE	13	18	25	34	47	63	63	60

Note: Based on notifications. Acquisitions of outstanding stocks only.
Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

1. Greenfield vs. M&A activity

Since the financial crisis broke out in late 1997, the pace of foreign direct investment through cross-border M&A has picked up markedly. Compared to US$ 698 million or only 10% of total foreign direct investment in 1997, foreign acquisitions of outstanding Korean stocks have increased to US$ 1,241 million or 14% of total FDI in 1998 (Figure 1 and 2).[4] If the acquisitions of assets were included in the statistics of cross-border M&A, the amount of cross-border M&A would be even larger.[5]

4) These are on a notification basis for acquisitions of greater than 10% of total outstanding shares of a company.

5) The Korean FDI statistics are classified into the acquisition of new shares, acquisition of outstanding or existing shares, and long-term loans. The acquisition of assets or business units of Korean companies are presently

⟨Table 2⟩ Major Cross-Border M&A since the Currency Crisis in Korea (1998)

Korean Firm	Foreign Buyer	Contents
Hanwha	FAG OEM & Handel (Germany)	sold bearing unit at 320 billion won (US$ 213 million)*
Hanwha	BASF (Germany)	sold 50% stake of Hanwha BASF Urethane at 120 billion won (US$ 80 million)*
Hyosung	BASF (Germany)	sold 50% stake of Hyosung BASF at 64 billion won (US$ 43 million)*
Daesang	BASF (Germany)	sold Lysine unit at US$ 600 million
Halla	Bowater (USA)	sold Halla Pulp and Paper at US$ 210 million
Shinho Paper Co.	Norske Skog (Norway)	sold at US$ 175 million
Sambo Computer	Seiko Epson (Japan)	sold printer unit at US$ 20 million
Korea Exchange Bank	Commerz Bank (Germany)	sold 29.8% stake at US$ 276 million
Korea Makro	Wal-Mart (USA)	sold Makro's subsidiary at US$ 181 million
Samsung Heavy Industries	Volvo (Sweden)	sold construction equipment division at US$ 750 million
Anam Semiconductor	ATI (USA)	sold semiconductor manufacturing factory at US$ 600 million
Samsung Electronics	Fairchild (USA)	sold semiconductor manufacturing factory at US$ 455 million

Note: * denotes that exchange rate of 1,500 won per dollar is applied.

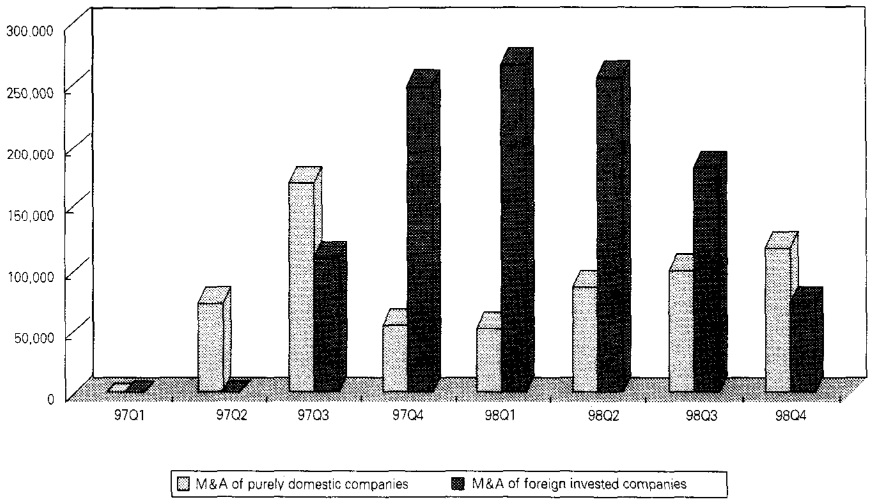
counted as acquisitions of new shares. The proportion of the acquisition of assets or business units combined with the acquisition of outstanding shares is estimated to be 53% in total FDI in 1998 (Korea Ministry of Commerce, Industry and Energy, 1998).

The initial surge of transactions involving buyouts by foreign investors of Korean joint venture partners is shown in Table 2. These buyouts were defensive or rescue reactions necessitated by the failure of key business partners such as Hanwha or Hyosung. Until the third quarter of 1998, these joint venture buyouts along with acquisitions of existing foreign invested companies such as Wal Mart's acquisition of Makro Korea, a Dutch discount retail company, represent a larger portion of acquisitions than transactions involving purely domestic companies (Figure 3).[6)]

Another common type of transaction is the move by existing

〈Figure 3〉 Trends of Cross-border M&A by Type of Targeted Companies, 1997~1998

(unit: thousand U.S. dollars)



Note: Based on notifications. Acquisitions of outstanding stocks only.
Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

6) A significant portion of the increased acquisition of purely domestic

investors seeking to expand through acquisition. BASF's purchase of a new lysine-manufacturing unit from Daesang Group for about $600 million represent this type of transaction. The deal has two important implications. First, it was one of the first examples of a South Korean firm selling its most profitable core business. The unit supplied 20% of the world lysine market. Second, it is also noteworthy that BASF bought a facility and a business unit, not an entire company. Purchase in this way enables BASF to avoid many of the hidden problems and obligations which might have otherwise been incurred.

2. Sectoral distribution

In terms of sectoral distribution, the total FDI realized since 1962 shows that 59.4% has gone to the manufacturing sector and 39.3% to the services sector (Table 3 and 4). FDI in agriculture, mining, and fisheries has been marginal (Figure 4). The share of manufacturing as a percentage of total FDI has remained at approximately 55% since 1996. Among the manufacturing sector, chemicals received the largest share of FDI with 12.1% since 1962, followed by electrical and electronics (9.6%) and transport equipment (7.5%). Recently, there have been increasing investments into food products and machinery, as seen in recent large purchases by Coca-Cola and Volvo.

companies in the second and third quarter of 1997 is foreign borrowings in nature as local companies utilized friendly M&A and long-term loans to circumvent regulations on foreign borrowings. Examples are the acquisition of 20% equity shares of the Samsung Motors by a Malaysian offshore fund in April, 1997 and the acquisition of 30.93% of equity share of the Kookmin Trust and Securities by Canadian Imperial Bank in July, 1997.

〈Table 3〉 Share of Selected Manufacturing Industries in Total FDI, 1962~1998

(unit: percent)

	1962~86	1987~90	1991	1992	1993	1994	1995	1996	1997	1998	Cumulated
Manufacturing	67.4	63.3	80.0	75.3	67.6	35.4	43.2	56.2	59.4	54.9	59.4
Food	3.4	4.5	1.3	13.5	2.0	0.5	1.1	1.8	15.0	12.2	7.1
Chemicals	14.2	12.4	15.5	28.5	33.7	11.0	10.0	10.1	8.3	8.3	12.1
Medicine	2.8	3.6	4.8	3.8	1.8	3.2	2.9	1.1	1.3	2.3	2.5
Petroleum	3.3	1.5	33.5	0.2	2.8	0.5	3.3	9.3	0.1	0.0	3.8
Machinery	4.2	7.7	9.5	5.9	3.3	7.0	6.5	5.9	3.1	10.4	6.8
Electrical & Electronics	14.7	17.9	9.1	7.1	3.6	3.7	10.2	12.2	7.1	4.5	9.6
Transport Equipment	11.2	10.1	2.0	4.2	11.5	3.1	3.4	10.8	11.6	3.0	7.5
Other Manufacturing	9.9	4.5	4.2	9.2	8.6	5.5	5.2	4.4	12.6	0.6	0.8

Note: Based on actual investments. For 1962~86 and 1987~90, figures are annual averages.
Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

〈Table 4〉 Share of Selected Service Industries in Total FDI, 1962~1998

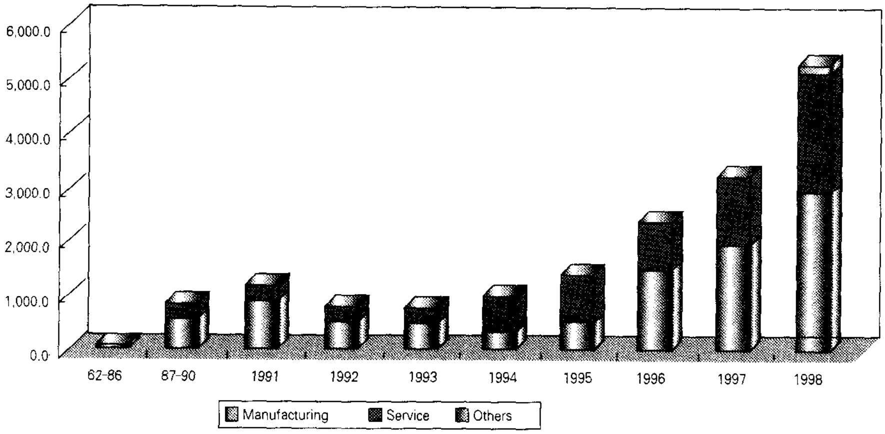
(unit: percent)

	1962~86	1987~90	1991	1992	1993	1994	1995	1996	1997	1998	Cumulated
Service	31.9	36.3	20.0	24.4	32.4	64.6	56.8	43.8	39.0	41.5	39.3
Wholesale & Retail	0.6	0.1	0.4	1.4	0.7	2.5	4.3	14.3	8.3	10.1	5.7
Trading	0.0	1.7	4.5	6.8	11.6	9.5	8.0	4.8	6.3	4.7	4.7
Hotel	18.7	20.7	3.1	1.1	7.1	20.8	4.3	5.0	3.1	0.0	8.1
Transport & Storage	1.2	0.2	0.1	0.2	0.2	0.2	0.3	5.2	1.0	0.1	0.9
Financing	7.1	9.5	6.2	5.7	4.5	20.5	26.3	7.7	9.8	9.1	10.0
Insurance	0.1	2.4	3.7	5.4	1.2	0.8	4.0	0.7	0.2	1.4	1.6
Construction	1.6	0.3	0.2	0.0	0.1	0.7	0.9	1.4	1.6	0.1	0.7
Restaurant	0.0	0.1	0.3	1.3	4.7	0.6	0.5	0.1	0.1	0.1	0.4
Other Service	2.5	1.2	1.6	2.5	2.4	9.0	8.3	4.5	8.5	15.8	7.1

Note: Based on actual investment. For 1962~86 and 1987~90, figures are annual averages.
Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

⟨Figure 4⟩ Trends of FDI in Korea, By Sector, 1962~1998

(unit: million U.S. dollars)



Note: Based on actual investments. For 1962~82 and 1987~90, figures are annual averages.

Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

The composition of investment in the service sector has also changed. Even though the financing industry is recorded as the largest subsector in terms of cumulated FDI since 1962, wholesale & retailing has been receiving rapidly increased investments since 1996 when the retailing industry was completely opened. The subsector of "other services" also recorded a significantly increasing share (15.8%) after the currency crisis, with rising investments in consulting, market research, and advertising.

Table 5 shows the large role Japan and the US have played in FDI in Korea since 1962 with shares of 23.4% and 24.8%, respectively. In 1996, investments from Malaysia and Ireland significantly increased, providing more than 44% of all FDI that year. However, these investments are presumed to be capital flows from the other regions which seek to exploit tax benefits of offshore banking in these

⟨Table 5⟩ Share of FDI from Selected Source Countries, 1962~1998

(% in Total FDI)

	1962~86	1987~90	1991	1992	1993	1994	1995	1996	1997	1998	Cumulated
U.S.A	32.0	26.2	22.2	33.3	41.7	22.5	25.2	17.0	12.7	28.1	24.8
Japan	49.1	49.1	17.3	21.7	21.6	34.8	24.9	12.1	6.4	8.0	23.4
H.K	2.8	2.8	0.5	1.1	0.8	1.4	1.7	0.7	0.8	0.2	1.3
Malaysia	0.0	0.0	0.0	0.0	0.0	0.5	8.8	28.9	14.0	5.1	6.9
Australia	0.1	0.1	0.0	0.0	0.1	1.0	0.1	0.3	0.2	0.0	0.1
Germany	2.0	5.0	8.6	8.3	7.6	4.9	3.4	2.0	12.9	12.5	7.5
France	0.9	1.9	3.5	6.2	6.1	5.5	2.4	3.9	16.2	6.8	5.8
Netherlands	1.5	3.2	36.2	8.8	8.0	9.2	9.1	10.9	10.2	23.6	12.6
Ireland	0.0	0.0	0.0	0.0	0.0	12.5	8.5	15.5	10.7	1.7	4.7
England	2.4	2.2	4.9	1.6	8.4	2.2	3.7	2.1	3.1	0.9	2.5

Note: Based on actual investments. For 1962~86 and 1987~90, figures are annual averages.
Source: Ministry of Finance and Economy. *Trends in International Investment and Technology Inducement.*

countries. While Japanese investment has declined since 1996, investment from European countries, including the Netherlands and Germany, has increased remarkably in recent years as such countries increasingly embraced the strategic importance of the Korean market.

The trend of rising investment from European countries is expected to continue. In particular, if the restructuring process removes a substantial amount of uncertainty, there will be new European investors seeking a presence in Korea as well as in its neighbors. Meanwhile, the prospect of Japanese investments may depend on the behavior of labor unions and the general public's anti-Japanese sentiment that has contributed to the recent fall in FDI from Japan.

Ⅲ. Recent Changes in Inward FDI Policy

1. Transparency

The lack of transparency is recognized as one of the most critical factors of the current crisis which led foreign creditors to lose confidence in the Korean economy. According to a survey by Political & Economic Risk Consultancy in November 1997, Korea lagged far behind other OECD countries and newly industrialized economies in the area of transparency.[7)]

To enhance regulatory transparency, the government is embarking on far-ranging regulatory reform. For measures directly related to foreign investment, the government streamlined investment procedures including those concerning mergers and acquisitions and reduced the number of application documents for establishing businesses by foreign investors. Also, the Committee for Regulatory Reform under the Prime Minister's Office is currently reviewing about 10,000 regulations and aims to deregulate at least half of them.

Transparency in the corporate sector is another problem for foreign investment, especially for mergers and acquisitions. Those doing business with *chaebol* frequently find the decision-making process within these companies unclear due to their complex hierarchy. Also, off-balance sheet liabilities including loans to subsidiaries and cross-

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7) The Asian countries that had lower rating in transparency of business environments are Indonesia, China, India, and Vietnam. (Asian Intelligence Issue #498, November 19, 1997, Political and Economic Risk Consultancy, Ltd.)

debt guarantees present major concerns for foreign companies considering M&A activity in Korea.

To enhance transparency in the corporate sector, corporations have been required to produce consolidated financial statements that are in line with international standards as of 1999, in advance of the original schedule of 2000. Penalties for any improper acts in the course of auditing are also increased in order to enhance the accountability of external auditors and accounting personnel. In addition, the government has required disclosure of off-balance sheet liabilities such as affiliate payment guarantees and strengthened regulations concerning inadequate or delayed disclosure.

In tandem with these steps, the government has implemented measures to improve the corporate governance structure. A compulsory appointment of outside directors have been introduced and voting rights of minority shareholders have been strengthened as the representation requirement for class action suits was drastically reduced from 1% to 0.01%.

2. Expanding market access

A. Liberalizing sectoral restrictions

Since June 1993, the Korean government has been revising the Five-Year Foreign Investment Liberalization Plan to liberalize restricted business categories (Table 6). In particular, multilateral trade negotiations, such as GATS, and the government's aim to induce more competition in the domestic market has enabled gradual opening in the service sector since 1994.

After the crisis, the government has accelerated the liberalization schedule to promote FDI. Ten business categories, including real-estate

⟨Table 6⟩ Korea's FDI Liberalization, 1993~1999 (As of April 1999)

(Unit: Number of business categories liberalized)

Classification	Total	Liberalized[2]							Remaining Restricted
		1993	1994	1995	1996	1997	1998	1999	
Manufacturing	585	2	1	–	6	1	2	–	2
Services	495	9	23	42	39	16	20	1	16
Others[1]	68	5	6	2	4	10	–	–	4
Total	1,148[3]	16	30	44	49	27	22	1	22

Note: [1] Others denote agriculture, fisheries and mining.
[2] "Liberalized" includes both the complete and the partial liberalization.
[3] In KSIC (Korean Standard Industrial Classification) five digit level.
Source: Ministry of Finance and Economy, 'Five-Year Foreign Investment Liberalization Plan', various years.

rental and sales, securities dealings, the operation of golf courses, grain processing, and insurance-related business were fully opened to FDI in April 1998. Twelve more business categories, including the operation of oil service stations, land development, commodity exchanges, investment companies and investment trusts, and waterworks were opened by August, 1998. Manufacturing of tobacco products was partially opened so that 25% of the total shares of the Korea Tobacco and Ginseng Corporation will be sold to domestic and foreign investors upon its privatization. The manufacture of refined petroleum products was also liberalized to facilitate restructuring after business swaps among the domestic firms in this sector. Foreign investments into privately owned electric power generating firms and trusts were fully opened. To promote tourism, foreign investment in the operation of casinos will also be liberalized by May 1999. Furthermore, existing ceilings on foreign equity ratios were raised in 5 business categories in January 1999.[8]

8) For newspaper publishing, ceilings on foreign ownership were raised from 25% to 33%. For the publishing of periodicals, ceilings on foreign ownership

The number of business categories in which foreign investment remains restricted is 22 and the restrictions are stipulated in the Foreign Investment Regulations (Table 7). These remaining sectoral restrictions to foreign investments are mainly due to national security, cultural protection, and the protection of low-income farmers and fishermen.

〈Table 7〉 FDI Restricted Business Categories (As of April 1999)

Wholly restricted	Partly restricted
Cattle husbandry[1]	Cereal grains production
Inshore and coastal fishing	Publishing (newspapers, periodicals)
Wholesale of meats[2]	Coastal water transport
Radio and television broadcasting	Air transport
News agency activities[1]	Telecommunications
	Domestic banking
	Trust and trust companies
	Cable broadcasting
	Electric power generation
	Gambling[3]

Note: (1) will be partially liberalized in Jan. 2000.
(2) will be partially liberalized in Jan. 2001.
(3) will be completely liberalized by allowing operation of casinos in May 1999.
Source: Ministry of Finance and Economy.

B. Liberalizing cross-border mergers and acquisitions

Until recently, foreign investors were only allowed to pursue greenfield investment, such as the establishment of foreign invested enterprises and the acquisition of newly issued shares. Since February 1997, foreign investors have been allowed to purchase outstanding

were raised from 25% to 50%. For wire telegraph and telephone, wireless telegraph and telephone, and other telecommunications areas, the limits on foreign ownership were raised from 20% to 33%.

shares of Korean companies. However, hostile M&A were not allowed and even friendly M&A (the term "friendly" constitutes permission from the board of directors of target companies) were limited to cases where the total assets did not exceed 2 trillion won.

Since the signing of the IMF-supported assistance program in December 1997, the Korea government has implemented various measures to facilitate M&A activity.

1) The ceilings on foreign equity ownership in the stock market have been completely eliminated as of May 25, 1998.
2) Hostile takeovers have been fully liberalized as of May 25, 1998; the seeking of permission from the target Board of Directors (by a foreign company) to exceed 33% of the equity of that company is no longer required.
3) The mandatory tender offer rule was abolished on February 16, 1998. Formerly, if any person wished to purchase 25% or more of a publicly traded company's shares, such person was required to make a tender offer to purchase more than 50% of the company's shares.
4) Spin-offs have been allowed as of February 16, 1998 and merger procedures have been streamlined so that the period during which creditors may file an objection was shortened from 2 months to 1 month.

C. Liberalizing foreign land ownership

The need to secure foreign capital and avoid a sharp downturn of the real estate market has led the Korean government to fully liberalize foreign land ownership through amending the Foreigner's Land Acquisition Act in July, 1998. Previously, foreign companies could only acquire land for business purposes.[9] If a foreign company acquired "non-business" real estate as a result of an acquisition of a Korean company, it was required to sell it within 5 years. This restriction was one of the major impediments to the facilitation of mergers and acquisitions by foreigners.

Under the amendment, all previous restrictions have been lifted and a foreign company may freely acquire land irrespective of business or non-business purposes.[10] In particular, with the removal of the restriction on the use of purchased land, foreign companies which merge with or acquire Korean companies are now allowed to hold any real estate owned by the Korean company regardless of purpose.

Foreign investors regard the opening up of the real estate sector as one of the most drastic changes that the Korean government has enacted since the onset of the economic crisis.[11] Considering that the Korean people are intensely attached to the land, liberalization of foreign land ownership demonstrates that the Korean government is sincere in its pledge to welcome foreign investment and open its market.

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9) A foreign manufacturer could only acquire land for factories, offices, warehouses, company residences, and dormitories for workers. A non-manufacturing company could only acquire land for office use and company residences.

10) The amendment also liberalized land ownership foreign individuals. Before the amendment, foreign individuals were allowed to purchase land only if they held an F-2 visa and resided in Korea for more than five years.

11) See AMCHAM (1998).

3. Improvement of the foreign investment support system

The Foreign Investment Promotion Act, which became effective beginning in November 1998, signifies the government's effort to drastically change its policies regarding foreign direct investment from passive liberalization into active promotion.[12] This new act aims to create an investor-oriented support system. For instance, the Korea Trade and Investment Promotion Agency (KOTRA), a quasi-governmental organization, is designated as the key institution which takes full charge of investor relations (IR), including marketing, administrative service, and aftercare.

The new act also seeks to make investment incentives competitive enough with those of other Southeast Asian countries. It augments exemptions or reductions of tax and rental fees on factory sites as well as providing various forms of subsidies. The new act is also devised to induce active promotion activities on the part of local governments by providing budgetary support from the national government for investment incentives. The basic framework of the Foreign Investment Promotion Act consists of:

· Streamlining foreign investment procedures,
· Strengthening investment incentives,
· Establishing a "one-stop" service system, and
· Introducing the ombudsman system for foreign investors

A. Foreign investment procedures

The quasi-notification system in which notifications by foreign

12) The Foreign Investment Promotion Act replaced the Act on Foreign Investment and Foreign Capital Inducement.

investors are subject to acceptance were replaced with a genuine notification system in which foreign investors simply have to notify foreign exchange banks or KOTRA of their investment. Only in the case of mergers or acquisitions of 81 defense-related firms is prior approval required. For the sake of investor convenience, the requirement to designate a resident agent for notification was also abolished. Foreign investors can now convert foreign loans into capital without undergoing formalized redemption procedures. Furthermore, the number of documents to file for investment application is reduced from 83 to 37.

B. Investment incentives

The Foreign Investment Promotion Act strengthens investment incentives by furthering the reduction or exemption of national taxes, local taxes, and rental fees of national and local government properties. In November 1998, the number of business categories eligible for tax benefits was raised from 265 to 516, which added such producer services as engineering and electronic commerce to high-tech manufacturing.

Tax exemptions for corporate and income taxes following the first year of profitability have been expanded from 5 to 7 years. A reduction of corporate and income taxes by 50% for the subsequent 3 years remains. Local tax is also likely to expand as local governments now have the autonomous power to grant tax benefits for as long as 15 years. The scope of local taxes to which tax holidays can be applied has also been expanded to registration taxes (tax holidays can already be applied to acquisition taxes, property taxes, and aggregate land taxes).

Tax benefits provided to high-tech businesses are also given to the investment projects located in Foreign Investment Zones (FIZs). City and provincial governors with the approval of the Foreign Investment Committee may establish FIZs. The designation of FIZs depends on the investment size and employment creation effect as well as locational demand among foreign investors. Besides tax benefits, the investment projects located in FIZs will receive various benefits. First, they will receive infrastructure support, such as roads, telecommunications, and water facilities.[13] They may also receive lower utilities rates, including electricity and sewage rates. The projects in FIZs will also be exempted from 7 types of mandatory fees, such as the farm or forestland conversion fee. In addition, those foreign invested firms in FIZs are allowed to conduct business in sectors restricted solely for SMEs.[14]

Since the local governments are constrained by insufficient budgets, the national government will support local government FDI promotion activities by providing funds for the creation of FIZs, funds to purchase land to be rented to foreign invested enterprises (FIEs), and budgetary support for job training subsidies. In order to induce active promotion activities on the part of local governments, the size of budgetary support by the national government will be determined on the basis of the assessment of local government efforts in promoting FDI.

The period of rental exemption for government properties has also been expanded to 50 years with possible further renewals. The investment projects located in FIZs, National Industrial Parks, and local

13) The infrastructure support can be provided to specific firms if their investment projects are large enough to be designated as FIZ.

14) There are about 80 business categories restricted solely for SMEs (which is defined for each business categories according to the size of employees and total assets) including manufacturing of toys, towels, and umbrellas.

government properties will receive the benefits of reduced rental fees. The precise reduction rates are stipulated in the Presidential Decree, varying according to the economic effects of each project, including investment size and employment creation effects.

While strengthening investment incentives is a necessary element of creating a competitive FDI environment, it raises the degree of discrimination to domestic investors since these incentives stipulated in the Foreign Investment Promotion Act are applied exclusively to foreign investors. It also contains a danger of triggering a harmful competition based on incentives among countries in the region. Another concern of the incentive clauses of the new act regards its effectiveness and efficiency. In particular, most of the incentives are pre-determined and offered uniformly to the eligible foreign investors without careful cost-benefit analyses.[15] Also, in order to induce more active promotion activities of local governments, local governments still require greater autonomy in terms of their rights to raise revenue and allocate resources. Meanwhile, those communities lacking sufficient revenue and other needed resources will need help from the central government to realize significant inward FDI.[16]

C. Administrative service

Even though the government has streamlined investment application procedures, poor bureaucratic service of government officials at both

15) Eligibility of tax incentives, rental reduction, and designation of FIZs stipulated in the Presidential Decree are dependent on the size of investment and employment creation effects as well as whether or not the projects are of high-technology nature.

16) Korea's decentralization is still in the early phases. The local governments are lacking in their rights to raise revenue and allocate resources.

the central and local level makes it difficult for foreign investors to establish their business in Korea. To alleviate this problem, the government recently designated the Korea Investment Service Center at KOTRA as a one-stop service agency. This center takes the role of settling applications related to establishment either directly by seconded officials or indirectly by the related administrative institutions and ministries. The Center also takes full charge of investor relations (IR) in promoting FDI.

To expedite processing applications at the local government level, the government introduced the Comprehensive Processing System for applications and the Automatic Approval System. Under the Comprehensive Processing System, applications are reviewed by grouping investment types into only a few categories, while approval of the main application among a certain package of applications implies supplementary approvals of the remaining applications. The Automatic Approval System means that an approval related to FDI shall be regarded as automatically granted if there is no response to its application within the time period stipulated by law.

Recognition of the role of post-establishment service in promoting FDI has led the government to set up an ombudsman for foreign investors at KOTRA. The ombudsman will address grievances and difficulties of investors. In order to solve matters requested by the ombudsman and to coordinate promotion activities of various institutions, the Foreign Investment Committee has been upgraded to the minister level. This committee makes decisions on the following issues: basic policy and FDI law; criteria for tax incentives (e.g. scope of businesses eligible for tax benefits); budgetary support for local governments; and designation of FIZs.

Even though the government made efforts to improve administrative service to foreign investors, the inter-ministry competition and lack of cooperation of government officials at the working level may raise doubts over these efforts.[17] The lack of expertise of local government officials also makes the effectiveness of the Comprehensive Processing and Automatic Approval systems questionable.

4. Privatization

Since the early 1990s, the Korean government tried to implement privatization plans for some of the state-owned enterprises (SOEs) to improve management accountability and to eradicate inefficiency. But these efforts failed due to opposition from interest groups, such as the SOEs themselves and their related ministries. However, the urgency to increase revenue and inject stable capital as well as to enhance efficiency has led the government to develop comprehensive programs for the privatization of SOEs. On July 3, 1998, the Planning and Budget Commission announced its first phase privatization program for 11 state-owned enterprises including Korea Electric Power Corp. (KEPCO), Pohang Iron & Steel Co. (POSCO), Korea Heavy Industry Construction Corp., and Korea Telecom (KT).

Out of these 11 state-run corporations subject to the first phase privatization plan, five companies and their 21 subsidiaries were selected to be privatized immediately. They are POSCO, Korea Heavy Industry & Construction Corp., Korea General Chemistry Corp., Korea Technology Banking Corp., and National Textbook Corp. The six

17) The lack of coordination of government ministries is a chronic problem in Korea and continues to shade the efforts of its top executive (The Korea Economic Daily, 7 October 1998).

remaining SOEs will be privatized on a gradual basis by 2002. A detailed privatization plan for major state-run corporations is presented in Table 8.[18]

The second phase privatization program which was announced on August 4, 1998, focuses on restructuring 19 SOEs, including the 6 SOEs targeted for gradual privatization under the first phase privatization plan.

5. Liberalizing foreign exchange transaction

For the last thirty years, Korea has strictly controlled its foreign exchange transactions. The heavily regulated foreign exchange control system has been a major roadblock for foreign investment. To facilitate foreign investment, the government has been undertaking incremental steps that will liberalize foreign exchange transactions to the level of advanced countries.

A. Liberalizing medium-term foreign loans and trade credit

As of July 1998, the government liberalized medium-term foreign loans in order to reduce the burdens on businesses seeking foreign capital. The requirement that commercial borrowing from abroad should exceed $1 million was eliminated. Furthermore maturity dates for commercial borrowing and the issuance of securities need only exceed one year instead of three years. The restrictions on the type of

18) Most of the foreign investments in the process of privatization are presumed to be counted as portfolio investment since there are individual ownership limits in many cases. Investment classified as FDI consists only of cases where investment exceeds 10% of total outstanding shares.

⟨Table 8⟩ First Phase Privatization Plan for State-run Corporations (July 1998)

Name[1)]	Privatization plans concerning foreign investment	Implementation
Korea Telecom Corp. (71.2%, 13)	· issuance of 15% of new shares to a strategic investor by 2000 · international public offering of up to 18% by 2000 · sell 33.4% of the government's shares after 2001	-
Korea Tobacco and Ginseng Corp. (35.3%, 1)	· public offer of 25% of government's shares by 1999 · remove the individual ownership ceiling and eliminate monopoly rights in 2000	-
Pohang Iron and Steel Corp. (26.7%, 16)	· immediate sell off of 26.7% shares · eliminate the aggregate foreign ownership limit & the individual ownership limit in 2001	· sold 5.11% shares through NYSE and LSE by ADRs on 11 December 1998
Korea Electric Power Corp. (58.2%, 7)	· offer for sale 5% shares by 1998 · offer for sale two power plants by 1999	· sold 5% shares through NYSE and LSE by ADRs on 26 March 1999
Korea Heavy Industries and Construction Corp. [2)] (3)	· immediate sale of shares to be offered through international open bidding process	-
Korea Gas Corp. (50.2%, 5)	· complete privatization by 2002	-
Korea General Chemistry Corp. [2)] (1)	· offer for sale 45% shares through trade sale	· sold a subsidiary (Namhai Chemical) to Farmer's Co-op on 30 September 1998
Korea Technology Banking Corp. (10.2%, 1)	· offer for sale shares through open bidding	· sold to The Will-Bes & Co. on 21 January 1999
National Textbook Corp. (40.0%)	· full divestiture of the government's equity interest by 1998	· sold to Daihan Textbook Corp. on 5 November 1999
Daehan Oil Pipeline Corp. (48.8%, 2)	· divestiture of the government's equity interest by 2000	-
Korea District Heating Corp. (46.1%, 3)	· offer for sale 51% or more of the government's shares by 2001	-

Note: 1) The government's shareholdings and number of subsidiaries are in parentheses.
2) The Government has no direct equity holding in Korea Heavy Industries and Construction Corp. and Korea General Chemistry Corp..

Source: Korea Planning and Budget Commission.

goods and duration of credit were also relaxed for import and export credits.

In addition, restrictions on investments in domestic securities by foreigners as well as the requirement that domestic subsidiaries of foreign companies obtain government approval when introducing more than $1 million from abroad have been eliminated.

Specific limits on the amount of foreign currency and forward exchange contracts have also been eliminated. Instead, a comprehensive management system has been put in place so that foreign exchange banks can more flexibly manage their assets, while at the same time, the bank supervisory can concentrate on enforcing the prudential regulations essential to maintaining the soundness of the banking sector.

B. Liberalizing foreign exchange transactions by business and financial sectors

In April 1999, Korea abolished the restrictive Foreign Exchange Management Act and replaced it with the Foreign Exchange Transaction Act. With the Foreign Exchange Transaction Act in place, most of the restrictions on foreign exchange transactions and domestic transactions in foreign currencies have been eliminated. Remaining restrictions are now classified under a negative rather than a positive listing system.

In addition, whereas previously the government specifically designated which financial institutions could be engaged in foreign exchange services, the new act stipulated that any financial institution which satisfies certain conditions need only to register in order to provide foreign exchange services. To eliminate the possibility of illegal capital flight and money laundering, the government requires various post-transaction confirmations and improved reporting, and bolsters prudent supervision on the capital procurement, operation and management of financial institutions.

Capital transactions to be allowed from 1 April 1999 are as follows:

- Offshore issuance of securities and foreign borrowing with a maturity of less than one year,
- Offshore investment in foreign financial markets, foreign insurance markets, and foreign real estate markets by domestic firms and financial institutions,
- Establishment of domestic savings deposits (including trust deposits) with a maturity in excess of one year by non-residents,
- Issuance of won-denominated and foreign-currency-denominated securities by non-residents, and
- Transactions of derivatives through domestic financial institutions.

C. Liberalizing foreign exchange transactions by individuals

From 2001, foreign exchange transactions by individuals such as won-based domestic deposits with maturities of less than one year by non-residents will be liberalized. The government will also allow individuals to freely deposit their money in foreign-based banks, buy foreign securities or foreign real estate. At this stage, the level of liberalization in Korea will be close to that of the OECD countries.

6. Import liberalization

The prevalence of import restrictions is a common complaint among foreign investors in Korea. In particular, Japanese investors have been attributing their diminishing investment to the prohibition of Japanese imports under the Import Source Diversification Program.[19] Thus, the government expects its market liberalization to increase foreign investor confidence in Korea while simultaneously improving the overall market efficiency. Also, through trade liberalization, Korea can facilitate competition, which will improve the international competitiveness of domestic industries, as well as improve consumer welfare.[19]

Currently, Korea has liberalized all 10,502 categories of imports with the exception of eight beef-related items. By January 2001, even these remaining eight items will be liberalized. When the Import Source Diversification Program is completely phased out in June 1999, Japanese firms in the automobile, machinery, and electronics markets will receive the greatest benefits.[20]

〈Table 9〉 Items under the Import Source Diversification Program (As of April 1999)

Tires used on motor cars	Excavators
Engine parts with spark-ignition internal combustion piston engine	Machining center
Motor cars of sedan type, 1,000-1,500cc, gasoline	NC horizontal lathes
Motor cars of sedan type, 1,500-3,000cc, gasoline	Electric rice cookers
Motor cars of station wagon, 1,500-3,000cc, gasoline	Video cassette recorder
Motor cars of jeep type, 2,500cc-, diesel	Radio-telephony apparatus (portable type)
Other parts for motor cars	Color TV (above 25 inch)
	Other camera for 35 mm roll film

Source: Ministry of Commerce, Industry and Energy.

19) This program has been implemented since 1981 in order to reduce trade deficit vis-à-vis Japan and to protect domestic industries. In 1981, 924 items (HS 10 digit level) were under this program. The number of items was gradually reduced to 200 items in the mid-1990s and 16 items in 1999.

20) The 16 items to be liberalized by June 1999 are presented in Table 9.

Other factors inhibiting imports will also be ended. Already, customs procedures have been changed from a pre-approval system to a notification system. Also, in order to improve the transparency of the import certification system, the government plans to revise various legislation on public health and safety, environmental protection, and public morals which deal with import procedures and import requirements for various goods. Currently, fifty-five laws administered by seventeen government ministries are being reviewed to simplify and clarify import procedures. Through this review and other efforts, the government is trying to improve the transparency of various technical requirements, certifications, and other criteria affecting imports. In addition, the government will examine the safety standards of Korea's trading partners so that these standards may be recognized in Korea's import procedures.

The government also revised the export promotion system to make it consistent with WTO norms by eliminating direct subsidies. In 1998, the government abolished three trade-related subsidies: Reserves for Export Losses, Reserves for Overseas Market Development, and Tax Credit for Investment in Facilities.[21] Export promotion efforts are now focused on improving trade infrastructure, trade exhibitions and on-line information systems.

21) The tax credit for investment in facilities is to encourage investment in facilities so as to develop technology and manpower or increase productivity. However, the rates of deduction applied to domestically produced facilities are higher than imported facilities.

IV. Some Evidences of Spillover Effects in Selected Industries

Foreign direct investment has an important role in economic development not only because it brings stable foreign capital but also because it raises productivity and efficiency through spillover effects. Studies on the spillover effects of FDI in Korea are limited: ESCAP, 1987; Kim, 1996; Kim, 1997a, for case studies; Choi and Hyun, 1991; Hong, 1997; Kim and Hwang, 1998, for empirical estimations. Due to the lack of firm-level data, most of the empirical studies are based on sector-level (two-digit) data. After correcting for the identification problem that comes from the tendency of FDI to be located in the more productive sectors, the spillover effects of FDI into Korea turned out to be insignificant (Kim and Hwang, 1998). Table 10 shows the detailed empirical results which used the random-effects model to deal with the possible endogeneity that FDI flows into the manufacturing subsectors with high productivity. For both OLS and random-effects model with or without instruments, the coefficient on the growth rate of FDI stock turns out to be positive, even though statistically insignificant.[22]

Spillover effects of foreign direct investment are more evident in some case studies. The case studies on the following industries show that foreign invested firms raised domestic productivity by:

· spinning out skilled workers
· providing technical guidance to subcontractors

22) The coefficient and t-ratio become smaller when the random-effects model is estimated using instruments.

· bringing in new capital goods and technology
· introducing advanced management know-how
· conducting in-house R&D
· enhancing competition

1. Electronics

The total number of foreign invested firms in the electronics sector was 62 in 1971. It was increased to 180 in 1980, 360 in 1990, and 450 in 1998. A typical example of the spillover effect can be found in the development of the semiconductor industry. In the late 1960s, US-multinationals such as Komy, Fairchild, KMI, Motorola as well as

〈Table 10〉 Regression estimates of the productivity effects of foreign direct investment into Korean manufacturing (1974~1996)

$$a_{it} = \beta_0 + \beta_1 fdi_{i,t-1} + \beta_2 roy_{i,t-1} + \varepsilon_{it}$$

	OLS	Random Effects	Random Effects (Instruments)[1]
Constant	0.049 (3.413)	0.049 (3.520)	0.064 (3.312)
$fdi_{i,t-1}$	0.037 (1.145)	0.037 (1.149)	0.032 (0.214)
$roy_{i,t-1}$	-0.054 (-0.948)	-0.052 (-0.926)	-0.132 (-1.116)
No. of observations	138	138	138
Adj. R^2	-0.001	-0.001	-0.002

Notes: Figures in parentheses are t-statistics.
1) $fdi_{i,t-2}$, $fdi_{i,t-3}$, $roy_{i,t-2}$, and $roy_{i,t-3}$ are used as instruments.
Source: Table 4-1 in Kim and Hwang (1998).

Toshiba and Sanyo, established assembly and test facilities in Korea. In the mid-1970s, Samsung made its entry into the semiconductor industry by taking over a joint-venture company, Korea Semiconductor (KSEC), which imported LSI technology for the production of CMOS chips used in electronic watches through its US partner, ICII. LG also started producing transistors by forming a joint venture with American Microsystems of the US.

Maybe the best example of spillover effects from foreign-invested firms is that of **Motorola Korea.** Founded by Motorola Semiconductor, **Motorola Korea** has been carrying out production on an OEM (original equipment manufacturing) basis at ANAM and Korea Electronics. Through field guidance, technical training, and production technology transfer conducted to enhance product quality, these two companies all grew to become world class semiconductor manufacturers, with many competent technicians going on to lead the Korean semiconductor industry at other companies such as at Samsung and LG Semiconductors.

Foreign firms also contributed to establishing the supporting industry by not only founding suppliers themselves but also through supporting promising former employees in establishing their start-up suppliers. In particular, Motorola Korea founded a nitrogen factory in 1968 and transferred the know-how to the domestic gas industry, which assisted local companies, such as Daesung Sanso Co., in developing industrial high purity nitrogen. At the same time, seeing that the Korean electronic industry was heavily dependent upon imported moldings, Motorola Korea established a separate molding production division within its factory and trained employees overseas at its U.S. headquarters. Moreover, when those technicians were establishing their own suppliers, the company allowed them to buy facilities at lower prices and supported their sales by way of purchasing their products. Through this method of start-up assistance, nearly ten firms were created, including Hanmi, Kookje, Micron, and Crown Precision Co., all eventually becoming leading semiconductor-molding producers in Korea.

Foreign invested companies often apply advanced managerial know-how as well as production technology from its headquarters to their operations in Korea. Founded as a joint venture with a Japanese electronic component manufacturer, **Roam Korea** has introduced TPM (Total Productive Maintenance), and this productivity improvement method has spread to many local companies. TPM is a movement targeting better productivity through the maximization of facility efficiency. TPM is implemented through operational reform in all departments ranging from the production floor to the offices of management. Another management technique was introduced by the Japanese partner. Similar to the Toyota production method, this new technique enables the producer to tailor the goods to order, achieving greater consumer satisfaction, simply by adding speed to the manufacturing process. In addition, this technique reduces cost and amplifies productivity by carrying out inspection and packaging at the production sites.

Halla Electronics, an automotive parts manufacturer set up as a 50% joint venture with Ford, is in charge of improving management efficiency and lowering the parts rejection ratio of the 21 local affiliated companies in the areas of electric field, injection, cutting tools, and pipes. For the 6 largest affiliates, Halla is directing management innovation campaigns in the areas of productivity, quality, organization, production, resource management, and computerization. Further it has presented management reform measures based on company-specific diagnosis to 10 local firms including Daewoong Electronic and conducted guidance for 9 firms including Daejung Polymer in their efforts to achieve ISO9002 certification.

2. Chemicals

There were 34 foreign subsidiaries in the chemical industry in 1971. The number has been increased to 82 in 1980, 235 in 1990, and 338 in 1998. Established in 1977 as a branch, **DuPont Korea** provides a good example of 'forward linkage effect' cases. The company renders full technical support for its customers, dispatching highly skilled technicians to locations throughout the world when a new DuPont product is introduced. For this purpose, the company is running technical support centers for engineering polymer, a state-of-the-art material, Butasite, an auto/construction adhesive safety glass resin, TiO2, a white pigment, and its automotive paint series, *Centaree*. DuPont Korea also holds various seminars and exhibitions to provide its customer with the most up-to-date information regarding DuPont products.

DuPont Korea also serves as a good case of 'backward linkage effect'. The company regards subcontractors as partners and provides all sorts of advice and know-how needed in the production process. In particular, DuPont Korea prioritizes sponsoring security and environmental protection activities, as demonstrated in its "Transportation Emergency Reporting Procedure." The program was initiated by the company under the idea that delivery/transportation of products are equally important elements of the production process and thus require equivalent awareness of security issues as other production processes. Also, in order to transfer accumulated experience and know-how to local companies, DuPont Korea developed and made widely available SEMS, a safety and environment management program, as part of its service activities since 1995. In implementing the project, DuPont conducted safety diagnosis of the production process for three Yochon and Ulsan factories of Hanwha Chemical, and provided a production process safety workshop to Samsung Electronics. Furthermore, since May 1996, DuPont has been working in partnership with the Korea Industrial Safety Association in all industrial safety matters, contributing to the enhanced safety management of industrial organizations in Korea.

Furthermore, foreign subsidiaries contributed to upgrading the overall management process in the Korean chemical industry. **DuPont Korea** provides the managers of domestic firms a chance to visit the U.S. headquarters and learn their security & environment policy, marketing technology, and managerial know-how. Through a new business management process ("Business Resource Planning") adopted in 1996 from its headquarters, Dupont is reviewing strategic decision-making process with customers in order to solidify the production process of effective market forecast, production planning, and inventory minimization.

Likewise, **Prex Air Korea,** an industrial gas manufacturer, has also adopted MPC (model predictive control) to reduce electric power consumption, while maximizing productivity. At the same time, in the area of security management, the firm has introduced an auto safeguard driving system (Smith System), an emergency action guideline called LEAP (Linde Emergency Action Procedure). It also launched a new management analysis technique, called EVA (Economic Value Added) in 1995.

3. Machinery

Machinery is one of Korea's fastest growing sectors in terms of the presence of multinationals since 1990s. The number of foreign subsidiaries in machinery was 36 in 1971, increasing to 97 in 1980, 305 in 1990, and 525 in 1998. The case of Volvo Korea established in 1998 signifies the role of multinationals in changing the management system of Korean firms. After the acquisition of the construction equipment unit of Samsung Heavy Industries, Volvo has shown dramatic changes in the management atmosphere including rationalization of operational process, enhancing transparency, and globalizing the management system.

In sharp contrast to the hierarchical and authoritative structure of Korean companies, Volvo has rationalized the administrative process of its new Korean subsidiary into a more horizontal and consultative one. Examples such as the chairman seeking employee input prior to making decisions abound. Approval procedures also have been changed; the previous practice of reporting only the best option to be approved has been ended. Instead, vigorous consultation among the chairman, the board and the employees over various options precedes any final decisions.

Since Volvo's acquisition, the company has also enhanced transparency by disclosing all corporate information to the public in principle. The only exceptions are those of trade secrets.

Volvo combined its construction equipment units across 15 countries worldwide, establishing a global system of **purchasing-sales-after service** departments network. As a result, the earlier hierarchical approval system has disappeared, and each department is grouped separately, creating individual clusters of purchasing departments, development departments, and sales departments. Thus, the previous uniform top to bottom corporate decision making no longer exists as each group makes decisions and operates largely autonomously.

4. Pharmaceuticals

Until the late 1950s, the Korean pharmaceutical industry remained at a primitive stage where most of the production was based on herbal drugs. Since the Foreign Capital Inducement Act was enacted in 1962, many wholesale merchants and importers established joint ventures with foreign pharmaceutical firms. During the 1960s, five joint ventures were established and the total number of foreign invested pharmaceutical firms increased from 10 in 1971 to 24 in 1980, 60 in 1990, and 70 in 1998. These foreign invested firms contributed to the upgrading of drug manufacturing from the fabrication using imported raw materials to raw material manufacturing.

Handok Pharmaceutical provides a good example. It was originally incorporated in 1954 as an import agent and wholesaler of drugs. In 1959, it started fabricating with technical assistance from a German chemical multinational, Hoechst. In 1964, establishing a joint venture with Hoechst, it expanded into synthesis with fundamental and intermediate raw materials rather than mere fabrication. The company also began to build up its own in-house technical capabilities in the early 1970s. In 1976, its local research institute developed the chemical synthesis technology for ethambutol which is the raw material of tuberculin.

5. Retailing

Retailing, along with the financial industry, is one of the least developed industries in Korea. The share of mom-and-pop grocery stores and traditional local markets which are usually run by one of two family members accounted for around 80% of Korea's $116 billion retail market in 1996.

Since the removal of restrictions on the numbers and sizes of retail stores in 1996, large-sized discount stores or hyper-markets (HPMs) have been established by such foreign retailers as Makro, Carrefour, and Wal-Mart. The most significant impact of this liberalization is the change of market structure. The Korean retail industry was characterized by a manufacturer-dominated structure in which manufacturing firms not only produce but also participate in retail sales as a dominant player.[23] However, the increasing number of HPMs is changing this structure in that increased buying-power now puts the price determination into the hands of retailers rather than manufacturers. Due to the fear of losing price determining power to foreign HPMs, the *Chaebol* manufacturers are entering the retail industry by setting up HPMs on their own.[24] In this sense, a Big-Bang is occurring in the Korean retail industry (Korea Economic Daily, 23 May 1997).

23) This manufacturer-dominated structure is perceived to originate from government policies to promote the manufacturing industry (Chun 1991, pp.25-26). The percentage of retail sales by manufacturing firms is 100% for automobiles, 90% for consumer electronics, 80% for apparel, and 70% for food in 1994 (Ministry of Trade and Industry 1994, pp.10)

24) It is estimated that such *Chaebols* as Samsung, LG, Daewoo, and Hyundai will establish 100 HPMs by 2000 (Discount Merchandiser, January 1997, pp.22)

The HPMs are also helping small- and medium-sized manufacturers by selling their products which department stores have ignored. These small- and medium-sized firms account for more than 60% of the total sales of HPMs. Also, in the process of purchasing from domestic producers, foreign HPMs provide technical assistance in production methods, training of workers, financial assistance, and marketing information (Lim 1990, pp. 127)

Foreign convenience stores (CVS) also contributed to the Korean retail industry via technology transfer in the area of merchandising and inventory management including Point of Sales (POS) system.

V. Future Agenda: Removing Remaining Impediments to Inward FDI

Considering the benefits of FDI in raising productivity through spillover effects, it is needed to attract more FDI by removing remaining barriers. As entry barriers have been almost completely ended, most remaining obstacles are the same as faced by domestic investors. These barriers are more complex to remove because they are part operating practice, part regulation, and part cultural. Also, the present FDI promotion system, including incentives, are aimed at large investments. Thus small and medium investors, who could potentially play an important role in improving labor skills and in providing further benefits to the local economy, largely ignored (Michell, 1998).

1. Formal barriers

Although the government is making some progress by streamlining investment procedures, Korea's markets and industries are still bogged down with regulations that are as complicated as they are vague. In particular, the ambiguous tax laws as well as cumbersome regulations on customs and import procedures are regarded as the most serious impediment to foreign investors (KOTRA, 1998). A common problem faced by foreign businessmen is that regulations are subject to various interpretation by different regulatory authorities.

Besides the sectoral restrictions stipulated in the Foreign Investment Regulations, there remains some discrimination to foreign investment specified in other laws and regulations. For example, in order to practice law or accounting in Korea, one should pass the national examination which is in the Korean language. Also, the Special Management Law Concerning the Defense Industry imposes limitations on foreign participation in the defense industry so that at least 50% of the employed technicians should be Korean nationals.

In the case of the financial service sector, there are minimum investment requirements in terms of paid-in capital. These requirements are considered as prudential regulations but foreign investors complain that the extent of this requirement is so excessive as to deter entry by smaller investors.

Another important area which has not been adequately addressed is labor market inflexibility. Layoffs are still difficult to execute on a large scale and are allowed only in the case of emergency. Efforts to enhance labor market flexibility is limited by the lack of a social safety net.

A key barrier to deals related to M&A activity in Korea is valuation. Agreement on valuations in Korea is difficult because Korean sellers often appear to be fixed on one price which is derived from a mix of book values, personal contribution to a business and other factors difficult to assess. This differs markedly from Western concepts of company valuation which center on discounted cash flows (Feltis, 1998). Another barrier related to M&A has been created by the government providing a special revaluation period for 1998 during which companies can revalue real estate and tangible assets without paying special taxes (Moskowitz, 1998).[25] Other barriers to M&A

25) The explicit objective was to improve Korean company balance sheets in anticipation of aggressive inbound investments. However, the immediate effect of this measure was to stop many acquisition negotiations. The Koreans wanted to delay proceedings so they could execute revaluations,

activity besides valuation can be summarized as follows[26]:

1. The veracity of even audited financial statements remains uncertain as accounting transparency remains a goal, rather than reality
2. Korean firms are often cited as carrying out transactions that disregard the shareholder's best interests, such as intra-group loan guarantees
3. A company's tax status might not be as straightforward as in many Western countries in that the Korean tax authorities have a much wider ability to apply special tax incentives, or to deny their applicability.
4. Most Korean firms are highly leveraged and banks are often reluctant to haircut their loans.

2. Informal barriers

Koreans appear to have lost their fear and embarrassment of a foreign company taking control of a domestic company.[27] However,

which would strengthen their positions, while foreign investors believed that the revaluations were rather artificial and that this measure held "surprises" for foreigners and represented a continued lack of transparency in regulation.

26) These issues were raised in the Sixth Roundtable with the Government of the Republic of Korea held by the Economist Conferences in Seoul, June 22-24, 1998. They are also addressed in Morris and Underwood (1998).

27) According to a survey by Sofres FSA, a French market research company, Koreans changed their attitudes toward foreign companies. The survey of 1,000 Koreans revealed that 75% of respondents accept the need for foreign M&A. In fact, 86% of workers in industrial facilities said they

anti-foreign public sentiment remains at the top of lists of perceived weaknesses of the Korean culture from the point of view of foreign investors (KOTRA, 1999). Other weaknesses pointed out by foreign investors include a lack of rationality due to personal decision-making or emotional reactions, relationships based on school or locality, lack of flexibility or resistance to change, militant labor unions, poor dissemination of information, and the lack of internationalization.

Furthermore, legal weaknesses of the Korean society in general aggravates the problem. One of the common complaints by foreign businessmen is that real estate owners often demand side contracts to reduce their tax burden (Kim, 1997b).

Regarding the living conditions for managers and employees of foreign investors, the Political and Economic Research Consulting (PERC) of Hong Kong conducted a survey in May 1998. Among the ten East Asian capital cities that were surveyed, Singapore was rated as having the highest living standards, Hanoi ninth and Seoul tenth. The main reasons cited by those surveyed on Seoul were the closed society,[28] language problems,[29] traffic congestion, air pollution and the

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were willing to accept a merger with a foreign company (Korea Times, 10 July 1998).

28) Many foreign managers argued that openness in all areas of society including imports is the most important factor to raise confidence among foreign investors. Some even complained that it is difficult to buy their favorite foreign food products (Kim, 1997b).

29) It is extremely difficult to find English language competency below the level of top officials in Korea. One World Bank official argued that if investors were ready to accept language barriers, they could easily go to China which has lower wages and few labor relations problems (Aiyer, 1998).

high cost of living.

There also exists a substantial trust deficit or perception gap between Korean and non-Korean negotiators. According to a recent survey, more than half of non-Korean negotiators had difficulty trusting Korean counterparts and only 20% of non-Koreans felt that treating foreigners as a partner was of value to Koreans. This can, in part, be attributed to a lack of understanding by the Western party of the Korean social system and of how this system is reflected in organizational structure.[30] Such understanding takes time and experience to accumulate (Bowen, 1998).

30) Deals are often broken after exchanging a Memorandum of Understanding (MOU) in such cases as the negotiation between Hanwha and AES over Hanwha's power plants (Maeil Business Newspaper, 14 September 1998). Bowen (1998) argues that the lack of creativity on the part of Korean negotiators originates from the educational system which encourages a "win-lose" type of fierce competition as well as from their decision-making process of delegating very little responsibility to negotiators.

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國文要約

우리 정부는 1997년말 외환위기 이후 적극적인 외국인투자 촉진정책을 실시하였다. 1998년 11월에는 수요자중심의 투자제도를 마련하기 위해 외국인투자촉진법을 제정하였다. 동 법의 주요내용은 외국인투자 절차를 간소화하고, 투자인센티브를 확충하며, 원스톱서비스를 제공하는 제도적 장치를 마련하는 것이다. 이와 함께 정부는 국경간 인수합병과 외국인토지 소유에 대해 전면적인 자유화를 실시하였다.

또한 1998년 7월 정부는 상업차관에 대한 한도를 철폐하는 등 중장기 해외차입을 자유화하였고, 1999년 4월에는 외국환관리법을 외국환거래법으로 대체함으로써 외국환거래에 관해 대부분의 규제를 철폐하였고 나머지 규제도 네거티브 시스템으로 전환하였다.

이러한 자유화정책에 힘입어 1998년 외국인투자는 51억 달러로서 사상최고 수준을 기록하였다. 특히 인수합병에 의한 외국인투자가 크게 늘어났는데, 1998년도 구주취득에 의한 외국인투자는 12억 달러로서 총 외국인투자의 14%를 차지하였고, 자산취득에 의한 것까지 합한다면 총 외국인투자의 50%를 초과하는 것으로 추정된다.

기존의 사례분석 결과에 의하면 외국인투자기업들은 반도체 및 화공분야를 포함한 여러 산업에서 생산성을 제고시키는 효과를 가져왔다. 이러한 생산성 파급효과를 가져오는 경로로는 숙련 고용자의 배출 및 이들에 대한 창업지원, 하청기업에 대한 기술지원, 신기술 및 자본재의 도입, 선진경영기법의 이전, 자체 연구개발, 경쟁제고 등을 들 수 있다.

이와 같은 생산성 제고효과 등의 이득을 고려할 때 향후 잔존하는 투자장애요인을 제거하여 외국인투자를 더욱더 유치하는 것이 필요하다. 현재 국경을 넘나들 때 겪는 진입 장벽을 거의 제거되었으나, 국내기업과 마찬가지로 겪게 되는 영업환경상의 규제 등 국내적인 장애요인이 많이 잔존하여 있는 실정이다. 특히 애매모호한 세법과 복잡한 통관 및 수입절차 등은 외국인투자자들이 가장 불편을 지적하는 사항이다.

또한 경영상의 긴박한 어려움이 있을 때에만 고용조정이 가능하도록 한 요건이 너무 엄격하다는 것도 지적되고 있으나, 노동시장 유연성의 확보를 위해서는 사회안전망의 구축이 시급한 과제이다.

한편 외국인투자자의 입장에서는 아직도 우리 국민의 배타적 인식이 문화상의 약점으로 지적되고 있고, 그 외 개인적 의사결정 및 감정적 대응 등 합리성의 결여, 학연 및 지연, 변화에 대한 유연성의 결여, 호전적인 노조, 정보전파의 부족, 국제화의 미흡 등도 문화상의 장애요인으로 지적되고 있다.

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