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The Impact of Foreign Direct Investment on Domestic Economic Activity in Korea

LEE Seungrae

Ph.D., Research Fellow, Trade and Investment Policy Team
Korea Institute for International Economic Policy

Foreign direct investment (FDI) is an investment made by a firm based in one country, into a firm or affiliate based in another country. FDI is substantially different from indirect investments such as portfolio foreign investment, which is passive investment in the securities of another country, for instance public stocks and bonds. While portfolio investment is made by firms whose overseas institutions invest in equities listed on a nation's stock exchange, firms making direct investments typically have a significant degree of influence and control over the firm into which the investment is made. The control is implemented by participating in management, forming a joint-venture, or transferring technology and expertise. FDI usually involves mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations, and intra-company loans. Open economies with skilled workforces and good growth prospects, therefore, tend to attract larger amounts of foreign direct investment than closed, highly regulated economies.

Korea started investing directly abroad since the late 1960s. Korean FDI initially had an insignificant annual outflow because of governmental control on foreign exchange outflows and incapability on the part of firms. Korean FDI began to expand from the late 1980s when the relevant restrictions were lifted. Over the next few decades, while there have been ups and downs due to the regional and global financial crisis, FDI increased exponentially, amounting to $4.2 billion of investment outflow in 1996, $11.8 billion in 2006, and $26.7 billion in 2014. The number of foreign affiliate has increased to 2796 affiliates in 2014 from 345 affiliates that were established in 1990. Across the industry sectors, a large amount of FDI originated from manufacturing sectors, especially capital-intensive sectors such as electronic components, motor vehicles and trailers, and chemical products sectors, while FDI from service sectors is steadily increasing over time. An investigation into the destination of FDI flow shows that China and the United States account for more than 50% of Korean FDI, followed by developing and emerging economy countries including Brazil, Indonesia, Hong Kong, and Vietnam. Between Korean multinational firms, it appears that most of FDI is generated by large conglomerates with much use of capital-intensive technologies. While small and medium-sized firms appear to have an increased number of new affiliate establishments, they are mostly concentrated in labor-intensive technologies and investment amount per affiliate is very small relative to large conglomerates.

Along with the growth of Korea’s outward FDI, in particular, the rapid growth in the 21st century, the concern for its effect on trade and domestic economic activities, such as investment and employment has also grown. While Korean outward FDI could improve the competitiveness of Korean firms in the global market and also boost exports from Korea to the host country through intra-firm trade in intermediate inputs and capital equipment, concerns are growing over the so-called ‘hollowing-out effect’ of these FDIs, which implies that greater outward FDI crowds out domestic economic activities, especially employment, and that outward FDI may substitute Korean exports to the host country. In regards to the effects of Korean outward FDI on trade and domestic economy, while most of previous academic studies reach the same conclusion that FDI can increase exports and improve the trade balances of the home country, there also exist mixed results on the effects of FDI on domestic investment and employment. For instance, there are a number of studies showing that FDI can have an ambiguous effect on the domestic economy in general, and hollowing-out is possible, while other studies found that outward FDI does not crowd out domestic investment nor has a negative effect on domestic employment in Korea. Investigating the same issues using data from other countries, the results were also mixed, showing that outward FDI can have positive, negative, or indeterminate effects on domestic investment and employment.

A recent project report by KIEP used Korean firm- and affiliate-level data to examine the effects of outward FDI on trade and domestic economic activities, in particular on firm exports, domestic investment and production, and employment. The results showed that firm FDI has a positive effect on trade and domestic economic activities. When dividing a sample group of firms based on their industry sectors, destination country, firm size, and purpose of investment, the positive effects of FDI on domestic investment and production appear to be significant across firms that engage in vertical FDI, a firm activity of establishing manufacturing facilities in multiple countries, each producing a different input to, or stage of, the firm’s production process, in developing countries. Considering that these “vertical” affiliates have a large share of purchases from their parents in Korea, it is reasonable to conjecture that active intra-firm trade in intermediate inputs and capital equipment induces an increase in related domestic investment and production.

On the other hand, the positive effects of FDI on exports are shown to be significant across firms that engage in horizontal FDI, a firm activity of duplicating home-based production activities at the same value chain stage in a host country, in developed countries. While firms’ engagement in horizontal FDI may create concern about substituting production activities in the home country and exports, “horizontal” affiliates’ having a large share of purchases from parent firms in Korea imply that intermediate or final products and capital equipment are actively traded through firm exports from home, and this intra-firm trade offsets the substitution effects of horizontal FDI. Since these results were based on the data of multinational firms that made at least 1 million dollars of foreign investment between 2006 and 2013, one must be very cautious about interpreting the results. In particular, we should be aware that the positive effects of Korean FDI on domestic economic activities apply to these multinational firms and should not be over-interpreted from the national perspective.

Previous and recent reports on the effects of Korean FDI on domestic economic activities suggest that FDI has a positive effect on domestic economic activities and provide evidence that FDI does not have “hollowing-out effects”. However, in order to overcome public concern on the negative effects of FDI, such as hollowing-out or substitution effects, it is very important for the government to undertake a promotion based on logical reasoning. In particular, it is necessary to convince the public that FDI is a part of firm activity to maximize profit, and firm decisions should be respected. Rather than investing more resources in lifting restrictions that hinder ex-ante FDI activities, we need to consider ex-post FDI activities. For instance, results from the recent report that show small and medium-sized firms experience the negative effects of FDI on their employment, while most domestic economic activities are positively associated with firms' FDI, suggest that firm investment and production are connected weakly to employment. Taking into account that most of Korean FDI related restrictions are lifted and that firms make their own FDI decisions, we need to turn our attention to the effects of FDI spillovers on the connectivity between internal firm factors. KIEP