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Please cite this paper as:

Nicolas, F., S. Thomsen and M. Bang (2013), "Lessons from Investment Policy Reform in Korea", *OECD Working Papers on International Investment*, 2013/02, OECD Publishing.
http://dx.doi.org/10.1787/5k4376zqcpf1-en

OECD Working Papers on International Investment 2013/02

Lessons from Investment Policy Reform in Korea

Françoise Nicolas, Stephen Thomsen, Mi-Hyun Bang

JEL Classification: F21, F23, F53, O24, O53

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Abstract

LESSONS FROM INVESTMENT POLICY REFORM IN KOREA

by

Françoise Nicolas, Stephen Thomsen and Mi-Hyun Bang*

As more and more countries seek to liberalise their foreign investment regimes to attract global flows of foreign direct investment (FDI), an essential question for policy-makers is no longer just *what* to reform but also *how* to reform. How is a reformist government to sell the idea of reform to the general public and to counter any opposition to reform? How are those who lose from reform in the short term to be compensated? Does sequencing of reforms matter?

Korea offers a particularly interesting case study because its reforms beginning in the 1990s were both rapid and far-reaching. Based on the OECD *FDI Regulatory Restrictiveness Index*, Korea was the biggest reformer of its policies towards FDI between 1997 and 2010 among a sample of 40 developed and emerging countries. The objective of this study is to document the liberalisation of the FDI regime in Korea and to examine how and why it came about. What were the main obstacles and what were the main drivers? How did FDI liberalisation relate to other reforms (trade policy and regulatory reform, policies towards outward investment)? The paper does not ask what more Korea needs to do but rather what lessons can we draw from the Korean experience about how to achieve rapid and sustainable reforms?

The insights from Korean liberalisation are useful for other countries, particularly non-OECD members in Asia and elsewhere, which still have high levels of statutory restrictions as measured by the FDI *Index*. Many of these countries are eager to attract more investment and recognise that they will need to reform their investment regime but are unsure how best to proceed. Each country's reform path is unique, and this study will not provide a roadmap for other countries to follow, but it will nevertheless serve as a useful model for reformers in other countries and provide evidence that successful reform is accompanied by rising inflows of direct investment.

JEL Classification: F21, F23, F53, O24, O53
Keywords: South Korea, foreign direct investment, FDI Regulatory Restrictiveness Index, investment policy reform, segyehwa

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EXECUTIVE SUMMARY

Starting from a situation in which FDI was severely restricted, Korea has been the greatest reformer of its FDI restrictions among OECD members and key emerging economies since 1997. Reforms in Korea were driven by a mixture of microeconomic considerations (the need to acquire foreign technologies and to enhance competitiveness) and macroeconomic ones (chronic trade and current account deficits and the need to fill a domestic savings gap). As in most countries, the government embarked upon reforms once the status quo was no longer seen as sustainable or sufficient.

Reforms almost always involve the interplay of internal and external factors, and the question of whether the pressure for reform was primarily internal or external is not germane. Governments routinely use crises and external pressure to push through unpopular reforms and sometimes lock in existing reforms through international agreements. If anything, crisis-induced reforms can lack legitimacy once the crisis has abated. In Korea, reforms clearly accelerated at the time of the crisis, faced with the acute need to repair balance sheets. But the substantial reforms undertaken in Korea since the early 1990s cannot be reduced to a simple crisis response. Two Five-Year Liberalisation Plans were introduced in the early 1990s, together with a Reform Programme to improve the investment environment. The government at the time also negotiated OECD membership by late 1996 with a commitment to further reform.

The Korean experience also demonstrates the need to have a critical mass of reform in place before foreign investors will respond. Many early reforms – such as the shift from a positive to a negative list of restricted sectors – were hesitant and incomplete, leading to only a modest rise in FDI inflows at the time. The takeoff in FDI inflows in the mid-1990s is a clear manifestation that this critical mass had been achieved.

Going beyond the roadmap for reform, successive governments have made sustained efforts to promote public awareness of the benefits of further openness, including both high-level pronouncements and the *segyehwa* or globalisation policy. The Korean government has also made many institutional changes, such as through the Committee on Foreign Direct Investment and the Investment Ombudsman, to improve not only the investment climate itself but also the climate for investment policy making. The *segyehwa* policy and the Tripartite Commission were designed to foster greater acceptability of the need for reform.

Reform is not a one-time occurrence but rather a continuous process. While many countries have reformed significantly over time, as Korea did in the 1990s and beyond, increasing regional and global economic integration, together with technological change, imply that policies will have to be continuously adjusted in response to changing circumstances. The most interesting lessons from the Korean experience do not relate to the crisis in the late 1990s and the government's response but rather to how successive governments have worked to create a suitable enabling environment for reform.

Reforms should be pre-announced, with political support at the highest level, a credible schedule for implementation and no backtracking

- Like many countries in Asia, Korea prepares Five-Year Plans which set out the objectives of government policy over the next five years. Beginning in the early 1990s, the government set out a medium-term agenda for reform through its five-year FDI liberalisation plan. According to a *Trade*

Policy Review[1] by the WTO just before the crisis, "actual implementation of liberalisation measures and programmes, usually announced years in advance, has been remarkably consistent, without any significant delays or reversals".

Public awareness campaigns about the benefits of openness should be recurring events

- As with the government's *segyehwa* strategy, the public needs to be informed about the benefits of openness. Since this policy ended in the late 1990s, public opposition to foreign investors has grown, along with the rise in FDI in the Korean economy. Foreign investors can also take upon themselves part of the responsibility for public information campaigns, but these are likely to be most effective if the government is also involved.

A forum for public dialogue is an essential component of reforms, helping to improve both the effectiveness of reforms and the buy-in from local stakeholders.

- The Tripartite Commission was created in Korea in 1998 in order to involve all key stakeholders in the discussion of reform as a way of escaping from the crisis. The Commission was renamed the Economic and Social Development Commission in 2007, with an even greater role for civil society.

Dialogue should also include foreign investors...

- In addition to its role in settling grievances of foreign investors through its Home Doctor system, the Investor Ombudsman also represents the views of foreign investors within government.

...as well as across ministries and different levels of government

- In 1999, the government also established the Committee on Foreign Direct Investment (CFDI) to review FDI policies and systems on a continual basis. The Committee consists of representatives of various ministries and agencies, such as the Ministry of Knowledge Economy (MKE) and the Ministry of Strategy and Finance (MOSF), and heads of relevant local and city governments. It is chaired by the minister of MKE. The Committee makes major policy decisions on FDI and prepares an annual FDI Environment Improvement Plan, based on proposals submitted by ministries and local governments, which are members of the Committee. Conflicts between the central government and local governments, for example, are to be resolved in this committee (Jeon and Ahn 2001).

- Under an amendment to FIPA, the president of KOTRA was designated as an official member of the CFDI (members were previously limited to ministers and governors).

- The 2000 amendment authorises the CFDI to adjust the measures of relevant government agencies for the improvement of the foreign investment environment. It also obliges MOCIE to report to the CFDI about steps being taken by such agencies to improve the foreign investment environment.

FDI liberalisation is most effective when embedded in a broader reform agenda

- FDI reform was complemented by both trade and regulatory reform, the liberalisation of restrictions on outward investment and by significant improvements in investment promotion and facilitation, including the creation of the Investment Ombudsman providing feedback to the whole reform process.

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[1] WTO (1996), p. 67.

INTRODUCTION

South Korea is one of the greatest economic success stories of the past 50 years. From an impoverished country after the Korean War, it is now one of the richest economies in Asia. During the same period, South Korea successfully managed a transition from authoritarian regime to democracy with a popularly elected president. Direct presidential elections were restored in 1987, followed by the first civilian president, Kim Young-Sam, elected in 1993 (Box 1).

Box 1. **Presidents of the Republic of Korea**

Rhee Syngman (1948~1960)
Yun Bo-Seon (1960~1962)
Park Chung-Hee (1962~1979)
Choi Kyu-Hah (1979~1980)
Chun Doo-Hwan (1980~1988)
Roh Tae-Woo (1988~1993)
Kim Young-Sam (1993~1998)
Kim Dae-Jung (1998~2002)
Roh Moo-Hyun (2002~2008)
Lee Myung-Bak (2008~2013)
Park Geun-Hye (2013~)

Because of its tremendous economic success over decades, interrupted only by the Asian financial crisis in 1997, Korea is often taken as a development model for other countries in Asia and beyond. Unlike in some other countries in the region, foreign direct investment (FDI) played much less of a role in the early stages of Korean development. Successive Korean governments experimented with import substitution, export promotion and then industrial policies in the form of the Heavy and Chemical Industry (HCI) Promotion Plan. Within these strategies, any role for foreign investors was carefully circumscribed. Foreign investment was welcomed when it could contribute to exports or technology transfer or to alleviate balance of payments difficulties. But for long periods, technology licensing and international borrowing were preferred means of achieving these objectives.

In spite of this legacy, Korea is now host to USD 133 billion in foreign direct investment, with few regulatory restrictions on foreign investors. While the stock of FDI remains relatively low in relation to GDP, partly for historical reasons, FDI inflows have soared since the late 1990s in response to dramatic reforms of restrictions since the early 1990s. These reforms transformed Korea from the second most restrictive country for FDI out of all OECD members and major emerging economies based on the OECD *FDI Regulatory Restrictiveness Index* to one of the most open in Asia in terms of statutory restrictions. The improvement in Korea's score under the *FDI Index* was unprecedented since 1997 and twice as great as the next most reformist country.

The objective of this study is to document the rapid and far-reaching liberalisation of the FDI regime in Korea and to examine how and why it came about. What were the main obstacles and what were the main drivers? How did FDI liberalisation relate to other reforms (trade policy reform, regulatory reform, etc.)? The paper does not ask what more Korea needs to do but rather what lessons can we draw from the Korean experience about how to achieve rapid and sustainable reforms?

The insights from Korean liberalisation are useful for other countries, particularly non-OECD members in Asia and elsewhere, which still have high levels of statutory restrictions as measured by the *FDI Index*. Many of these countries are eager to attract more investment and recognise that they will need to reform their investment regime but are unsure how best to proceed. Each country's reform path is unique, and this study will not provide a roadmap for other countries to follow, but it will nevertheless serve as a useful model for reformers in other countries and provide evidence that successful reform is accompanied by rising inflows of direct investment.

MEASURING FDI LIBERALISATION IN KOREA

Measurement allows for benchmarking of performance over time and across countries. In the context of this study, it provides a visual estimate of the pace of FDI liberalisation. This can then be correlated both with the response of investors in terms of FDI inflows and with the stages of reform in terms, not only of FDI policies, but also of complementary measures in the areas of competition and trade policies or regulatory reform. The reforms of Korean FDI policies will be measured on the basis of the OECD *FDI Regulatory Restrictiveness Index* (Box 2).

Box 2. Calculating the FDI Regulatory Restrictiveness Index

The OECD *FDI Regulatory Restrictiveness Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial and professional services).

For each sector, the scoring is based on the following elements:

- the level of foreign equity ownership permitted,
- the screening and approval procedures applied to inward foreign direct investment;
- restrictions on key foreign personnel; and
- other restrictions such as on land ownership, corporate organisation (*e.g*. branching).

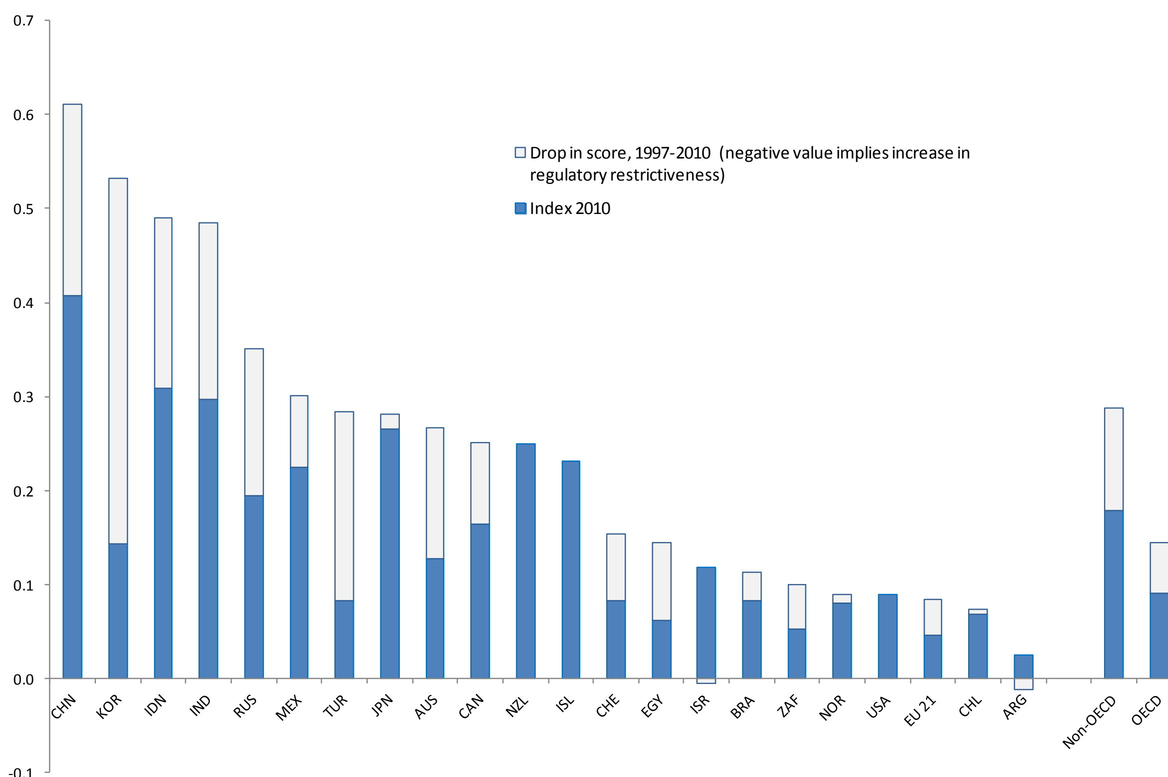
Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a weighted average of individual sectoral scores.

The measures taken into account by the *Index* are limited to statutory regulatory restrictions on FDI, typically listed in countries' lists of reservations under FTAs or, for OECD countries, under the list of exceptions to national treatment. The *Index* does not assess actual enforcement. The discriminatory nature of measures, *i.e*. when they apply to foreign investors only, is the central criterion for scoring a measure.

For the latest scores and for a discussion of the methodology, see www.oecd.org/investment/index

From 1997 to 2010, during a period when many countries removed statutory barriers on investment, Korea managed to remove almost twice as many restrictions as the next more reformist country: China. In 1997, Korea ranked second after China in terms FDI regulatory restrictiveness but by 2010 it had moved to tenth place (Figure 1). Based on the OECD *FDI Regulatory Restrictiveness Index*, Korea's score fell from 0.532 in 1997 to 0.143 in 2010 (Table 1). Reforms were accelerated by the Asian financial crisis in 1997, but the process was already under-way in the mid-1990s at the time of accession to the OECD.

Figure 1. OECD FDI Regulatory Restrictiveness Index, 1997 versus 2010



Source : OECD (www.oecd.org/investment/index)

Figure 2 shows FDI liberalisation in Korea over time by two different measures. The Korean government typically shows liberalisation by calculating the number of sectors closed to FDI out of all possible sectors. In 1980, almost 600 sectors were fully closed to FDI, representing one half of all possible sectors.[2] This number was halved in the first half of the 1980s, with a similarly dramatic drop in the first half of the 1990s. Only three sectors are now completely closed to foreign investment (radio and television broadcasting, nuclear power).

Many sectors which were opened in the 1980s maintained some limits on foreign equity initially. Thus complete liberalisation of these sectors occurred with a lag. By 2002, 27 sectors had partial restrictions on FDI, a still significant number relative to other OECD countries but a substantial improvement over only a decade earlier.

Table 1. Countries* with the greatest absolute decline in their FDI Index score from 1997 to 2010

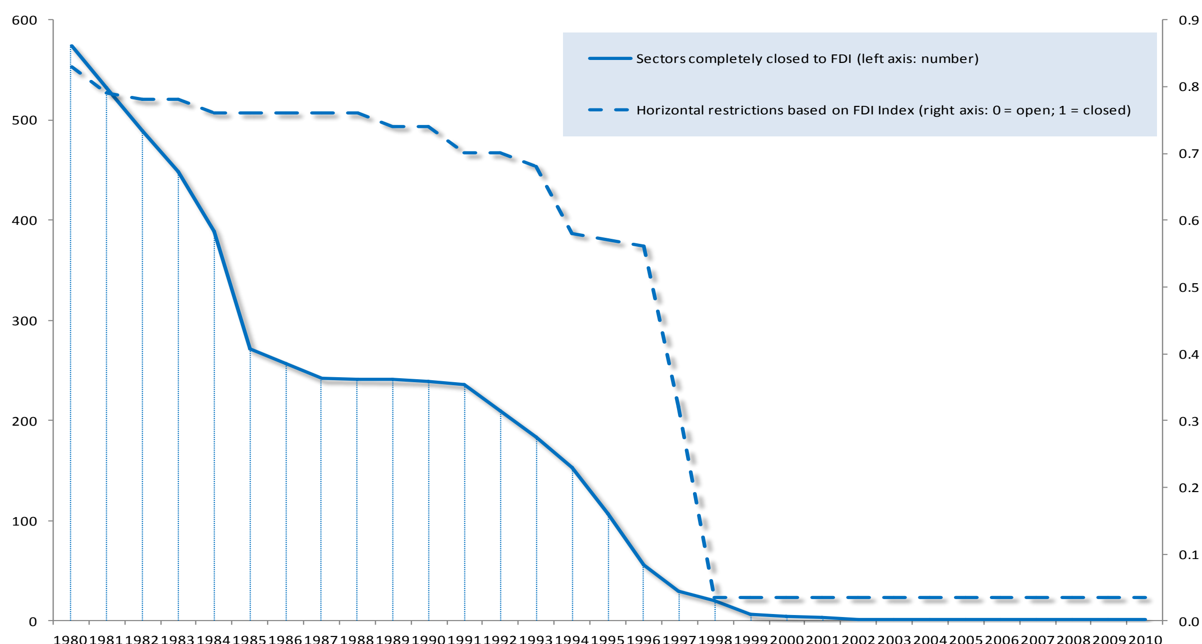
Country	Decline
Korea	**0.390**
China	0.203
Turkey	0.201
India	0.188
Indonesia	0.184
Finland	0.146
Australia	0.138
Belgium	0.108
Hungary	0.105
Poland	0.094

*Based on a sample of 34 OECD member countries and 6 major emerging economies.

Source: Calculated from the OECD *FDI Regulatory Restrictiveness Index*

2 The data are calculated assuming a constant number of total sectors. The years 1981-82 and 1986 are interpolated.

Figure 2. **FDI liberalisation in Korea, 1980-2010**



Source: Government of Korea and OECD.

The second measure of FDI openness is based on a variant of the OECD *FDI Regulatory Restrictiveness Index*.[3] The *FDI Index* shows that the Korean economy was highly restrictive for foreign investors prior to 1980. A separate regime existed for certain export-oriented, labour-intensive activities which fell outside of the usual regulatory environment but which nevertheless included various performance requirements relating to local content, technology transfer and exports. The *FDI Index* suggests that very little broad-based liberalisation occurred until the early 1990s. Sectors may have been opened up to some extent, but investors still faced a number of important horizontal restrictions on their activities. From 1990 to 1996, the *Index* fell from 0.74 to 0.56, a significant change by historical standards but much less than what was to come in 1997-98.

The impact of liberalisation of policies on FDI inflows

The rapid liberalisation of FDI policies in Korea beginning in the mid-1990s had a dramatic effect on inflows of FDI. The stock of inward FDI as a share of GDP more than quadrupled between 1996 and 1999, largely on the back of rising cross-border mergers and acquisitions (Figure 3).

The second wave of post-crisis reform led to a sharp rise in inward FDI in the first few years following the crisis. In Korea the crisis-driven slowdown in net FDI inflows lasted for only about two quarters. From then on, owing to the improvements in FDI policy, the amount of FDI flowing into the country increased remarkably - from USD 7 billion in 1997 to USD 15.2 billion in 2000 (notification basis) - placing Korea as the second-most favoured investment destination in Asia and contributing significantly to overcoming the economic crisis. This performance is all the more remarkable, given that the country attracted only USD 8 billion in FDI from 1962 to 1990 and USD 17 billion from 1991 through 1997.

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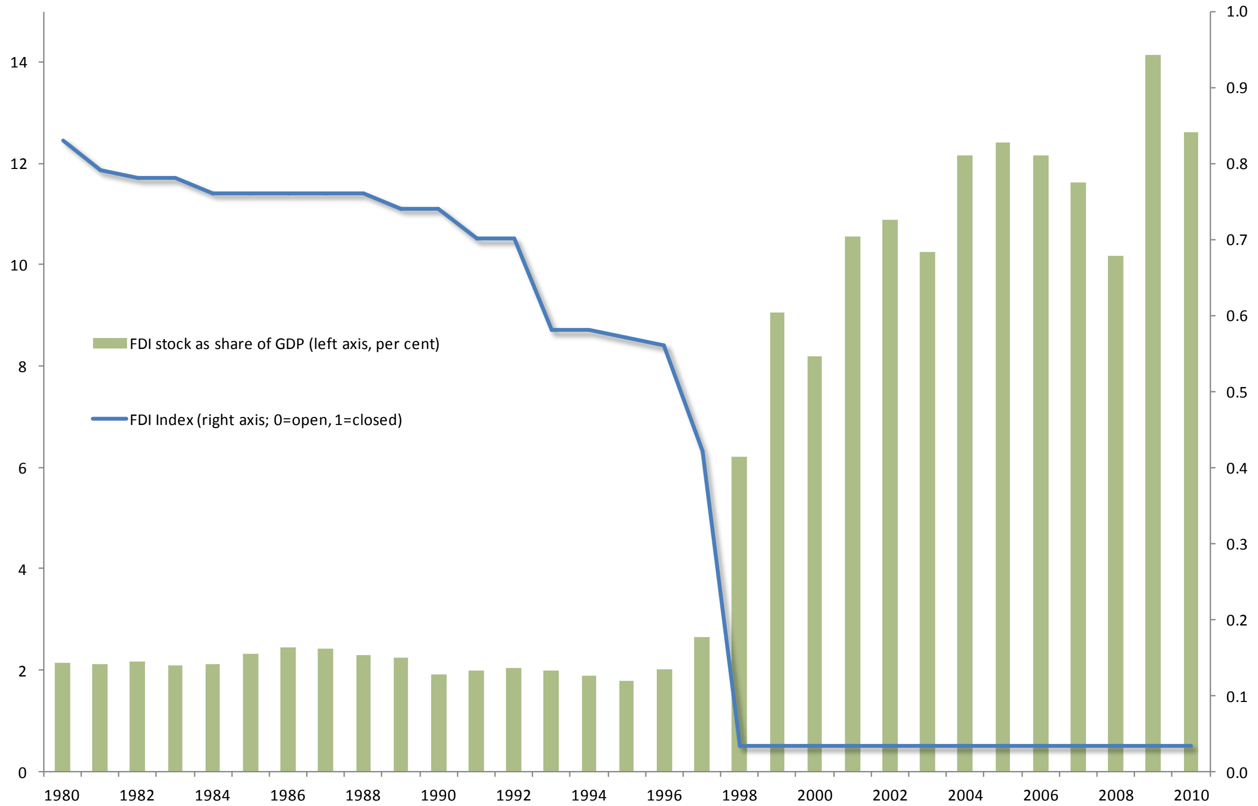
3 The Index score in Figure 2 is based mainly on horizontal measures and hence does not equal the overall score for Korea shown in Figure 1.

Figure 3. FDI liberalisation and its impact on the FDI inward stock as a share of GDP



Source: Government of Korea and OECD.

Before the crisis, Korea was unusual in that the dominant mode of investment was minority-stake joint ventures. After the crisis in contrast there was a sharp rise in M&As as the number of distressed firms increased sharply. The spike in inflows in 1999-2000 stemmed partly from foreign minority partners buying out their distressed Korean counterparts (Noland 2005), the crisis-induced decrease in the costs of acquiring assets for foreign investors and the increasing availability of firms seeking capital. But liberalisation no doubt played a role in the continued growth in the inward stock relative to GDP through the 2000s.

Following these developments, foreign multinational enterprises (MNEs) were found to contribute substantially to the country's net trade surplus as well as to employment generation and manufacturing production.[4] This is all the more positive for the Korean economy since firms and sectors with high FDI have higher than average labour productivity, wages and R&D expenditures. According to Hussain (2006), the retailing, banking and life-insurance industries are the three obvious examples where foreign investors have introduced a superior way of serving customers, one that addressed Korea's endemic productivity gap by using labour and capital more efficiently.

[4] In the period 1997-99, they contributed 44% of the production of the domestic manufacturing sector.

THE EVOLUTION OF FDI POLICIES

Korean economic development can be divided into four distinct phases. Until 1962, foreign exchange was scarce and the Korean economy relied on official development assistance principally from the United States. The government followed a policy of import substitution, with little economic growth as a result. The takeoff of the economy began in the 1960s when the government shifted towards an active policy of export promotion where funds were allocated on the basis of firms' export potential.

In June 1973, the government changed direction in its economic policies by launching the Heavy and Chemical Industry (HCI) Promotion plan. The HCI plan, which continued throughout the 1970s, directed credit largely through state-controlled banks to these industries. These policies gave rise to the *chaebols* (large conglomerates).

The starting point for economic liberalisation was over-investment and excess capacity in targeted industries, together with wage inflation for workers in those sectors, political turmoil following the assassination of President Park in 1979, the second oil price shock and subsequent recession both worldwide and in Korea. The process of FDI liberalisation began – albeit tentatively – in the early 1980s and accelerated rapidly in the course of the 1990s.

The following discussion divides the liberalisation period into three phases: restrictive policies prior to 1980s; gradual liberalisation, coupled with some investment promotion prior to the Asian financial crisis in 1997; and rapid liberalisation following the crisis. Individual liberalisation measures over all three periods are shown in Table 2. This section concludes with a special focus on the liberalisation of the financial sector over time.

Table 2. A Chronology of FDI Liberalisation in South Korea

Year	Event
1960	- Enactment of the Foreign Capital Inducement Promotion Act; 75% foreign equity allowed
1962	- FCIPA amended; tax holidays for foreign firms, equal treatment with national firms
1966	- FCIPA modified to allow 100% foreign ownership and more generous tax concessions
1970	- Establishment of the first Free Export Zone in Masan
1973	- Establishment of the second Free Export Zone in Iri
	- Issuance of the General Principles on Foreign Investments with areas open to FDI entitled to various tax reductions and exemptions but subject to various limitations (minimum investment requirements, export requirements, etc)
1977	- Minimum investment set at USD 500 000
1979	- More industries opened to FDI, but high-tech and skill-intensive industries favoured
1981	- Opening up of a number of business categories to foreign investment, relaxation of local ownership requirements for hi-tech, export-oriented, diversifying or non-tax-privileges investment, and reduction of the minimum investment level from USD 500 000 to USD 100 000.
1983	- New Foreign Capital Inducement Act and shift from a positive to a negative list system
1984	- Relaxation of approval procedures and of restrictions on the repatriation of capital
1985	- Revision of the negative list with substantially increased number of industries open to FDI
1987	- New revision of the negative list; 97% of manufacturing sectors open
1988	- Insurance opened to FDI, advertising and maritime services opened partly
1989	- Abolishment of various performance requirements on new foreign investments (export, local content, technology transfer) as well as of the limitation on 50% foreign equity participation
1990	- Automatic approval system
1992	- Introduction of the prior notification system.
	- Elimination of all pre-existing performance requirements.
1993	- Five-year FDI liberalisation plan expanding the number and range of sectors open to FDI
	- Friendly M&As allowed
1995	- Establishment of the Korean Trade and Investment Promotion Corporation
1997	- Liberalisation of FDI in some 129 service activities (e.g. production, collection and distribution of electricity only partially restricted; wholesale of household goods liberalised)
1998	- New Foreign Investment Promotion Act, establishment of a one-stop service (KISC)
1999	- Opening up of business categories including real estate rental and sales, securities dealing, petrol service stations, land development, etc.
	- Introduction of the ombudsman system (OIO)
	- Establishment of the Committee on Foreign Direct Investment
	- Liberalisation of hostile M&As
	- Liberalisation of land acquisition
	- Foreign participation allowed in large public enterprises and key industries
2000	- Amendment of the New FIPA with relaxation of restrictions, increased incentives in the form of tax breaks and establishment of Foreign Investment Zones (1999), Free Trade Zones and Free Economic Zones (2003)
2003	- KISC turned into "Invest Korea"
2006	- Definition of foreign investments enlarged to include investments in non-profit institutions
2010	- Latest revision of the FIPA giving more power to the OIO

Liberalisation of FDI policies

FDI policies prior to 1980

Unlike in some other countries in East Asia, FDI did not play a prominent role in the early years of takeoff of the Korean economy. In the 1950s, FDI was not legally permitted and the Korean economy relied on official development assistance principally from the United States. The takeoff of the economy began in the 1960s (Box 3) when the government shifted towards an active policy of export promotion where funds were allocated on the basis of firms' export potential. Some opening towards foreign investors occurred, but the government favoured both foreign loans and technology licensing over FDI.

In keeping with some other countries in Asia at the time, Korea created Free Trade Zones (FTZs)[5] after 1970 to attract foreign investment in labour-intensive, high value-added manufacturing activities and through this to promote foreign exchange earnings through increased exports and employment and improved technological knowledge among local firms through technological transfer (Warr 1983). In spite of this partial opening, FDI was still discouraged in those sectors protected by import-substitution measures (Kim and Hwang 2000). Moreover, foreign investment was restricted or prohibited in services industries such as banking, hotels, insurance services and real estate, so as to protect the monopoly interests of local firms (Chung 2007).

Box 3. The legislative basis for foreign investment in the 1960s

The *Foreign Capital Inducement and Promotion Act* (FCIPA) was enacted in 1960 to secure an adequate amount of foreign capital by permitting foreign investment inflows, regardless of amount or type, as long as the purpose of the investment was deemed appropriate. In general terms, any firm in any sector could qualify if it could demonstrate to the government that it would increase Korean exports (Graham 2003). Because the initial provisions were rapidly deemed insufficient, they were complemented in 1962 with the *Law for payment guarantee of foreign borrowing* and the *Special Law to facilitate capital equipment imports* on a long-term deferred payment basis. These provisions guaranteed the repayment of foreign loans and provided tax and other incentives to foreign investors and licensors of foreign technology.

All three laws were eventually merged in 1966 into the *Foreign Capital Inducement Law*, which regulated inflows of foreign loans, direct investment and technology. It stipulated the requirements, criteria, and procedures for authorising capital inflows, and also provided for the privileges, tax incentives, and repatriation of capital as well as remittance of dividends. Priority was given to foreign loans rather than to FDI, which was kept to a minimum. Over time, as mismanagement of loans was reported, FDI began to be seen as an alternative to private loans, so long as it did not create friction with local industries.

During the period of the Third Five-Year Plan (1973-78), the government started to discourage foreign loans, especially short-term commercial loans, in favour of FDI. The policy was still very selective, however, with a distinction between “favourable” and “unfavourable” industries for FDI (Stoever 2002). In 1973, the Economic Planning Board issued General Principles on Foreign Investments to direct foreign investment to sectors desirable for the Korean economy: “large-scale complex projects impossible for domestic firms to undertake because of their limited capital, technology, and managerial skills; export-oriented projects where it is difficult for domestic firms to develop or exploit foreign markets; and projects which contribute to the development and effective use of domestic resources” (Kang 1998).

Areas open to FDI were entitled to tax reductions and exemptions but were subject at the same time to various limitations, according to the type of business involved. Minimum investment requirements, as well as export requirements, were imposed and many sectors were excluded for foreign investors, particularly if they resulted in competition with local exporting firms. By contrast, certain strategic sectors in need of better technology, such as electronics, were not subject to export requirements although in those sectors divestment was imposed within a given time frame.

Outside the FTZs, the government preferred joint ventures to exclusive foreign ownership, with a maximum foreign ownership limit set at 50% for most business categories. No more than 50% of

[5] In 1970, the government established the first FTZ in Masan (following the Chinese Taipei experience of Kaohsiung in 1965). This special zone provided an industrial estate where land, utilities, transport facilities, and even buildings were supplied by the government at highly subsidised rates. The Masan FTZ also allowed the duty-free entry of goods destined for re-export. A second zone was established in Iri in 1973.

foreign equity was allowed in principle and less than 50% was permitted in simple labour-intensive sectors (Sakong 1993, p. 115).

During the 1970s, the government faced new problems in attracting long-term foreign capital which were aggravated by oil crises and the worldwide recession. Faced with these difficulties, the liberalisation of FDI rules was seen as a way of helping the economy to upgrade technologically and to restructure industry toward higher value-added and more sophisticated production.[6] This reform was also consistent with the general direction of market liberalisation and the new development strategy (Sakong 1993).

The transition to an open economy: FDI reforms since 1980

Liberalisation started in the early 1980s, with the opening up of a large number of business categories to foreign investment (Figure 1). At the same time, the minimum investment level was lowered significantly from USD 500 000 to USD 100 000. The basic direction of FDI policy changed most significantly in 1983 when the *Public Loan Inducement and Supervision Law* and the *Foreign Capital Supervision Law* were integrated into the *New Foreign Capital Inducement Law*, reflecting less stringent government controls on FDI.

A major feature of the reform was the switch from a positive to a negative list system. Under the positive list system, FDI was allowed only in those listed sectors, thus giving the Korean government the ability to direct investment to "priority industries" where foreign capital, technology and general know-how were deemed necessary (Kim and Wang 1996). Under the negative list system in contrast, any industry not specified in the list became open to foreign investment. By opening almost the entire manufacturing sector to FDI, the shift is indicative of a more liberal approach to FDI and of a decline in government interventionism. Under the new system, applications for FDI fell into one of the following three categories: *i)* prohibited industries, such as public utilities, public transport and healthcare, *ii)* restricted industries in which FDI is prohibited in principle but for which authorisation may be obtained from the Ministry of Finance, and *iii)* liberalised industries not on the negative list. In the restricted category, FDI had to be in the form of a joint venture with a domestic firm.

Seoul twice revised the negative list system after its initial introduction (first in September 1985 and again in April 1987) to open more industrial sectors to foreign investors. The result of this sectoral liberalisation can be seen in Figure 1 which showed the ratio of open sectors to all sectors over time. The manufacturing sector was the first to open but was followed quickly by services.

Towards the end of the 1980s, Korea faced declining competitiveness of its manufactured exports partly due to rising production costs. As a result, the government and business elites recognised the need for technology enhancement in medium-technology industries (Kim and Wang 1996) and the government took further steps to encourage FDI in high-technology industries (Amsden 1989).

The government also made significant efforts to relax restrictions and simplify administrative procedures. Existing restrictions on the repatriation of capital were relaxed in 1984 and various performance requirements imposed on foreign-invested enterprises, such as export, local content, and technology transfer requirements, were abolished in December 1989. Similarly, the 50% foreign equity limit was scrapped in most industries, but, according to Chang (2006), foreign majority ownership remained banned in practice, with some rare exceptions, outside the FTZs.

[6] While licensing had proven to be an efficient channel for transferring mature technologies, new technologies were found to be better transferred through joint ventures or wholly-owned subsidiaries (Chaponnière 1997).

At the same time, administrative procedures for FDI approval were also simplified, through an automatic approval system under which all projects meeting certain requirements were to be immediately and automatically approved by the Ministry of Finance[7]. This system eventually evolved into the prior notification system whereby FDI in designated categories could be conducted as long as it met predetermined criteria (Kim and Wang 1996). In 1992, business categories subject to notification rather than approval were expanded. The notification system was initially applied to projects in liberalised sectors with less than 50% foreign equity ownership, but it was eventually extended to all liberalised sectors, regardless of the foreign investor's equity share.

The Five-year FDI liberalisation plan (1993–98)

In the early 1990s, FDI liberalisation regained momentum as part of the so-called *segyehwa* (globalisation) policy (Box 4).[8] The primary objective of the policy was to enhance independent technological capability.[9] In June 1993, the government announced a five-year FDI liberalisation plan to continue the process of easing inward FDI-related regulations, expand the number and range of sectors open to FDI, and increase efforts to promote inward FDI. Under the plan, 132 out of 224 restricted sectors were liberalised. Corporate taxation of foreign invested firms was reduced, regulations on foreign ownership of land were relaxed and approval procedures were simplified. Japanese investment was targeted, particularly in auto parts, electric/electronic parts and machinery industries (Harvie and Lee 2005). The Five-Year Plan was followed by another one starting in 1995 and by a 1994 Reform Plan for the Improvement in the Foreign Investment Environment.

Box 4. *Segyehwa* Policy (1994~1998)

First introduced at an APEC summit in late 1994, the *segyehwa* (translated as "globalising the economy and internationalising local society by adopting new ways of thinking"[10]) policy was an overarching policy framework of the Kim Young-Sam government to emphasise the importance of deepening Korea's integration into the world economy and to turn around the adverse public sentiment against inward foreign investment. The ***Segyehwa* Promotion Committee** was established as a focal point in early 1995 and announced the **Vision and Strategy of the *Segyehwa*** shortly thereafter which contributed to amending or establishing over 100 laws and regulations.[11] The government strongly publicised the *Segyehwa* policy through massive public campaigns emphasising the need for Korea to open up to the global economy in order to sustain growth in the long term. The notion of *segyehwa* became an overarching theme in all public policies, from reunification and education to the environment and the economy. This policy direction was in line with the government's emphasis on liberalising the FDI regime in order to ease technology transfer and deepen the industrialisation of the economy. With the launch of the WTO and Korea's accession to the OECD, Korea also needed to follow international standards and thereby adopt new policies for strengthening fair competition and further liberalising the FDI regime and capital markets.

The actual effects of the *segyehwa* policy are still debated.[12] It nevertheless is likely to have helped to lay the foundation for changing the direction of the FDI regime from passive liberalisation to active promotion of liberalisation from the mid-1990s.

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7 Approval responsibility was transferred from the EPB to the Ministry of Finance.

8 As encapsulated in the Seventh Five-Year Plan (1992–97).

9 The *segyehwa* policy coincided with the interests of the *chaebol* in their own international expansion.

10 Kevin Murphy, "Seoul arrives at a difficult crossroads", *New York Times*, 16 September 1996.

11 National Archives

12 East Asia Institute http://www.eai.or.kr/data/bbs/kor_book/2010120313294326.pdf

The concept of FDI was also expanded to encompass long-term (five year or more) loans and foreign investors were allowed to acquire outstanding shares of domestic companies through friendly M&As. Liberalisation was also extended to a number of service activities as required by negotiations under the GATS (see Kim and Kim (2003) on service liberalisation). Some 129 service activities were liberalised from 1993 to 1997.

In April 1995, the Korean government established a comprehensive one-stop service system in Seoul and in the provinces. The Korean Trade Promotion Corporation (KOTRA) changed its name to Korean Trade and Investment Promotion Corporation, reflecting its new role in promoting cross-border investment and providing support for technological and industrial cooperation projects (Cherry 2007). Approval authority was transferred from the Ministry of Finance and the Economy to other relevant ministries. At the same time, the government also introduced a new incentive system in which discretion was significantly reduced (Kim and Wang 1996). Under the old system, tax deductions and exemptions were only granted to foreign investment that was accompanied by advanced technology.

In 1997, land acquisition was facilitated for foreign-controlled firms for legitimate business purposes (Kim and Wang 1996, p. 25). In 1997 the FCIA was revised and promulgated as the *Foreign Investment and Foreign Capital Inducement Act*, providing for the liberalisation of 47 out of the 81 sectors that remained closed to foreign investment.

Lastly, according to the Five-Year Liberalisation Plan, restricted business categories were scheduled to be opened to FDI in several stages from 1996 to 2000 (Kim and Wang 1996). In other words, a full reform of the FDI policy was about to be implemented when the crisis broke out.

The Asian financial crisis (1997-98): The open door

"What we need now, more than anything else, are foreign investors. Market reforms and foreign investment are the only solution."

President Kim Dae-Jung[13]

The years leading up to the crisis were marked by a two track strategy of liberalisation of FDI restrictions. Foreign investors were allowed into a rapidly increasing number of sectors but the overall mechanism for restricting foreign investment remained in place in the form of horizontal impediments such as screening. These broader impediments were gradually dismantled beginning in 1993, a process which accelerated during the negotiations for OECD membership. As part of OECD accession, the Korean government made a number of upfront commitments to liberalise further in 1997 and 1998. The crisis was not so much a window of opportunity as a door that was already partly open.

Korea's traditional strong policy bias against FDI and in favour of short term foreign borrowing made it vulnerable to the exchange rate and foreign debt roll-over crisis it suffered in late 1997.[14] With the outbreak of the Asian financial crisis, the Korean authorities had to accelerate and enhance planned reforms. Faced with an urgent need for inflows of foreign capital, the government clearly favoured FDI over other forms of capital – particularly borrowing – because it was deemed to provide a more stable way of financing development and to lower the risk of currency crashes (Park and Rhee, 1998; and Kim and Hwang, 1998). As explained by President Kim Dae-Jung, "Korea's new FDI policy was intended to catch five birds with one stone, bringing not only an injection of new capital, but also enhanced

[13] Address to a Joint Meeting of the US Congress 10 June 1998. Quoted in Crotty and Lee (2001).

[14] DFAT (1999).

transparency of business management, the transfer of advanced management techniques, an expansion of markets and job creation."

As a result, the country embarked on an active FDI-promotion strategy. The liberalisation move, which was already under way, gained renewed momentum and FDI was prioritised as a key component of the country's revival strategy (Nicolas 2003). Korea's FDI policy thus shifted from "restriction and control" to "promotion and assistance".

The Korean government embarked on significant structural adjustments in the financial and industry sectors. In November 1998, as part of the reform programme agreed with the IMF, the government enacted the *Foreign Investment Promotion Act* (FIPA), with a view to attracting FDI and regaining the confidence of foreign investors. The Act eased the regulations and restrictions on investment by foreign nationals while expanding the range of tax incentives intended to attract foreign investment into the country. Complicated administrative procedures were streamlined with the relaxation of more than half of existing restrictions. One notable feature of the new law was the greater autonomy granted to local governments in attracting FDI (through local tax exemptions, land leases or development and management of Foreign Investment Zones – FIZs).[15]

The FIPA was amended in December 2000 and became effective on 1 February 2001. The objective of the amendment was to adapt the Act to the changed foreign investment environment and also to correct problems that were apparent in the application of the Act. The contents of the amendment can be classified into two major areas: *i*) revisions reflecting changed market conditions through the extension of the definition of FDI and the introduction of the FIZ system; and *ii*) revisions to improve the investment environment and strengthen the follow-up management function by relaxing registration requirements, introducing the foreign investment ombudsman and strengthening the notification system for foreign investment restrictions (InvestKorea).

The major changes included:

- opening additional sectors to foreign investment;
- expanding investment incentives;
- full-fledged liberalisation of cross-border M&As;
- removing regulations on foreign ownership of real estate;
- streamlining foreign investment procedures.

When the crisis began, Korea had an extensive, although shrinking, list of sectors which excluded foreign investors. In April 1998, the government accelerated sectoral liberalisation, opening ten business categories including real estate rental and sales, securities dealing, golf course operation, grain processing and insurance-related business to FDI. In May 1998, twelve more business categories including the operation of petrol service stations, land development, commodity exchanges, investment companies and trusts, power generation and waterworks were wholly or partially opened (Australian Commonwealth). As of September 1998, only 13 (out of a total of 1,148) business sectors remain closed to FDI, and 18 were partially opened.

Under the FIPA, virtually all business sectors are now open to foreign investors and FDI is subject to no specific restrictions provided it does not violate national security, public order, public health,

[15] The Ministry of Knowledge Economy is responsible for FDI inflows, compiling all the relevant measures and policies on foreign investment and publishing them regularly in the *Consolidated Notice of Foreign Investment*.

environmental preservation or social morals.[16] Only three sectors (television and radio broadcasting, and nuclear power generation) are fully closed to foreign investment, and a further 26 are partially restricted (including rice and barley growing).[17] The most common types of restriction found in these partially opened business sectors are differing limits on foreign equity participation or the exclusion of some business lines from foreign investment.

Restrictions on shareholdings by foreign investors in some public enterprises have been abolished or significantly reduced. Ceilings on foreign equity ownership in the stock market have also been eliminated. Before the crisis individual foreigners were not allowed to own more than 7% of the shares of a Korean company and the collective foreign portion was limited to 26%. In December 1997 the Korean government committed to raise both limits to 50% and eventually abolished all ceilings on foreign shareholding (Kalinowski and Cho 2009). More importantly perhaps, cross-border mergers and acquisitions and even hostile takeovers are now allowed.

The amendment to the Foreigner's Land Acquisition Act in May 1998 saw restrictions on foreign ownership of land, property and dwellings completely removed. Foreigners, including non-residents, are now given national treatment in the acquisition of land, without limits on land use or land size.[18] Exclusions are limited to land of military, cultural or environmental significance, and farmland designated for rice and barley.[19] Kim (1998) argues that "the opening of the real estate sector is regarded by foreign investors as one of the most drastic changes that the Korean government has enacted since the on-set of the economic crisis".[20] Restrictions on foreign ownership of land had indirectly impeded M&As "as foreign companies acquiring non-business real estate resulting from the acquisition of a Korean company were required to sell within five years" (DFAT, 1999).

Under the FIPA, government approval of FDI is no longer required. Only prior notification by foreign investors is needed, and this can be made at domestic or foreign bank offices in Korea, Invest Korea or at any one of KOTRA's overseas trade centre.[21] Foreign-capital invested companies must also register to be eligible for incentives. Approval by the Ministry of Knowledge Economy is still required, however, to invest in 90 designated Korean defence-related companies. These include many major electronic and industrial conglomerates that are also major producers of non-defence products.

The FIPA has been revised various times since its enactment. In 2006, the definition of foreign investments was revised to include investments in non-profit research institutions. The latest revision approved in April 2010 lengthened the maximum period state and public land can be leased, increase the amount of cash grants foreign firms operating or expanding in Korea can expect.

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16 FDI may however be restricted under other legislation, such as the Fisheries Act, Maritime Act, and Telecommunications Business Act. From Shin (1999).

17 The number of partially closed sectors increased from 14 to 27 because of the partial opening of closed sectors and the disaggregation of some partially closed sectors. www.investkorea.org/InvestKoreaWar/work/ik/eng/bo/bo_01.jsp?code=102030105

18 Foreign land ownership may be denied to nationals of countries that do not allow Koreans to purchase land. Such reciprocity conditions have not been used.

19 To acquire other farmland, foreigners, like Koreans, must be directly involved in farming.

20 Kim (1998), p. 55.

21 Post notification within 30 days is allowed for stock transfers related to mergers and acquisitions.

Special focus: liberalisation of the financial sector

The liberalisation of the financial sector in Korea (Box 6) involved both external and internal factors. The very first plan to open up the financial sector came out in the Long-Term Plan for Globalisation of Capital Market in 1981. Then the Korea Fund, a closed-end mutual fund, was introduced in 1984 which was listed on the New York Stock Exchange to provide an indirect way for foreigners to invest in Korean stocks.

Box 6. **Liberalisation of the Korean financial sector over time**

Year	Measures
1981	· Long-Term Plan for Globalisation of the Capital Market
1981-1983	· Privatised commercial banks
1984	· Indirectly opened stock market to foreign investors through Korea Fund
1988	· Step-by-step Implementation Plan for Liberalisation of the Capital Market · Relaxed entry barriers to financial industry (banking, life insurance , investment trust) · Opened insurance industry to foreign firms
1989	· Raised foreign shareholding limit in Korean securities firms · *Allowed Korean securities firms to establish offices overseas** · *Raised limit of investment overseas by Korean institutional investors**
1990	· *Non-financial Korean firms allowed to invest in foreign securities market** · *Removed Foreign exchange holding limit for institutional investors**
1991	· Allowed establishment of branches of foreign securities firms · *Allowed Korean securities firms to open branches overseas and extend services in international financing**
1992	· Stock market opened for individual foreign investors · Allowed foreign securities firms to be incorporated in Korea
1993	· Announced the Three-Stage Blueprint for Liberalisation of the Financial Sector
1994	· Abolished economic needs test for establishing branches of foreign banks · Raised foreign equity shareholding restriction to 20%
1996	· Blueprint for Liberalisation of the Financial Sector (1997-2000)
1997	· Adopted notification system for opening branches of foreign banks (world's 500 top banks), no permission needed · Opened investment trust industry to foreign firms · Raised foreign equity shareholding restriction to 50% · Abolished foreign shareholding restriction in bond market
1998	· Fully liberalised stock and bond market to foreign investors · Allowed incorporation of foreign banks (foreign subsidiaries were allowed) · Allowed hostile M&As of Korean financial firms · Abolished equity shareholding restriction for individual foreign investors · Allowed foreign nationals to become board members of Korean banks · Allowed FDI in insurance and in life-insurance-related services · FDI allowed up to 50% in investment trusts and credit-rating and credit-offering firms · Allowed foreign investment in financial advisory services firms
1999	· Allowed full foreign ownership of Korean banks
2000	· Abolished foreign equity shareholding restriction of 50% in credit rating companies · Opened non-life insurance industry to foreign firms

* Policies on outward foreign investment by Korean nationals

Deregulation of the financial sector took off in the latter part of the 1980s when the continued current account surpluses built up pressure both internally and externally. From outside, the United States and

other advanced economy trading partners demanded that Korea remove entry barriers against foreign firms in the financial sector and carry out liberalisation programmes more transparently. Moreover, internally Korea needed to liberalise the financial sector to develop diverse financial schemes to assist Korean firms in moving from labour-intensive to capital-intensive production. Towards the late 1980s, Korean firms faced higher costs caused by both the appreciation of the Korean won and continuous wage increases in the local labour market. Thus the government saw the need to develop lower-cost means of corporate financing in order to dilute these adverse effects on export competitiveness. This in turn, required developing advanced financial schemes and because Korean financial firms did not yet have the capacity, liberalisation of the financial sector became a necessity. It was a choice that Korea had to make to remain globally competitive when it was sandwiched between the developed economies and the rapidly growing economies of Southeast Asia and China.[22]

The government therefore announced in 1988 a **Three-Stage Plan for the Globalisation of the Capital Market**[23] to be carried out during 1989-1992. The plan not only encouraged inward foreign investment in the capital market through financial sector liberalisation but also covered deregulation of outward investment by Korean financial firms. While the shareholding limit for foreign securities firms in acquiring shares of Korean securities firms was eased in 1989, Korean institutional investors were encouraged to increase outward investment as the limit on the foreign currency holdings was abolished in 1990. In the following year, foreign firms were allowed to establish branches in Korea or set up joint-ventures with domestic firms while Korean securities firms also were allowed to open branches overseas or invest in joint-ventures in their location of operation. Non-financial Korean firms also were allowed to invest abroad by 1992. In 1992 the cornerstone of Korea's financial liberalisation, opening up of the Korean Stock Exchange for individual foreign investors, took place as part of the last phase of the plan.

In 1993 another **Three-Stage Blueprint for Liberalisation of the Financial Sector** was introduced following the finalisation of the previous plan in 1992. This plan aimed at realising full-fledged liberalisation of the financial sector by 1997.[24] The government intended to reinforce global competitiveness of domestic financial firms as the international financial environment in the 1990s changed fast in terms of globalisation, diversification, deregulation and innovation.[25] The blueprint was broadly part of the *segyehwa* policy, Korea's policy framework for globalisation, but it also had another aim of preparing the country for the OECD accession as well as the launch of the WTO. A large part of the plan was to harmonise the rules and policies on capital movements of the country with the OECD's *Code of Liberalisation of Capital Movements* and the *Code of Liberalisation of Current Invisible Transactions*.[26] The issue of freer capital movements and international investment took centre stage during the course of negotiations between the government and the OECD. Pursuant to the announcement of the long-term plan, deregulations followed in three phases although the third phase saw replacement of the entire plan with another year-by-year liberalisation plan.[27] The first phase (1993) introduced the notification system for inward FDI that replaced the approval system; the second phase (1994-95) raised the limit of foreign equity holdings to 20% from 3% and allowed foreign investment in the primary market for bonds while facilitating foreign banks' establishment of branches; the third phase (1996) allowed foreign financial firms to hold shares of domestic banks.

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22 Park (1997)

23 National Archives, 자본시장 국제화의 단계적 추진계획

24 Park (1996).

25 Hwang and Shin (2000).

26 Park (1997)

27 *Ibid*.

The government adopted a new year-by-year **Blueprint for the Liberalisation of the Financial Sector (1997-2000)** in September 1996 when Korea and the OECD were finalising the country's accession (Korea acceded to the OECD in December 1996). The blueprint was divided into two parts: a liberalisation plan for capital movements and another one for opening up the financial sector to greater foreign participation.[28] According to Park (1996), the blueprint was the result of negotiations between Korean policymakers that argued for gradual and limited opening up and the OECD that stood by a faster and comprehensive transformation.[29] Korea's OECD accession was a cornerstone in setting the country on a path towards greater openness and less government interference in the financial sector. According to the blueprint, the foreign equity shareholding restriction of domestic companies (20% in 1996) was to be eliminated by 2000 and foreign banks were to be allowed to establish local corporations by 1998. These scheduled changes show that although the crisis gave a big push to accelerate the liberalisation process, the fundamental structure was already in place.

The Asian financial crisis accelerated and deepened the liberalisation of the financial sector. Both the speed and the scope of liberalisation exceeded those of the blueprint, even if many of the measures had already been anticipated in the blueprint announced in 1996. The full liberalisation of the equity market, for example, was undertaken in 1998 with the crisis rather than in 2000 as foreseen by the blueprint. Other measures that were slightly accelerated by the crisis include allowing foreign financial firms to incorporate their subsidiaries and the opening up the life insurance, investment trust, and financial advisory industries to foreign investment. The acceleration was also fuelled by Korea's urgent need to sell off distressed domestic financial firms to foreign investors as neither the government nor other domestic investors had the capacity to acquire such firms. In 1999, foreign investment in the financial sector was the largest share in FDI inflows to the entire services sector.[30]

Investment promotion and facilitation

The Korea Trade-Investment Promotion Agency (KOTRA) established the Korea Investment Service Center (KISC) in July 1998 as a one-stop shop for foreign investors, providing administrative support for investment as well as counselling services and post-investment services. In September 2003 the government finalised its comprehensive plan to attract foreign investment and reform the overall FDI support system. These changes were embodied in the transformation and expansion of the KISC and its re-launch as Invest Korea.

The independent Foreign Investment Ombudsman was created in October 1999 to handle specific grievances by foreign investors in Korea through prompt aftercare services, and in conjunction with Invest Korea, to provide one-stop service to foreign investors. In a proposed revision to the FIPA in 2010, the **Office of the Investment Ombudsman** (OIO) was granted a significant increase in reach. Once the revision is enacted, the OIO will have the legal authority to request from related agencies data, materials and other information deemed relevant and vital to the resolution of foreign investor grievances (Box 5).

In 2007, the government set a new goal of increasing high value-added investment and established an action plan to support the national effort to attract more foreign companies and expand FDI-related infrastructure. These initiatives aimed at improving the efficiency and scope of the current FDI promotion system by accentuating high-priority industrial sectors and creating cooperation mechanisms

[28] *Ibid*.

[29] *Ibid*.

[30] Brooks and Hill (2004).

between relevant government agencies. To this end, the government has been stepping up investment incentives as well as upgrading the current one-stop service system and foreign investor support system.

Box. 5 The Office of the Foreign Investment Ombudsman (OFIO)

The Office of the Foreign Investment Ombudsman (OFIO) was created within the Korea Trade-Investment Promotion Agency (KOTRA) during the rapid liberalisation of the foreign investment regime in 1999. The OFIO focuses on post-investment services for foreign investors and provides on-site consultation in areas covering finance, taxation, accounting, intellectual property rights, construction and labour. Through its **Home Doctor System**, OFIO resolves grievances reported by foreign investors not only directly by sending experts who are licensed and experienced to business sites but also by taking pre-emptive measures to prevent future grievances by encouraging systemic improvements and legal amendments.[1]

In cases whereby systemic changes are required, the OFIO reports to the government's highest foreign investment authority, the Committee on Foreign Direct Investment (CFDI). The OFIO also uses other channels such as the Regulatory Reform Committee and the Presidential Committee on National Competitiveness (PCNC) to push for government interventions or changes in the enforcement decrees of relevant laws. Over 4,700 cases have been reported to OFIO during the past decade and many of them have prompted systemic changes and government interventions. [1]As the system matured, the resolution ratio which was around 25% in the beginning has been enhanced to reach over 90% from 2007 and onwards (Figure 4).[1]

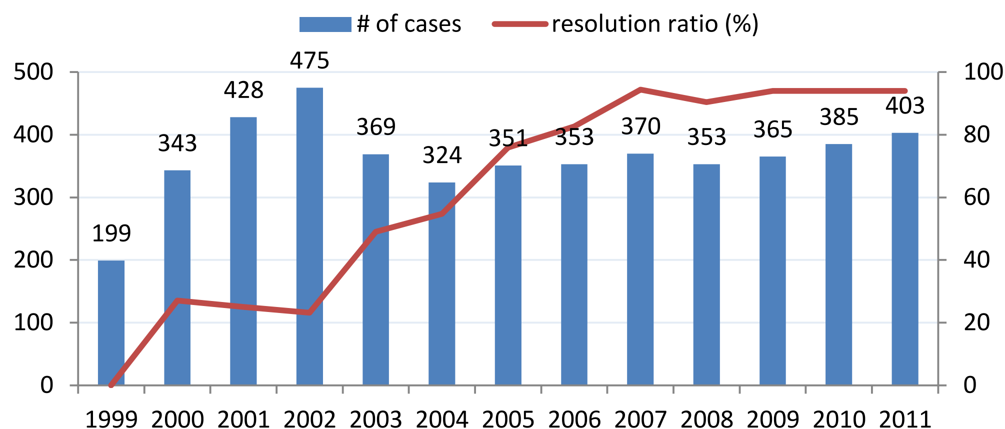
Table 3 **The institutional evolution of the Office of the Foreign Investment Ombudsman**

Date	Event
June 1991	The Office of Foreign Investment Consultation was established within the Ministry of Telecommunications and Industry
April 1996	The Office of Foreign Investment Consultation was reorganised to the Office of the Foreign Investment Grievance Consultation under the Ministry of Telecommunications and Industry.
July 1998	The Investment Aftercare Team was established within the Korea Investment Service Center (KISC), as KOTRA's one-stop service centre for potential foreign investors entering the Korean market.
November 1998	The Foreign Investment Promotion Act (FIPA) went into effect, offering a variety of investment incentives and simplified administrative procedures
October 1999	The Office of the Foreign Investment Ombudsman (OFIO) was established to address the post- investment difficulties faced by the foreign-invested companies in Korea
March 2001	With a revision of the relevant laws, the Ombudsman came to be directly appointed by the President of the Republic of Korea.
December 2003	Korea Investment Service Center (KISC) was renamed as Invest KOREA and reorganised to further bolster the Korean government's foreign investment promotion activities.
March 2004	The Ombudsman was appointed as a member of the Regulatory Reform Committee to give foreign investors a stronger voice in revamping the country's regulatory environment.
March 2008	The Ombudsman was appointed as a member of the Presidential Council on National Competitiveness.
June 2010	The Ombudsman was appointed as the Chairman of the Regulatory Reform Committee.

Source: InvestKorea website

Box. 5 The Office of the Foreign Investment Ombudsman (OFIO) *(cont.)*

Figure 4. Cases reported and addressed by the OFIO



The Foreign Investment Ombudsman is, since 2010, the Chair of the Regulatory Reform Committee (RCC) and sits on the Presidential Council on National Competitiveness (PCNC), thereby ensuring foreign investors' opinions are heard at the highest levels of policy-making. Membership in the PCNC allows the OFIO to address grievance issues directly to various ministers and heads of relevant government authorities in the presence of the President at monthly meetings of the PCNC. The OFIO is accompanied in the PCNC by four foreign investor representatives from the American Chamber of Commerce, the EU Chamber of Commerce Korea, Seoul Japan Club and the Dubai Investment Authority.[1] Since 2010, OFIO has had the legal power to contact directly the heads of ministries and government agencies for its requests and recommendations.[1] The OFIO's authority has been reinforced continuously reflecting the government's commitment to promote FDI. As reinvestment by existing foreign investors accounts for more than half of the total inward investment in Korea, OFIO's role has become increasingly critical in promoting FDI.

One piece of evidence of the effectiveness of OFIO is the fact that there has not been a single case of Investor-State Dispute (ISD) in Korea. Korea is now internationally recognised for its sound ISD environment, and the OFIO is considered to have critically contributed to the result.[1] Overall, the OFIO as a grievance resolution centre and an advocacy body for foreign investors has played a vital role in improving the business environment in Korea for foreign investors. Korea's OFIO is now considered as a best practice example by many international organisations and foreign governments.

REFORMS IN OTHER POLICY AREAS

The removal of restrictions on foreign investment seldom occurs in isolation; it is often part of a broader reform programme to improve the competitiveness of the economy. In Korea, the reforms of FDI policies took place against the backdrop of an overall reform process which touched upon competition and trade policies, regulatory reform and measures to allow Korean firms to expand abroad, whether to shift labour-intensive production or to secure better access to foreign markets. FDI reform was accompanied by rising transparency, land acquisition reforms, and general regulatory reforms as well.[31] These reform endeavours are described briefly below.

Competition policy

Competition policy was introduced – after four abortive attempts at legislation (in 1964, 1966, 1969, and 1971) – through the *Monopoly Regulation and Fair Trade Act* (MRFTA 1980) and the creation of the **Fair Trade Commission** (1981). While the Act initially emphasised anti-competitive behaviour rather than market concentration itself, it was amended in 1986 and included *i.a.* the prohibition of cartel practices and cross-border equity investment among affiliated companies (Harvie and Lee 2005). The nature of competition law has been shaped greatly by the kind of industrial policy pursued. The promotion of export-oriented activities and later of heavy and chemical industries, which have tended to favour *chaebol*, had to be complemented by competition policy to curb the economic power of these large market players. For this reason, the MRFTA has taken on a more regulatory character than competition laws in other jurisdictions and relies heavily on administrative discretion. In 1994, the Fair Trade Commission became formally independent.

Trade policy

In the early phase of Korea's economic development, government interventionism was pervasive. Restrictions on FDI inflows belonged to an overall economic strategy aimed at encouraging the development of local industries. This translated in the trade area into import substitution combined with export subsidisation. Export-oriented industrialisation was chosen as a strategy to consolidate political power through economic development and maximising exports was clearly the top priority over all other policy objectives. In order to encourage exports, the government relied heavily on financial policy tools rather than on fiscal policy or the use of public enterprises[32]. Of the various export incentives, perhaps the most symbolic one was the export financing loans system. At that time, exports were clearly singled out for preferential treatment but in a non-selective way: promotion measures were neither industry nor firm-specific by contrast to what happened later.[33]

Import liberalisation did not start until the early 1980s when the balance of payments began to improve. Until then there was only a weak constituency in favour of trade liberalisation and the decision-making process remained primarily political rather than economic (Harvie and Lee 2003). A major step was the

[31] The Regulatory Reform Commission (RRC) was created to maintain a consistent set of principles to control regulatory quality.

[32] Among East Asian countries, government intervention via state-owned enterprises has been much more significant in Chinese Taipei, Malaysia and Indonesia (Kim and Wang 1996).

[33] Industrial targeting policies for specific industries were not widely practised (Sakong 1993).

establishment of a **Tariff Reform Committee** in 1983 to define a programme of import liberalisation measures. Most of the trade policy measures implemented in the 1980s were taken partly under pressure from the United States.

Regulatory reform

Investment climate improvements stem partly from an easing of the restrictions on foreign investment but also from improvements in the way rules and regulations are implemented. Around the time of the 1997 crisis, the Korean regulatory environment was criticised for the lack of consistency in implementation. "Laws and regulations are framed in general terms and are subject to differing interpretations by government official who rotate frequently."[34] One of the major goals of the 1998 FIPA was to simplify procedures, including those for FDI notification and registration.

Deregulation has figured prominently on the policy agenda at least since the presidency of Kim Dae-Jung and continues to this day. President Lee Myung-Bak, unlike his predecessors, came from a business background, having served as CEO of Korea's leading construction company during the heyday of industrial growth in the 1970s (Ahn 2008). One of the top five goals of the Lee government has been to revitalise the sagging Korean economy and further open domestic markets. To that end, the President has made regulatory reform one of the key elements of his economic policy and established the **Presidential Council on National Competitiveness** (PCNC)[35] shortly after his inauguration in February 2008. The missions of the PCNC are regulatory reform, public sector innovation, investment promotion and legal and institutional advancement. Similarly, the Prime Minister's Deregulation Taskforce team, the Corporate Resolution Centre and the standing Regulatory Reform Committee focus on the regulatory reform as well (US commercial service 2009).

Corporate governance reform

The Asian financial crisis brought to light serious deficiencies in the corporate governance culture in Korea, including a lack of both transparency and oversight mechanisms. All voting rights restrictions were eliminated in June 1998. The "shadow voting" principle which required financial intermediaries to vote with other shareholders was abolished, and minority shareholder rights were strengthened. All companies were henceforth required to establish committees for selecting external auditors and had to appoint at least one outside director to the board. In February 1998, the government simplified legal procedures relating to corporate rehabilitation and bankruptcy filing (OECD, 1999).

Liberalisation of outward direct investment

Outward foreign direct investment (OFDI) began to take off in the late 1980s when Korea started to ease restrictions on OFDI (Figure 5). By the 1990s, the *chaebol* that had experienced rapid growth throughout the 1980s were looking to expand globally in order to gain access to overseas markets and advanced technologies or to relocate their production facilities. Small and medium-sized enterprises (SMEs) joined the trend in the latter part of the 1990s faced with continued production cost rise at home. The Asian financial crisis temporarily slowed down the trend but OFDI picked up in early 2000s, with a particularly sharp increase in 2007. Outflows reached a record USD 25 billion in 2011.

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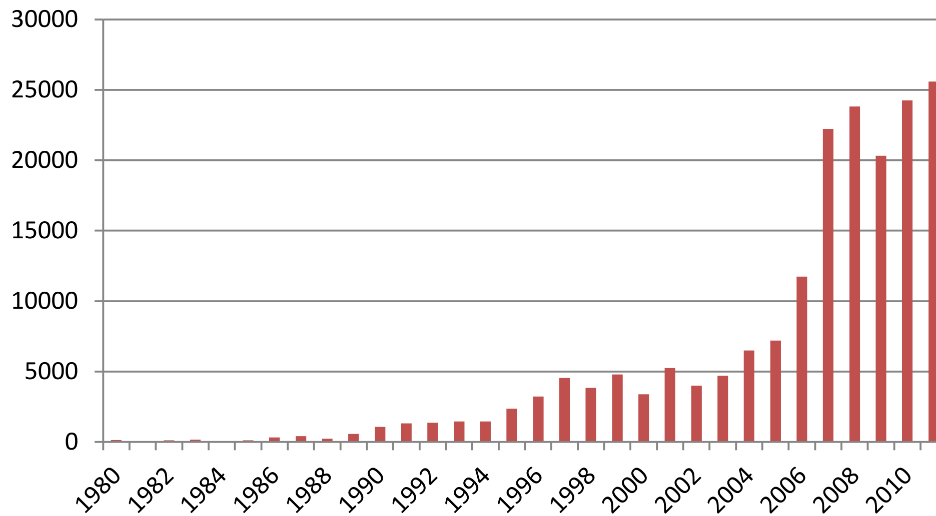
[34] www.aabf.org/skorea_inv_guide.htm

[35] With many foreign experts serving as members.

Figure 5. **Outward direct investment by Korean firms** (USD million)



Source: Korea Export-Import Bank

Korea's policy approach towards outward foreign direct investment

Korea's policy approach towards OFDI has evolved strategically over time, reflecting the needs of the Korean economy at different stages of development. Initially restrictive until the late 1970s, gradual liberalisation started in the 1980s. The export boom in the latter part of the 1980s encouraged further the liberalisation of the OFDI regime, but active promotion of OFDI only began in the 1990s. Korea's accession to the OECD was a watershed in terms of OFDI policies since the new policy stance for freer capital movements led to liberalisation of restrictions on both inbound and outbound investment. From the late 1990s, OFDI policies began more actively to promote Korean investments abroad, with even more proactive policies in the past decade. The oil price hike in 2008 also prompted the government to further support Korean firms in their attempts to win foreign projects related to natural resources development with various policy tools through all relevant government agencies such as KOTRA, Korea Oil, government-linked financial firms and relevant Ministries.

The historical trajectory of Korea's OFDI policies during the past fifty years can be classified into "six stages of OFDI polices" based on different studies published by the Ministry of Knowledge Economy.

Introduction: 1968-1979

Outward foreign investment by Korean nationals was strictly controlled by the government in the 1970s in the face of chronic current account deficits. Although the *Foreign Capital Inducement and Promotion Act* adopted a new chapter on outward investment, OFDI was only allowed in certain circumscribed areas such as natural resources development and for securing raw materials. The Bank of Korea was in charge of giving **prior approval** after screening the investor's qualifications. The approval was only given to investors under certain conditions, such as a proven business record and the availability of internal funds. The Korea Export-Import Bank began funding projects for natural resources in foreign countries during this period.

Institutionalisation: 1980-1985

Resource nationalism and trade protectionism caused by the second oil shock led to the first steps by the government to promote outward investment. OFDI restrictions were relaxed and the prior approval system was removed in 1981. The government removed the requirement of recovering the invested principal within ten years.[36] In this period the **Committee of Investment Overseas** was established to replace the approval system, with an easing of the conditions attached, and the Small and Medium Business Corporation commenced financial support system for SMEs when relocating their idle plants to foreign countries.

Liberalisation: 1986-1990

Beginning in the mid-1980s, the Korean Won appreciated, domestic labour costs increased, the balance of payments was in surplus and trade conflicts deepened. In response, the government's attitude towards OFDI became more proactive. Recognising the need for firms in labour-intensive industries to relocate their production base to foreign countries, the government adopted the notification system in 1987 that allowed domestic investors to invest abroad in non-restricted areas simply by notifying the Bank of Korea. The qualification conditions including the self-financing and the business history requirements were abolished and individual investors were allowed to invest overseas. The list of investment areas that had to be reviewed by the Committee of Investment Overseas was shortened while the list for overseas real-estate properties for which OFDI was allowed was extended.

Reorientation: 1991-1998

In the 1990s, promotion of OFDI came to be associated with broader industrial policies which, together with Korea's decision to become an OECD member, pushed the government to liberalise further its OFDI policies. Firms in labour-intensive production continued relocating abroad, while other firms sought improved market access in advanced economies through a local presence. Between 1994 and 1995, notification was simplified by allowing investors simply to report to foreign exchange banks for small and medium-sized investment projects. At the same time, with the exception of three real estate related business investments, all other business areas were liberalised for OFDI.[37] The government adopted the notification system for all OFDI projects in 1997. OFDI for asset management purposes to diversify investment portfolios was encouraged; the number of restricted areas for OFDI was reduced; the obligatory review of the Committee of Investment Overseas on the foreseen effects of OFDI on the domestic economy was abolished.

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[36] Ministry of Finance and Economy (1996).

[37] *Ibid*.

Private-led promotion: 1999-2004

The OFDI liberalisation slowed down during the crisis only to pick up from 1999. The *Foreign Exchange Control Act* was replaced by the *Foreign Exchange Transaction Act* to allow simplification of procedures and to ease the pre-requisite conditions. From January 2001, the second phase of liberalisation on foreign exchange transactions aimed at promoting OFDI relaxed the condition that necessitated recovery of the investment principal while strengthening the post-investment monitoring system. During this period, overseas investment by SMEs grew from 17% of total OFDI in 2000 to 39% in 2004.[38] The *chaebol* also invested heavily abroad. Policymakers responded with various policy tools to support the trend and increase OFDI. **The Service Centre for Korean Overseas Investors** opened its first office in Beijing in 2004 followed shortly thereafter by offices in Indonesia and Viet Nam to assist Korean firms in collecting information on financing and on possible business sites. The government further encouraged cooperation among Korean firms to form Korean business associations abroad and to build regional co-logistics centres to be shared among Korean firms operating in the same region. The first one opened in Rotterdam in the Netherlands in 2004. The government provided support for Korean firms in bidding for contracts to build large-scale oil plants and other natural resource projects.

Proactive promotion: 2005~

The government has actively promoted OFDI since 2005, encouraging domestic firms to invest abroad and to deepen business alliance with foreign multinational enterprises operating in Korea. The investment restriction of USD 300 million per investment project (the amount allowed for one investment project) was abolished and the maximum investment restriction on individual investors was raised from USD 1 to 3 million and then to USD 10 million. In 2007, the Policy for Supporting Koreans Firms to Invest Abroad was adopted to transform Korea from into one of the strongest outward investor countries, and the **Committee for Global Business Operation** chaired by the Prime Minister was established. This committee coordinated among different agencies providing services for Korean investors abroad such as KOTRA's Global Korea and its country offices, different government-owned (or linked) organisations (*e.g.* banks, investment guarantee providers, the Korea Oil corporation, the SME association) and all ministries responsible for policies concerning OFDI.

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[38] Ministry of Industry and Resources (2006).

ACCOUNTING FOR POLICY SHIFTS: THE DETERMINANTS OF REFORM

"*The real test of the reform process is the extent to which it can elicit a major change in the behaviour of the various stakeholder groups that make up Korean society.*"

OECD (1999)

Korea's political economy is organised around five major players: the government, the large conglomerates (*chaebol*), the trade unions, the general public, and external influences through foreign governments and international organisations. Each group plays a role in promoting or resisting reform, and a government must try to balance these conflicting interests. The 1997-98 crisis changed the balance of interests in favour of reform and contributed to further liberalisation, but the government's public campaign for reforms had already been embarked upon since the early 1990s. Furthermore, changes in attitudes as a result of the crisis may sometimes and among some groups have reverted back to earlier attitudes.

Government

The government came around to the need for reform as early as the 1980s to address obstacles to further rapid economic development. Both microeconomic considerations (technology transfers, enhancing competitiveness, industrial upgrading) and macroeconomic ones (balance of payments financing, filling the domestic savings gap) account for the policy shift, although the former is often given more importance as a driver of Korea's FDI policy (Sakong (1993), p. 122 and Nicolas (2001)). As foreign firms became more and more reluctant to share technology with Korean firms as the gap in technological capability narrowed, the Korean government increasingly perceived FDI as a way to access technology.[39] The government at the time also felt the need to adopt a new industrial strategy to mitigate the costs of the HCI drive of the 1970s (Kim and Wang 1996).

While the benefits of FDI liberalisation were at first perceived as smaller than the costs (loss of control), this perception changed over time. Volatile debt-creating flows were found to be risky and costly, fuelling the need to restructure the corporate and financial sectors (Jones and Yoon 2008). A rising awareness of the need to open up (or alternatively the rising opportunity cost of maintaining restrictions) was due to fundamental economic reasons, such as the need to attract foreign currency as well as to improve corporate management. Attracting FDI to Korea was perceived and presented by the government as a way of overcoming the currency crisis and strengthening the competitiveness of Korean industry (Kim and Lee 2008). The need to enhance competitiveness was all the more pressing since competition from other neighbouring economies such as China was also rising.

The pro-liberalisation stance was not widely shared in other circles. Decades of state-led development had created a constellation of incumbent stakeholders opposed to any form of liberalisation. Among

[39] Outward FDI can also be a response to the difficulty in procuring foreign technologies. Caves (1982) cites the case of Japanese firms investing in the United States once American firms became more reticent to license technology.

those resisting reforms was part of the bureaucracy which had an interest in maintaining restrictions or granting permits and which thought that reform would reduce its discretionary powers. Resistance was particularly prevalent among lower-level civil servants (Sachwald 2001). These civil servants were often reluctant to implement reforms promulgated by top-level ministers and deputies, notably in the case of the one-stop service office for FDI approvals (Stoever 2002)

During the crisis, FDI was perceived as one way of keeping a number of firms afloat (and thus of preserving jobs) in the very short-term. In the immediate aftermath of the crisis, FDI liberalisation was easier to "sell" to the public because of its contribution to the economic recovery. The reform was also easier to reconcile with developmental priorities. As a result, the (social) costs of the reform were justified by citing the need to regain investors' confidence and stabilise the economy.

Moreover, reform was aided by the vagaries of the electoral calendar since the newly-elected President Kim Dae-Jung had played no part in the policies leading to the crisis. Leadership was provided by the newly-elected president as well as by the National Assembly. Arguing that foreign investment was the key to future Korean prosperity, Kim Dae-Jung sought to encourage FDI to overcome economic and financial difficulties. As emphasised by Kalinowski and Cho (2009), there were "congruencies in interests and ideologies between the IMF and the Kim Dae-Jung administration regarding liberalisation".

According to a survey on attitudes towards multinational enterprises (MNEs) held by government officials and business leaders in Korea, the perception of MNEs was overall positive in the immediate aftermath of the crisis.[40] The results of the survey are reported in Jeon and Ahn (2001) as follows: "Both elite groups responded that bringing foreign capital from abroad to the country is the most important positive impact of foreign affiliates. The creation of employment opportunities and technology transfer had the next highest ranking, followed by improvement in competitiveness and efficiency of local firms, the globalisation of domestic economic systems and improvements in the balance of trade."

Chaebol

In the initial stage of Korea's economic development in the 1960s and 1970s, large firms enjoyed exclusive government support and protection and helped to drive rapid economic growth through their monopolistic access to resources. These firms grew to become the so-called *chaebol*. The government gave them the exclusive right to engage in certain businesses, continuously favouring them with financial assistance, low interest rates, tax benefits, foreign exchange allocations, import and export licences and foreign investment incentives. Until the end of military rule in 1987, the government and the *chaebol* dominated the economic landscape in Korea, cooperating closely on the basis of largely congruent interests. Through its access to capital, the state was in a position to orchestrate the activities of the *chaebol*. At the same time the government was dependent on the *chaebol* for achieving its goal of industrial transformation and development.

In the period 1987–97, the Korean system could be characterised as *chaebol* capitalism. *Chaebol* gradually became increasingly independent from government protection, support and guidance (Kalinowski 2008). Through successive five-year plans, there was a shift from a strict and detailed control to a broader, frame-setting approach. The *chaebol* had become "too big to fail" but also "too big for the government to control". The government had sought unsuccessfully to curb the power of the *chaebol* since the early to mid-1990s. The post-crisis situation proved to be much more favourable, with an increase in the role of foreign investors providing a counterweight to the power of the *chaebol* (Kalinowski and Cho 2009). Mistakes in the way the *chaebol* chose to develop (excessive indebtedness,

[40] The survey was conducted in 1998-99. A total of 208 people, 97 government officials and 111 business leaders with different levels of job hierarchy and responsibility, completed the questionnaires.

reckless expansion strategies) were evidenced by the 1997-98 crisis, and some even went bankrupt (Hanbo, Kia, Daewoo). Since the *chaebol* were economically weakened by the crisis as much as politically discredited, they were less able to resist the government reform policies. The temporary weakening of the *chaebol* allowed the government to carry out its reform agenda.[41]

According to Kalinowski and Cho (2009), the first phase of liberalisation was still shaped by a preference for credit-financed development and by an anti-FDI bias: the *chaebol* benefited from easier access to international financial markets in order to finance their internationalisation but still feared the increasing influence of foreign investors through equity participation. Even before the crisis, however, the *chaebol* had some incentive to agree to the reforms and give up some of their vested interests in return for easier access to foreign money (Kalinowski 2008).

Using the crisis as a way of overcoming *chaebol* resistance and for opening up further to FDI inflows turned out eventually to be counterproductive. Reliance on FDI as a change agent may invite the temptation to use FDI as a scapegoat for the eventual difficulties of Korean firms (loss of competitiveness for instance). Another major problem is how to maintain the reform drive once the economy recovers. Once the *chaebol* regained clout (as the main beneficiaries of the recovery), the government had difficulty maintaining the reform momentum (Kalinowski and Cho 2009).

Some industrial groups (in particular the most competitive ones) had nevertheless gradually shifted to a more pro-openness stance even before the crisis, recognising the need to enhance their competitiveness by being exposed to foreign technology (see Kim and Wang (1996)). Local business groups were also growing to become global players and some started pushing for government deregulation. Kim and Wang (1996) suggest there was a general pro-liberalisation mood in Korea among business elites who were in favour of deregulation and no longer perceived government interventions as desirable.

Labour unions

Most trade unions are affiliated with one of two national organisations: the conservative Federation of Korean Trade Union (KFTU) or the progressive Korean Confederation of Trade Unions (KCTU). Korea's labour unions are known for their militancy partly as a result of past political repression. In the 1960s, the government emphasised a "develop first and distribute later policy" leaving little scope for labour union activism. With rapid democratisation in the late 1980s, Korea's labour movement underwent major changes and became increasingly vocal. The government made efforts to improve the labour-management relationship in the 1990s. In the wake of the crisis the Tripartite Commission was established on the basis of social consensus and common understanding (Box 7).

The KCTU tried, albeit unsuccessfully, to slow the pace of restructuring and liberalisation (with a dramatic rise in the number of work days lost to strikes)[42]. The labour movement, however, is divided and the more conservative KFTU refused to join forces with the KCTU in its fight against restructuring and liberalisation, agreeing in contrast to work cooperatively with the government to attract FDI (Kalinowski and Cho 2009, p. 236). The KCTU broke away from the commission in 1999 in opposition to the government's liberal policies.

In the years immediately following the crisis, labour unions strongly resisted foreign takeovers of some large bankrupt companies (Kim, 2003).

41 Kalinowski and Cho (2009).

42 An example is the strike led by the union against Citibank's takeover of KorAm Bank (Hussain 2006).

Box 7. The Korea Tripartite Commission *(Nosajeong Wiwonhoe*)*

The Korea Tripartite Commission was established in January 1998 by the Kim Dae-Jung government as a consultative body under the authority of the President. In the aftermath of the crisis, radical reforms (*e.g.* deregulation in employment protection, restructuring of the national insurance system, removing foreign investment restrictions) were to be implemented that would affect all social actors. The Commission opened a forum for consultations among the three social groups: labour, business and the government. The three groups sometimes conflicted sharply with one another, especially as the trade unions and business association had very different views on the causes of the crisis. With the mediating role of the government and voluntary trade-offs among the participants, however, the commission succeeded in drafting the **Joint Declaration for Overcoming the Economic Crisis and Re-Development** as early as February 1998. This set the stage for implementing major reforms that involved sensitive issues including liberalisation of the labour market, restructuring of the business sector (*chaebol*) and full-fledged liberalisation of the foreign investment regime.[1]

The Korean Confederation of Trade Unions (KCTU) broke away from the commission in 1999 in protest at what it perceived as the government's unbalanced implementation of agreements.[1] It was only one year later, when the Korean Federation of Trade Unions (KFTU) joined the commission in 2000, that the Commission began to function normally. The KFTU remains the representative of trade unions on the Commission.

One of the five goals of the commission was to create an investor-friendly environment to promote FDI into Korea. The commission enabled the restructuring of the financial, business and public sectors by providing the basis for social groups to voice their opinions in formulating policies to enforce change. Such efforts included opening up regional offices all around the country to reach out more effectively to ordinary citizens and encourage them to use the consultation system. The number of regional offices increased from a handful in the late 1990s to reach 101 in 2010.

As the initial function of the commission was to implement reforms in the post-crisis period, debates on the legitimacy of the existence of the commission continued. The commission was renamed the **Economic and Social Development Commission** in 2007 with a broader mandate than the earlier Commission and including other parts of civil society. Successful examples from the Tripartite Commission gave the ESDC legitimacy for continuing such social consultations. As the mandate has been broadened, the new structure of the ESDC provides a multi-layer consultation forum through its subcommittees by topic and by industry. All committee meetings are recorded and made public through a website.

The **Committee for Assessment of Implementation** helps to guarantee the effectiveness of the ESDC tracking the implementation process of each ESDC-agreed policy to make sure concerned government bodies promptly carry through the decision. As of September 2011, 80% of deliberations (128 out of 169) made by the commission had been implemented.[1] In the midst of the recent world economic crisis, the ESDC announced the Joint Declaration of *nosaminjeon*g (labour, business, civil society, and government) for Overcoming the Economic Crisis in 2009. The declaration included a "job-sharing" policy, creating youth employment, and reinforcing the social security network for crisis-affected population among its 64 agreements. The commission maintains an international network with similar commissions in other countries.

*No: labour; Sa: business; and Jeong: government).

The Korean public

As is common when transiting out of a state-led model, public support for liberalisation has remained relatively weak on the whole. A crisis such as Korea experienced in 1997-98 can help to overcome this resistance, but at the risk that reforms will not be strongly embedded in the political economy of the country. Public support for FDI liberalisation nevertheless grew during the crisis thanks to the positive impact foreign firms exerted on the economy. Opening up to FDI in the immediate wake of the crisis was perceived positively because the entry of foreign firms undoubtedly contributed to generate employment, sustain production and exports, upgrade technologies as well as to reform corporate

governance. A public survey in 1998 found that 75% of respondents accepted the need for foreign mergers and acquisitions.

With memories of the crisis receding, signs of a revival of anti-foreign sentiment could be found amongst the public and in the media (Cherry 2007). For instance, a number of press articles deplored the sale of Korea First Bank to Newbridge capital in December 1999 at fire-sale prices (Kim and Lee 2008). Despite rapidly changing attitudes since the crisis, popular disapproval and official resistance to foreign investment is deeply entrenched. Bishop (2002) identifies general popular opinion as one of three sources which also include business lobby groups and some parts of the bureaucracy. Resistance to M&As seems to be particularly strong, perhaps because such M&As are very much in contradiction with the Korean way of doing business. Also firms feel more vulnerable in a context of easier FDI. According to Jones and Yoon (2008, p. 12), the "negative attitude of management, labour unions and non-governmental organisations concerning M&As (…) has been fuelled by the experiences of private equity funds that purchased Korean banks following the crisis and the active role of foreign shareholders."

External influences

External factors include not only international organisations such as the IMF and the WTO but also important trading and investing partners such as the United States. Since the mid-1980s, Korea has been increasingly treated as a "normal" trading partner and has faced more aggressive market opening demands than policy makers in Seoul were used to. Pressures from the United States mounted in particular during President Reagan's second term in office (1984-88), when several high-level trade dialogues were convened between the United States and South Korea. The mounting US trade deficit with Korea in the early to mid-1980s prompted demands for Korea to open its domestic market to foreign goods and foreign investors (Kim 1999).

In 1989, the US government threatened to designate Korea as a Priority Foreign Country under the Super 301 Section of the Omnibus Trade and Competitiveness Act, because of its discriminatory practices. As a result, market liberalisation and opening became an important objective for the Korean government in the early 1990s,[43] but at the same time it fuelled anti-US sentiment in Korea (Nicolas, 2003). The reforms were viewed as being taken under US pressure and they were easily opposed as serving American interests.

Other external pressures were also at play, particularly the conclusion of the Uruguay round negotiations in 1994 which led to substantial changes in the international economic climate, leading Korea to seek to liberalise its investment regime further. According to Kim (1999), multilateral trade negotiations such as the GATS, and the government's aim to induce more competition in the domestic market have enabled a gradual opening in the service sector since 1994, including in such sectors as financial services.

Lastly, the perspective of Korea's accession to the OECD gave a new momentum to various market opening measures and particularly to the further liberalisation of FDI policy. As part of its accession to the OECD, Korea aligned its FDI system with international norms and standards. Also, since Korea joined the OECD at the end of 1996, there has been rising peer pressure to adjust its business environment (Jones and Yoon 2008).

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[43] It was under this pressure that Korea committed to promote more open competition in the Korean insurance market in the early 1980s, for instance. Similarly in the mid-1980s Korea agreed to improve protection of intellectual property rights.

The post-crisis IMF-mandated reform programmes[44] also played a role by enabling Korean policy makers to push through reform and convince all economic actors to do away with restrictive practices. As explained by Noland (2005) with respect to Korea's financial sector reform, the pressure exerted by the IMF undoubtedly allowed President Kim Dae-Jung to advance his own relatively liberal economic agenda, but the role of the IMF is easy to exaggerate. In a number of areas (such as allowing hostile takeovers), the Korean government went far beyond what the Fund had requested. This suggests that external pressures (from the IMF in particular) do not fully account for the policy shift but acted as an enabling factor.

The crisis and IMF pressure provided a window of opportunity to implement the reforms that were previously met by opposition (in particular from Korean big business and from the public at large (Kalinowski 2008)).

Further external pressure for reform has come through the negotiations for free trade agreements with the United States and the European Union. In the former, Korea committed to open its telecommunications sector to full foreign ownership for facilities-based providers within two years of the entry into force of the agreement.

[44] As part of its rescue package, the IMF pushed for the lifting of restrictions on FDI inflows, in particular in the financial sector.

CONCLUSION: CREATING AN ENABLING ENVIRONMENT FOR REFORM

Starting from a situation in which FDI was severely restricted, Korea has been the greatest reformer of its FDI restrictions among OECD members and key emerging economies since 1997. Reforms in Korea were driven by a mixture of microeconomic considerations (the need to acquire foreign technologies and to enhance competitiveness) and macroeconomic ones (chronic trade and current account deficits and the need to fill a domestic savings gap). As in most countries, the government embarked upon reforms once the status quo was no longer seen as sustainable or sufficient.

Reforms almost always involve the interplay of internal and external factors, and the question of whether the pressure for reform was primarily internal or external is not germane. Governments routinely use crises and external pressure to push through unpopular reforms and sometimes lock in existing reforms through international agreements. If anything, crisis-induced reforms can lack legitimacy once the crisis has abated. In Korea, reforms clearly accelerated at the time of the crisis, faced with the acute need to repair balance sheets. But the substantial reforms undertaken in Korea since the early 1990s cannot be reduced to a simple crisis response. Two Five-Year Liberalisation Plans were introduced in the early 1990s, together with a Reform Programme to improve the investment environment. The government at the time also negotiated OECD membership by late 1996 with a commitment to further reform.

The Korean experience also demonstrates the need to have a critical mass of reform in place before foreign investors will respond. Many early reforms – such as the shift from a positive to a negative list of restricted sectors – were hesitant and incomplete, leading to only a modest rise in FDI inflows at the time. The takeoff in FDI inflows in the mid-1990s is a clear manifestation that this critical mass had been achieved.

Going beyond the roadmap for reform, successive governments have made sustained efforts to promote public awareness of the benefits of further openness, including both high-level pronouncements and the *segyehwa* or globalisation policy. The Korean government has also made many institutional changes, such as through the Committee on Foreign Direct Investment and the Investment Ombudsman, to improve not only the investment climate itself but also the climate for investment policy making. The *segyehwa* policy and the Tripartite Commission were designed to foster greater acceptability of the need for reform.

Reform is not a one-time occurrence but rather a continuous process. While many countries have reformed significantly over time, as Korea did in the 1990s and beyond, increasing regional and global economic integration, together with technological change, imply that policies will have to be continuously adjusted in response to changing circumstances. The most interesting lessons from the Korean experience do not relate to the crisis in the late 1990s and the government's response but rather to how successive governments have worked to create a suitable enabling environment for reform.

Reforms should be pre-announced, with political support at the highest level, a credible schedule for implementation and no backtracking

- Like many countries in Asia, Korea prepares Five-Year Plans which set out the objectives of government policy over the next five years. Beginning in the early 1990s, the government set out a medium-term agenda for reform through its five-year FDI liberalisation plan. According to a *Trade*

Policy Review[45] by the WTO just before the crisis, "actual implementation of liberalisation measures and programmes, usually announced years in advance, has been remarkably consistent, without any significant delays or reversals".

Public awareness campaigns about the benefits of openness should be recurring events

- As with the government's *segyehwa* strategy, the public needs to be informed about the benefits of openness. Since this policy ended in the late 1990s, public opposition to foreign investors has grown, along with the rise in FDI in the Korean economy. Foreign investors can also take upon themselves part of the responsibility for public information campaigns, but these are likely to be most effective if the government is also involved.

A forum for public dialogue is an essential component of reforms, helping to improve both the effectiveness of reforms and the buy-in from local stakeholders.

- The Tripartite Commission was created in Korea in 1998 in order to involve all key stakeholders in the discussion of reform as a way of escaping from the crisis. The Commission was renamed the Economic and Social Development Commission in 2007, with an even greater role for civil society.

Dialogue should also include foreign investors...

- In addition to its role in settling grievances of foreign investors through its Home Doctor system, the Investor Ombudsman also represents the views of foreign investors within government.

...as well as across ministries and different levels of government

- In 1999, the government also established the Committee on Foreign Direct Investment (CFDI) to review FDI policies and systems on a continual basis. The Committee consists of representatives of various ministries and agencies, such as the Ministry of Knowledge Economy and the Ministry of Strategy and Finance (MOSF), and heads of relevant local and city governments. It is chaired by the vice-minister of MOSF. The Committee makes major policy decisions on FDI and prepares an annual FDI Environment Improvement Plan, based on proposals submitted by ministries and local governments, which are members of the Committee. Conflicts between the central government and local governments, for example, are to be resolved in this committee (Jeon and Ahn 2001).

- Under an amendment to FIPA, the president of KOTRA was designated as an official member of the CFDI (members were previously limited to ministers and governors).

- The 2000 amendment authorises the CFDI to adjust the measures of relevant government agencies for the improvement of the foreign investment environment. It also obliges MOCIE to report to the CFDI about steps being taken by such agencies to improve the foreign investment environment.

FDI liberalisation is most effective when embedded in a broader reform agenda

- FDI reform was complemented by both trade and regulatory reform, the liberalisation of restrictions on outward investment and by significant improvements in investment promotion and facilitation, including the creation of the Investment Ombudsman providing feedback to the whole reform process.

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[45] WTO (1996), p. 67.

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