CHAPTER I

INTRODUCTION

1.1 Background

1.1.1 Development of FDI

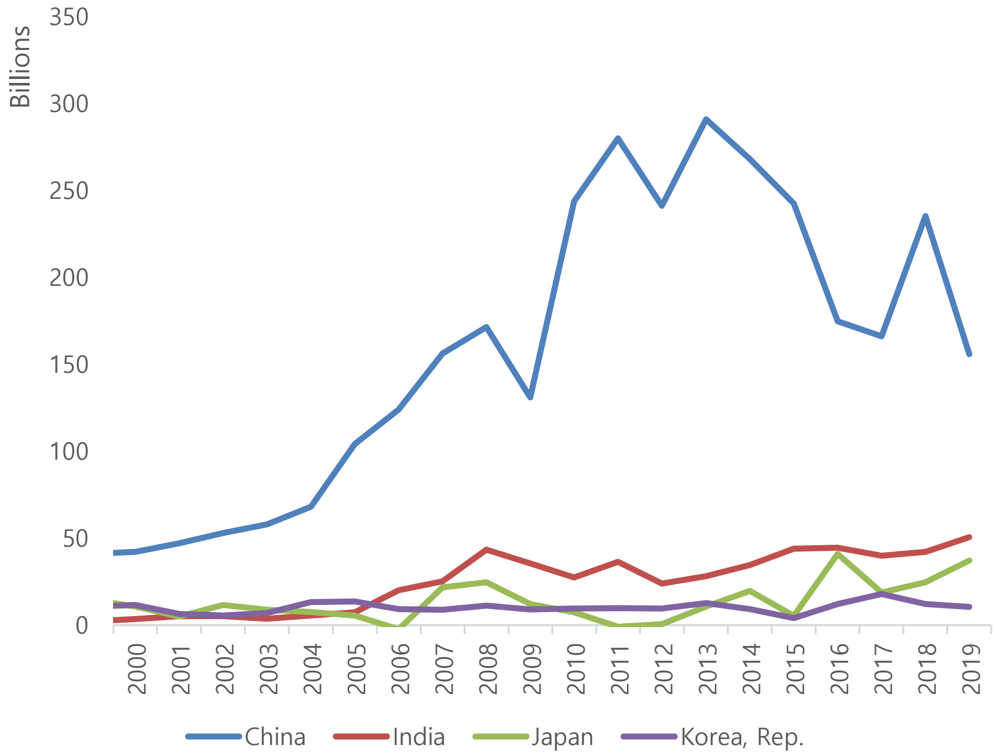
In the past years and until now, Foreign Direct Investment (here after, FDI) has been considered as a crucial role for both developing and developed countries in terms of the growth of the host countries' economy for decades. Researches about FDI and its determinants have been one of the most trending topics for decades.

FDI ownership is acquired by transferring abroad financial and/or other tangible or intangible assets (Daniel, Radebaugh, & Sullivan, 2013). There are several categories of FDI which includes acquisition, buying a certain stock of a foreign country-based company, and making Greenfield investments (subsidiaries).

For the host countries, supply of funds for capital formation will be boosted through FDIs, which one of the examples is; the production chain where the foreign entities buy inputs of local manufacturers, while then selling said raw material to local enterprises is considered as an FDI too. Developing countries can also increase their foreign exchange revenues and their export capacity towards the developed countries. FDI can also improve job opportunities, transferring technology and in economic growth of the host country (Ali & Mingque, 2018).

The main investors come from countries that have excess fund to facilitate the investment, which are the developed countries. By investing in other countries that have greater possibilities in growing, the FDI coming to their own home countries decreases. Also, the movement of factors of production from home countries to host countries is usually the labor skills/ expertise and technology transfers. Developed countries are more advanced in their technology compared to developing countries. Developing countries may not have enough skills and technology to grow their economy and it makes developing countries as the ones who are receiving more than developed countries (Eiteman et al., 2013).

1.1.2 FDI in Korea



Source: World Bank (2020)

Figure I-1 Foreign direct investment, net inflows (BoP, current US$) - Korea, Rep, India, Japan, and China 2000-2019

The economic development in Korea can be divided into four phases (Nicolas et al., 2013). In the decades following the Korean war, FDI was not a major contributor to the nation's economy due to the restrictions of foreign capital inflow by the government to foster in-country development and to prevent technology transfer. In the early 60s, there were not many foreign exchanges, and the economy was heavily reliant on development assistance from the United States. In the mid-1970s, the government changed the economic policies by launching the Heavy and Chemical Industry (HCI) Promotion plan which continued throughout the 1970s, directed credit through state banks to these industries which gave rise to the chaebols (large conglomerates). The economic liberalization happened due to the excess investment and capacities within these industries along with political turmoil which peaked with the assassination of president Park in 1979. FDI liberalization occurred in the early-1980s and accelerated through the 90s. In the mid-1990s, FDI increased and reached $3 billion in 1997 following the Asian economic crisis, due in part to the reform made as part of the IMF requirements which created a more favorable climate for foreign investors.

It has been considered that Korea has pursued restrictive FDI policies for the longest time, mainly to protect the influence of Korean government and the chaebol (four large conglomerates which are Daewoo, Hyundai, Samsung, and Goldstar) in the economy. Large Korean firms have controlled the majority of export industrialization until the late 1990s. The government played a key role in controlling foreign and domestic technology licensing to firms, while altogether invested heavily in research and development, all of which led to a far more diminished role of MNCs in Korea in relations to the other middle-income countries (Porter, 1990). In the 1990s, it became much more expensive to restrict FDI, which prompted Korea to challenge the establishment of these policies.

Considering the rising influence of globalization and the membership pre-condition originating from the OECD in the mid-1990s, Korea began to seriously reconsider its restrictive FDI policies while beginning to open up to much more lenient policies of other nations.

Korea adopted The Foreign Investment Promotion Act (FIPA) in 1998, a significant move to enable foreign investment. Nearly 99.8% of the Korean economy became open to foreign investment by 2001 with up to 1,121 sectors in the economy opened to investment and only two entertainment sectors (TV and radio broadcasting) remained absolutely restricted to FDI, while 27 other sectors in media and communications, electricity, and agriculture are partially restricted (Heritage Foundation 2003).

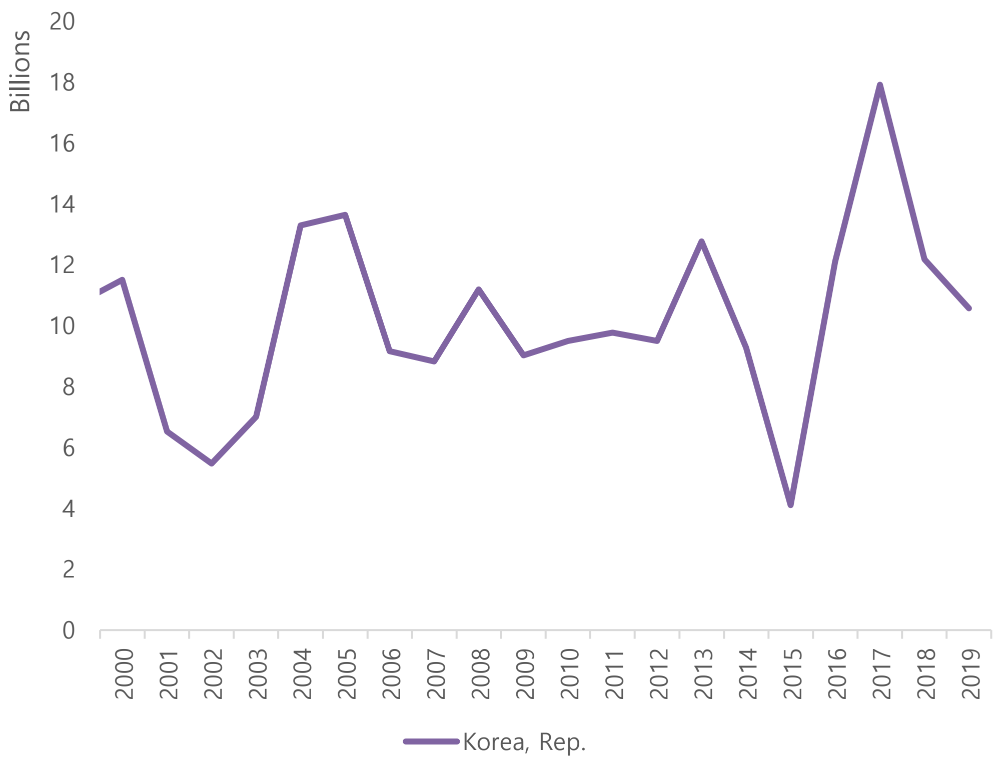
South Korea's main appeal in terms of FDI is the result of the country's rapid economic development and the country's specialization towards new information and communication technologies. However, the lack of appropriate transparency in regulations and policies remains a major concern for foreign investors. The World Bank esteems that the Republic of Korea is a country with a highly developed business environment as seen by its 5th position in the Doing Business 2020 ranking (World Bank, 2020).

Table I-1 South Korea FDI in recent years

Foreign Direct Investment	**2017**	**2018**	**2019**

FDI Inward Flow *(million USD)*	17,913	12,183	10,566
FDI Stock *(million USD)*	229,399	237,238	238,553
Number of Greenfield Investments	120	136	117
Value of Greenfield Investments (million USD)	5,234	8,539	3,608

Source: UNCTAD - Latest available data.



Source: World Bank (2020)

Figure I-2 Foreign direct investment, net inflows (BoP, current US$) - Korea, Rep. 2000-2019

By 2019, FDI inflows decreased by 13%, reaching USD 10,5 billion (UNCTAD, 2020) while FDI stocks had increased to USD 238 billion from USD 135 in 2010. FDI inflow in Korea has fallen by 36% (year on year) in the first quarter of 2019, according to the ministry of trade, industry, and energy. The main cause of this drop mainly due to the end of tax breaks given to foreign companies investing in Korea making it arguably less attractive for foreign fund to invest in Korea. Tax break for foreign investments was given until 2018 where companies and income taxes were reduced between 50%-100% for seven years. It is becoming more difficult for Korea to attract foreign investment.

On the other hand, FDI flows from major investors such as China, EU, and Japan have decreased significantly. EU especially have prioritized their investment among member countries due to escalating tensions following UK's separation from the European Union (2017-2020). The trade tension between the US and China also had an effect in slowing down investment inflows into the region. Investment from Japan had also fallen due to worsening diplomatic ties in what is known as the Japan–South Korea economic war on the Korean side[1,2]

FDI stocks increased to USD 238,5 billion, up from USD 135 billion of 2010. Investment flows from major investors, such as China, the EU and Japan, have decreased. In 2019, EU members prioritized investment within their own region due to Brexit, US and Chinese investment slowed amid escalating trade friction, while Japan's drop was due to worsening diplomatic ties.

Due to the fast-economic development and South Korea's specialization towards information and communication technologies, investments have been mainly directed towards finance or insurance, mining or quarrying, trade, manufacturing, real estate, information and communication, and transportation.

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[1] news.khan.co.kr/kh_news/khan_art_view.html?artid=201908090855018

[2] https://edition.cnn.com/2019/08/02/business/japan-south-korea-trade-war

There are only a handful of research that specifically studied the determinants of FDI into South Korea. Kim and Yang (2014) used dynamic panel quantile regression analysis on a panel data from 1995 to 2012 found that the determinants of FDI would differ based on the level of FDI inflows. GDP, employment, and human resources education levels of the host country are the three main significant determinants of FDI inflows only when the level of the inflow is low, while corruption and anti-environment investment levels are statically significant determinants for middle and high-level FDI inflows. Another research by Park et al., 2014 used GEE method that the mode of entry into South Korea shows high significance in location as a factor rather than the firm itself as a factor. However, the firm were found to have positive effects on the location of the headquarters, the size of the firm and investment motivation. Hayakawa et al., (2013) on firm-level evidence of host country characteristics in FDI of Japan, Korea, and Taiwan found that host countries with better environment for FDI, in terms of larger market size, smaller fixed entry costs and lower wages. On firm-level FDI, Jeon and Rhee (2008) found that Korea's FDI inflows from the United States are found to have significant associations with real exchange rates, relative wealth, relative wage costs, expected exchange rate changes, and interest rate differentials.

On the determinants of FDI inflow, this paper will refer to some relevant studies. Ang (2008) about determinants of FDI in Malaysia used eight variables (financial development, GDP growth rate, infrastructure development, trade openness, real exchange rate, statutory corporate tax rate in Malaysia, and macroeconomic uncertainty). Kumari and Sharma (2017) conducted for 20 developing countries from the whole of South, East and South-East Asia also used seven explanatory variables (market size, trade openness, infrastructure, inflation, interest rate, research and development and human capital). One study by Asiamah et al. (2019) on determinants of FDI in Ghana following Asiedu (2006), examined the factor affecting the FDI in Ghana using six variables (inflation rate, interest rate, exchange rate, GDP, electricity production, telephone usage). A study by Sahiti et.al (2018) on the empirical review of determinants of FDI used seven determinants for the review (trade openness, labor cost, market size, labor quality, infrastructure, tax rate, and exchange rate.)

1.2 Research Problem

Considering the situation explained above regarding dwindling attractiveness of investment in Korea, it is in Korea's interest to understand what other significant determinants of FDI inflow that can help Korea to attract more investment in the future. Numerous papers have been written on the determinants of FDI inflows in a country. There are however, limited research available that study specifically about South Korea. Therefore, the main purpose of this study is to figure out the influence of the determinants chosen towards foreign direct investment in Korea.

The research problem is stated as: what are the determinants of foreign direct investment inflows in South Korea. The research is conducted to identify the influence of the chosen determinants towards the FDI inflow of Korea, and also to figure out the future decision of South Korea to make in which determines which determinant should be focused for the constant increase of the FDI inflow in South Korea.

Therefore, the research questions are based on several determinants taken from the main papers, and stated as follows;

1. Does Trade Openness Influence Foreign Direct Investment inflow in South Korea?
2. Does Labor cost influence Foreign Direct Investment inflow in South Korea?
3. Does higher Exchange rate influence Foreign Direct Investment inflow in South Korea?
4. Does Macroeconomic Uncertainty influence Foreign Direct Investment inflow in South Korea?

1.3 Research Objective

1. To examine the effect of trade openness in influencing foreign direct investment inflow in South Korea
2. To examine the effect of labor cost in influencing foreign direct investment inflow in South Korea
3. To examine the effect of exchange rate in influencing foreign direct investment inflow in South Korea
4. To examine the effect of macroeconomic uncertainty in influencing foreign direct investment inflow in South Korea

1.4 Research Outline

The outline of this research is comprised of five chapters and is as follows:

Chapter I: Introduction

This chapter presents the research background, research outline, research objectives, research contributions, research limitations, and the research outlines.

Chapter II: Literature Review

The second chapter presents all the theories, previous studies, and the research model.

Chapter III: Research Methodology

The third chapter presents the types of the research, the types of study, the study settings, data collection methods, times, units of analysis, and the pre-test results.

Chapter IV: Research Findings

The fourth chapter presents the research findings including reliability and validity of data, and the figures of the research about the research model and hypotheses testing.

Chapter V: Conclusion and Recommendations

This last chapter will conclude the findings with implication of the research, research contribution and suggestions for future studies.