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STATE AND MARKET IN KOREA:  
HOST COUNTRY BARGAINING POWER AND FDI POLICY

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State and Market in Korea:  
Host Country Bargaining Power and FDI Policy

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## **Abstract**

The purpose of this thesis is to determine what constitutes desirable Foreign Direct Investment (FDI) policies for the state in the age of globalisation. The study begins with the realistic assumption that FDI has variable effects on host economies, and that multinational corporations (MNCs) are fundamentally national firms doing business internationally. This assessment of FDI reflects the needs of government efforts to increase their bargaining power vis-à-vis MNCs in order to maximise the positive effects of FDI while minimising its negative effects. Based on this view, I develop a theoretical framework, namely the Neo Bargaining Model (NBM), and identify the factors that have an impact on government bargaining power. The model is applied to the Korean state and produces the following findings that: (1) the bargaining power of the Korean state has diminished constantly over time; (2) the Korean state's bargaining power has been affected by internal factors (the decline of the developmental state) and external factors (the progress of globalisation); and (3) the bargaining power of the state affects its bargaining outcomes. Finally, these findings enabled me to argue that: (1) the state must have strong bargaining power in order to attain more beneficial effects and less harmful consequences from the MNCs; (2) in order to increase the bargaining power of the state, an active role of the state in the market is required; and (3) lastly, the NBM suggests ways for the state to increase its bargaining power, which are the key for successful FDI policy in the global era.

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## List of Abbreviations

BOK	Bank of Korea
EPB	Economic Planning Board
FDI	Foreign Direct Investment
FKI	Federation of Korean Industry
IFDI	Inward Foreign Direct Investment
IMD	International Institute for Management Development
IMF	International Monetary Fund
IPA	Investment Promotion Agency
KAMA	Korea Automobile Manufacturers Association
KCC	Korea Chamber of Commerce
KDB	Korea Development Bank
KDI	Korea Development Institute
KEIB	Korea Export Import Bank
KFB	Korea First Bank
KIEP	Korea Institute for International Economic Policy
KITA	Korea International Trade Association
KLI	Korea Labour Institute
KOTRA	Korea Trade-Investment Promotion Agency
KPIA	Korea Petrochemical Industry Association
LDC	Less Developed Country
MNC	Multinational Corporations
MOC	Ministry of Commerce
MOCI	Ministry of Commerce and Industry
MOCIE	Ministry of Commerce Industry and Energy
MOF	Ministry of Finance
MOFE	Ministry of Finance and Economy
MOS	Market over State
NBM	Neo Bargaining Model
NIC	Newly Industrialising Country
NSO	National Statistics Office
OECD	Organisation for Economic Cooperation and Development
PCNACI	Presidential Committee on Northeast Asian Cooperation Initiative
SAM	State and Market

SERI	Samsung Economic Research Institute
SOM	State over Market
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
WEF	World Economic Forum
WTO	World Trade Organisation

## **Introduction**

### **1. Research Questions**

We currently live in a global era in which it is usually assumed that states have no alternative but to don the ‘Golden Straitjacket’ (Friedman 1999: 104).<sup>1</sup> Globalisation is argued to lead to a convergence of national policies toward a ‘race to the bottom’ in which states enter into intense global competition by sacrificing domestic interests (Drezner 2001). It is assumed that states open their markets unquestioningly and liberalise their regulations in order to avoid missing out on the ever-expanding trend towards further globalisation. More states seem to become increasingly neo-liberal and competitive, involved in greater deregulation and liberalisation, and less able to act strategically or developmentally (Cerny 2000). Industrial policy and state intervention are now regarded as having been rendered obsolete by globalisation.

One of the main pressures on national policy options comes from the mobility and size of capital flows. Capital has become increasingly mobile and is seeking the locations where it can earn the highest return. Simultaneously, states are compelled to compete to capture this footloose capital for their economic prosperity and are forced to lower regulatory standards to attract it. Intensifying competition among states is putting pressure on governments to relinquish their bargaining power to multinational corporations (MNCs); this growing predominance of capital over state is likely to continue in the future as globalisation deepens (Stopford and Strange 1991, Strange 1996). If this is the case, (1) will states necessarily be dominated by expanding foreign

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<sup>1</sup> Friedman (1995: 104) likens the spread of the neoliberal economy to donning a ‘Golden Straitjacket’.

capital? (2) Are there any ways to enhance the bargaining power of states *vis-à-vis* multinational corporations? This study takes these questions as its starting point.

This thesis shall examine the specific relations between foreign MNCs and the South Korean government since 1962.<sup>2</sup> In particular this study will focus on foreign MNCs in the manufacturing sector due to its significance in the industrialisation of the Korean economy. The study shows that the Korean state had lost bargaining power *vis-à-vis* foreign MNCs over time and will identify the factors that have weakened the bargaining power of the state and thus present the key to restoring the state's power. The study suggests that if the developmental prospects for the Korean economy could be significantly enhanced, the state could regain its bargaining power. It is suggested that claims of the discard of the developmental state are premature and that a return to some form of developmentalism needs to be reconsidered.

In order to make this case, the thesis shall draw upon, and bring together, two complementary literatures — which have previously existed largely in isolation from each other. First, a revised bargaining model will be produced that can adequately characterise the bargaining relations and outcomes between MNCs and the Korean state. This develops a fresh insight by building upon previous models and is termed a 'Neo Bargaining Model' of state-MNC relations. Second, one aspect of the literature of the developmental state is drawn upon and integrated into the model. The result, it is hoped, will produce a fresh analysis both of the state and economy and of state-MNC relations which will help us understand how the economy can be enhanced through globalisation.

Korea is chosen as the focus for the study as it provides not only an excellent example of rapid development, but also because it was the principal East Asian state to

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<sup>2</sup> Unless otherwise noted, 'Korea' indicates South Korea hereafter.

be affected by the Asian financial crisis of 1997. The developmental state model, even though discredited by the 1997 crisis, has been responsible for the miraculous rise of East Asia (Amsden 1989, Evans 1995, Weiss and Hobson 1995, Chang 1996, World Bank 1997).<sup>3</sup> Since the region has supplied the principal models of the developmental state it makes sense to examine one of the leading examples. Moreover, the case of Korea provides a perfect comparison between pre-crisis developmental state and post-crisis neo-liberal state, demonstrating entirely different state attitudes to foreign capital in the two periods.

This study takes a longitudinal approach describing the dynamic changes in the Korean state. The period to be examined starts from 1962, when Korea's first inward investment occurred, and ends in 2005, which is the latest year for which statistical data is available. This period will be subdivided into three eras in terms of state-MNC relations: (1) the state over market (SOM) phase from 1962 to 1979; (2) the transition phase from 1980 to 1997; and (3) the market over state (MOS) phase from 1998 to 2005. Korea in the SOM phase was a typical model of a developmental state which dictated market forces including foreign capital. In this period, state initiatives manipulated businesses to achieve pre-determined goals. However, from 1980, when the transition phase began, the developmental state started to wane; market forces challenged state power and the state began to find it more difficult to dominate business, labour and foreign capital. This was an evolutionary period to another stage of economic development. After the crisis of 1997, the Korean state was reshaped to conform more to neo-liberal ideals as a result of both external and internal pressures. In the MOS

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<sup>3</sup> There has been an on-going debate between neo-classical orthodoxy and developmental theorists on the background to the economic success of East Asian Countries. For more details about this debate, see Chapter One.

phase, when market forces outflanked state power, the state appeared to have lost its developmental determination and capacity.<sup>4</sup> In particular, its approach to foreign capital changed totally from one of strict control to one of active promotion. This study will analyse the bargaining power of the state in the SOM and MOS periods, highlighting the stark contrast in the relationships between the state and market. Through the analysis of both periods, the extent of bargaining power of both phases will be compared and the relations between bargaining power and bargaining outcomes calculated.

This research is primarily concerned with the host country's bargaining power in relation to its foreign direct investment (FDI) policy because it is assumed that not all FDI has a positive effect on host countries. The assumption is drawn from the inherent differences in the respective motivations of governments and MNCs; governments seek to promote development within a national context whereas MNCs seek to increase their competitiveness in an international context (UNCTAD 1999: 154-155). Thus, not all FDI is always and automatically in the best interests of host countries; that is, a universal and beneficial result from FDI on all economies cannot be expected. Historically, the effects of FDI have been interpreted in two different ways: the benign model and the malign model (Moran 1999: 19-21), which means that FDI can have both a positive and a negative impact. Whether the impact of FDI is positive or negative is greatly affected by the consequences of bargaining between host governments and MNCs (Grosse and Behrman 1990). When the bargaining power of the host government is strong, it can select investor firms that will best serve its purposes, but when its bargaining power is weak, it has to make efforts to be selected as a location by the

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<sup>4</sup> According to Chang *et al* (1998) and Shin and Chang (2003), the Korean developmental state started to wane from the late 1980s, was dismantled from the mid-1990s, and was reconstructed according to neoliberal ideals after the financial crisis in 1997.

potential investor. When the bargaining power of the host government is strong, it can not only attract higher levels of FDI but it can also maximise the net contribution made by MNCs to development. However, when the bargaining power of the host government is weak, not only is the ability to attract FDI weak, but also its beneficial impact may be questionable. In this respect, strengthening the bargaining power of the host government increasingly becomes a crucial element in development, as FDI plays a greater role in national economies.

In this thesis, an examination of the shifts in the bargaining power of the Korean government vis-à-vis foreign manufacturing companies during the four decades covered by the study will highlight the factors affecting the host country's bargaining power. An analysis of the relationship between the Korean government's bargaining power and the bargaining outcomes allows us to answer the question of how the state increases its bargaining power in the globalizing world. This thesis seeks to address the three following questions regarding the state-MNC relationship in Korea throughout the chapters: (1) how has the Korean state's bargaining power vis-à-vis MNCs changed? (2) What factors have weakened or strengthened its bargaining power? (3) What are the consequences of the fluctuations in the state's bargaining power? Then, based on the findings of these questions, we answer two general questions above, that is, (1) will states necessarily be dominated by expanding foreign capital? (2) Are there any ways to enhance the bargaining power of states *vis-à-vis* multinational corporations?

## 2. Structure of the Thesis

The thesis, which consists of five parts, is structured in the following way. The first chapter reviews the literature relating to the relationship between governments and MNCs in general and bargaining theory in particular. Based on existing bargaining models, a theoretical framework for analysing the bargaining relationships between host countries and MNCs, the 'Neo Bargaining Model (NBM)', is developed. This model will offer a novel framework for analysing state-MNC relations. A brief overview of the Korean economy in the second chapter divides the whole period into three phases and sets the economic background for the chapters. In Chapter Three, Korea's bargaining power is analysed by applying the NBM and the questions of how the Korean government's bargaining power *vis-à-vis* MNCs has shifted and what factors have affected its bargaining power are addressed. Chapter Four illustrates the arguments made in Chapter Three by analysing statistical data relating to FDI activity in Korea and describing particular bargaining cases between the Korean government and MNCs. Chapter Five analyses how bargaining outcomes have changed according to the shifts in the bargaining power of the Korean government in legal aspects. Finally, drawing together the arguments of this thesis, the findings and implications of the study are presented.



### **3. Methodology**

This thesis employs both qualitative and quantitative approaches; the qualitative method being used in Chapter Three and Chapter Five and both approaches being employed in Chapters Four. Chapter Three, in which the bargaining model is applied to the Korean government, uses a qualitative approach that relies mainly on secondary evidence and scholarly accounts of Korean political economy. The secondary literature is supplemented by a variety of government documents and statistical evidence. The NBM basically consists of three dimensions: bargaining resources; stakes; and constraints. However, there are problems in trying to assess the level of importance of each factor in the model; while some aspects can be judged by quantifiable criteria (such as the level of resources) most of the elements in the model difficult to measure quantitatively (including the level of stakes and constraints). Hence, an assessment of the level of importance of each factor of the government's bargaining power must necessarily be based largely on qualitative judgements, a methodology used by Loewendahl (2001), Stoeber (2002) and Grosse (2005).

Chapter Four illustrates the arguments made in the preceding chapter by employing both qualitative and quantitative methods: case studies and statistical analysis. Case studies and statistical analysis have both advantages and disadvantages; although case studies enable us to have an in-depth insight into the bargaining process and the influential factors in each case, they are difficult to generalise. In contrast, a statistical approach offers generalised results but is limited in terms of insight into the specific dynamics of the relationships. By employing both approaches, the limitations of both methods can be minimised. The data for analysis are mainly obtained from the

Korean Ministry of Industry, Commerce and Energy (MOCIE) and Invest Korea, which is Korea's investment promotion agency (IPA).<sup>5</sup> Cases are selected from both the SOM and MOS periods to display clear differences in state-MNC relations. Chapter Five employs qualitative approaches; the core methodology in its analysis of FDI policy is an examination of Korean laws regarding FDI.

The romanisation of Korean words in this study follows in principle the Revised Romanisation of Korean system, which is the official romanisation system for the Korean language.<sup>6</sup> The new system is similar to the older system, the McCune-Reischauer system, but eliminates diacritics and is more closely based on Korean phonology than on western perceptions of Korean phonetics (for instance, Seoul instead of Sŏul). Korean names are given with the family name first, followed by the given names, and are romanised using the official Korean government system. However where names that are romanised under other systems are well-established in the literature, these versions are used, such as Park Chung-Hee rather than Park Jeong-Hee.

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<sup>5</sup> Most data in this thesis are provided by the Korean government, which tends to interpret figures in its favour. Therefore the use of such data has its limitations and has the potential to create distortions. However, it is the most widely available and relatively reliable.

<sup>6</sup> The Revised Romanisation of Korean was released to the public on July 4, 2000, by South Korea's Ministry of Culture and Tourism in Proclamation No. 2000-8 (Ministry of Culture and Tourism 2007)

## Chapter One: Theoretical Framework

The theoretical framework for this thesis draws on two key areas of the academic debate relating to the role of state: the bargaining model and the developmental state.<sup>7</sup> The bargaining approach will be the main theoretical framework for this study since its main concern is how to strengthen the bargaining power of a host government *vis-à-vis* multinational corporations (MNCs). The first section of the chapter begins with a discussion of the ideological background of the bargaining approach and an historical overview of the development of the bargaining model, providing the context for an explanation of the rationales for employing the bargaining model. Finally, the Neo Bargaining Model (NBM), the theoretical framework of this study, will be introduced. The second section of the chapter will explore theories relating to the developmental state and highlight key areas of the debate on the desirability of government intervention in economic activity. This review of the debate will serve to strengthen the model by providing rationales of the state's role in market. This is an indispensable aspect of our argument because the concept of 'host government bargaining power' is premised on the idea that governments can intervene in markets and that such intervention can be positive. The debate has significant implications for this study of host government bargaining power because the role of government lies at the centre of the viability of the NBM.

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<sup>7</sup> 'State' refers to a set of institutions that possess the means of legitimate coercion, exercised over a defined territory and its population. 'Government' may refer to the body that consists of three distinct set of powers: legislature, executive and judiciary, or sometime may be referred to as the administration body only. In this thesis the term state and government are used equivalently or interchangeably as they are often used in many other scholarly works (World Bank 1997: 20), and also both usually referred to as the national administration body because in either case they represent the entity that is responsible for bargaining with foreign companies and establishing regulations and laws regarding FDI within the Korean state.

# **1. The Bargaining Model**

## **Ideological Background**

During the past two decades, the role played by MNCs and FDI in the development and growth of host economies, and the relationship between host governments and MNCs have generated controversy and debate within academic circles and among government policy makers. Some regard MNCs as a ‘boon to mankind’, while others view them as ‘imperial predators’ (Gilpin 1987: 231); praise for FDI as an ‘engine for economic development’ contrasts with criticism of it as a ‘means for exploiting resources’. Perspectives on MNCs and FDI range from the Marxist view, which sees MNCs as instruments of imperialist domination, to the liberal view, which regards MNCs as contributing to an increase in the overall efficiency of the world economy (Hymer 1976, Vernon 1971, Dunning 1993b, Caves 1971). Between these two extremes there are many different shades of opinion, which vary according to the ideological orientation of the author. The relationships between MNCs and host governments have changed according to governmental perceptions of MNCs and the specific nature of the relationship.

Jenkins (1987) categorizes four main perspectives on MNCs: the neo-classical; the Global Reach; the neo-fundamentalist; and the neo-imperialist. The neo-classical and neo-fundamentalist approaches stress the positive role of MNCs in a host economy, whereas the Global Reach and the neo-imperialist views express anti-foreign investment sentiments. Lall (1974) classifies perspectives on FDI into six groups, of which three are pro- and three are anti-foreign investment. The pro-foreign investment perspectives

comprise the business school approach, the traditional economic approach and the neo-traditionalist approach, while the anti-foreign investment perspectives consist of three views: the nationalist approach; the dependency approach; and the Marxist approach. Gilpin (1975) introduces three models of the state-MNC relationship: the 'sovereignty at bay model' (liberalism); the *dependencia* model (Marxism); and the mercantilist model (mercantilism). Moran (1993) and Balaam and Veseth (2005) use the same categorization of perspectives as Gilpin, although they use different terminology.

Grieco (1986) identifies four major theoretical approaches with respect to host government-MNC relations: the proponents of FDI, the dependency school, the structuralist approach and the bargaining school. The proponents of FDI may belong to the liberal tradition, while the dependency school is roughly classified as Marxist. In this context, the structuralist approach is adopted by those who argue that the bargaining power of host governments tends to decrease over time, whereas the proponents of the bargaining school support the view of the 'obsolescing bargain,' in which host government bargaining power is expected to increase. However, the structuralist approach and the bargaining school can be categorized as being in the same group, in as much as both approaches assume the indeterminacy of gains, which means that the effects of FDI can be either positive or negative, and both argue the necessity of bargaining between MNCs and host governments.

As this literature review shows, the political ideology regarding FDI ranges from a free market stance that advocates a policy of non-intervention to a radical stance that is hostile to FDI; between these two extremes lies an approach that is best described as economic nationalism. The free market view has its roots in the tradition of liberalism;

most neoclassical economists and business economists have belonged to this category.<sup>8</sup> Internalisation theory (Buckley and Casson 1976), product life cycle theory (Vernon 1971) and the eclectic theory of international production (Dunning 1980) all seek to explain FDI within this tradition, and regard MNCs and FDI as a means of increasing the overall efficiency of resource utilization in the world economy. Academics working within this tradition usually work from the standpoint of the MNC rather than that of the host or home country, and they stress the positive effects of FDI such as resource-transfer effects, employment effects, balance of payments effects and competition promotion effects. They argue that government intervention in market functions should be discouraged as it serves only to cause distortions that create inefficiency (Gilpin 2001: 279-286).

The origins of the radical view can be traced to classical Marxism. Although a broad range of arguments exists among the various approaches within Marxism tradition, most of them perceive MNCs to be capitalist instruments for exploiting the natural and human resources of less developed countries (LDCs).<sup>9</sup> They stress the negative effects of FDI such as the displacement of indigenous production, the

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<sup>8</sup> *Liberalism may be defined as a doctrine and set of principles for organising and managing a market economy in order to achieve maximum efficiency, economic growth and individual welfare* (Gilpin 1987: 27). Neoclassical economics refers to the mainstream economics following the tradition of liberalism, which is committed to the market and the price mechanism as the most efficient means for organising economic relations (Gilpin 2001: 46).

<sup>9</sup> The representative Marxist theories in relation to MNCs are imperialism and dependency theory. In his book, *Imperialism*, Lenin (1939 cited in Gilpin 1987) argued capitalism could be escaped from its collapse through its prosecution of overseas imperialism. The acquisition of colonies had enabled the capitalist economies to avoid economic breakdown by providing them with cheap resource and captive markets for unconsumed goods. Therefore, as they increased their productive capability, they had to expand their markets abroad by establishing colonies. In his view, MNCs such as West India Company are should be regarded as the tools of imperialism. Dependency theorists, who were emerged in 1950s, argued that the terms of trade of underdeveloped Latin American countries with developed countries would be aggravated due to the structural problems in their trade; the world consisted of a 'core' of dominant nations and a 'periphery' of dependent countries; MNCs destroy local entrepreneurship, caused technical dependence of host countries to home nations, and distorted the economic structure of the host economy. Therefore, MNCs to them are the instruments of developed economies by which to depive developing countries of their wealth (Seers 1981, Gilpin 1975).

suppression of local capital formation, excessive profit taking, the transfer of inappropriate technology, and uneven income distribution (Biersteker 1978, Jenkins 1987). In order to solve these problems, they emphasize the need for revolutionary changes, both in external relations and in internal power structures. Although the prescriptions vary according to their place in the ideological spectrum, most proponents of the dependency theory propose a 'de-linking' from the international economy and the building up of self-reliant and viable economies (Brewer 1990). In their view, governments should not allow FDI and the entry of MNCs, as they are the instruments of economic domination, not economic development.

Economic nationalism, which takes the standpoint of the nation, holds that economic activities should be subordinate to the national goal of improving economic conditions and sees MNCs as potential tools for achieving that goal. As there are both benefits and costs associated with FDI, the nation's goal is to use the MNCs to maximize the benefits for and minimise the costs to the nation; to this end, host governments must bargain with MNCs. While the liberal view maintains that host governments should not intervene in the economic activities of MNCs, the radical view holds that host governments of developing countries should not allow FDI. However, according to the economic nationalist view, host governments should intervene in order to improve the terms in bargaining with MNCs (Grieco 1986).

Political ideology with respect to MNCs or FDI is an important determinant of government policy, as the ideological stances and perceptions of the external environment held by policy makers or opinion leaders play a crucial role in formulating a host government's FDI policy. Throughout history a common element in the behaviour of governments in their relationships with MNCs can be identified, which is

that they all seek to further their national goals. Before the Second World War, the governments of several powerful European nations used MNCs as an instrument of territorial expansion and a means of achieving economic and political goals. During this period, most European countries regarded their foreign colonies as sources of supply of raw materials and markets for their manufactured goods (Dunning 1993c: 311). People living in the colonies at this time can not be expected to have held liberal views regarding these instruments of imperialism. They might have adopted an attitude of defensive nationalism, which Gilpin (1987: 32) calls 'benign mercantilism', in order to protect their independence or ensure their survival.

After the Second World War, hegemony passed to the United States from Great Britain. The U.S. government also used its corporations as instruments of implementing its foreign policy; as Gilpin (1975: 139) observes "if British economic hegemony was based on the City of London, America's was based largely on her multinational corporations." Assuming that Gilpin's argument was valid, U.S. government officials must have held mercantilist views inasmuch as they wanted to implement their foreign policy through their MNCs. In response to the penetration of the Third World by U.S. multinationals, dependency theories emerged in Latin America, mostly between the late 1960s and the late 1970s (Brewer 1990). The dependency theorists' negative perception of MNCs influenced the attitudes of less developed countries (LDC) towards multinationals and caused strained and even hostile relationships between MNCs and LDC governments. This sometimes resulted in the expropriation or nationalization of foreign-owned assets by host governments, a phenomenon that peaked in the mid-1970s (Dunning 1998a). In this case, the underlying motivation of the majority of decision makers within LDC governments was the protection of their own or their countries'



interests rather than socialist revolution. They also can be called mercantilists rather than Marxists, even though they drew on Marxist logic.

From the second half of the 1980s, attitudes toward FDI began to change. In the 1980s, developing countries turned to a more open and market-friendly development strategy spontaneously or by force (Wiegel *et al* 1997, Dunning 1998a). Since the mid-1980s, communism and the import-substitution strategies of LDCs disappeared and many Third World and former communist countries became more willing to participate in the global market economy. The relevance of Marxism greatly declined with the end of the Cold War and the influence of liberalism increased significantly. More and more countries now accept liberal principles, open their economies to trade and FDI, and compete to attract MNCs into their territories. The whole world seems to be dominated by neo-liberalism and it is argued that MNCs are becoming truly global corporations that are stateless and independent from their national origins. However, in the real world, most countries do not adopt a pure free market policy toward FDI but instead implement policies that allow government intervention to win FDI competition. Moreover, MNCs are still national firms, which are embedded deeply in their national society, while actively conducting international business (Doremus *et al* 1998, Gilpin 2001: 297-300).

In a liberal world, FDI brings benefits to a host country and may contribute to its economic development, whereas in a radical world, FDI always exerts a negative influence on the host economy. However, in the real world, FDI has both positive and negative effects on a host economy. In their study of the economic effects of FDI projects, Encarnation and Wells (1993) found that the majority (ranging from 55 to 75 percent) of MNC operations increased the host country's national income. However, a

significant proportion (ranging from 25 to 45 percent) of investments have had a negative impact on host economies. This evidence shows that FDI can have either positive or negative effects, and suggests the need for government policy that is designed to maximize the benefits and minimize the costs of FDI. The costs and benefits of FDI will vary from case to case and many case studies show that MNCs' impact on a host economy depends on the host government's policies. Singapore and Ireland have developed their economies by means of FDI while many other developing countries suffered the adverse effect of MNC investment activity. Differing results from FDI reflect the success or failure of government to direct FDI, thus the role of government in dealing with MNCs is a crucial factor in determining whether FDI enhances or inhibits the economy of countries (UNCTAD 1999).

Grosse and Behrman (1992: 96) argue that governments seek growth and equity, and do not allow businesses to set the rules of the market on their own; government intervention causes 'appropriately' distorted markets, which are difficult to explain using the theories of liberalism. Therefore, they suggest the use of a bargaining model to explain international business activities, arguing that "in a mercantilist world such as ours, we need a mercantilistic theory of international business" (1992: 121). It may be concluded then that relationships between MNCs and host governments can be best described by a bargaining approach which can incorporate the standpoint of both governments and MNCs. In the following section an historical overview of the development of the bargaining model is provided and key elements of this approach are combined to construct a revised theoretical framework which can be used to further our understanding of the bargaining process.

## **An Historical Overview of the Bargaining Model**

Over the past two decades, a considerable number of studies have been undertaken on the relationship between host governments and MNCs. One particularly noteworthy paradigm for the analysis of MNC-government relations has been the bargaining model developed by Vernon (1971) and further enriched by Behrman *et al* (1975), Fargre and Wells (1982), Kobrin (1987), Lecraw (1984), Encarnation and Wells (1985), Poynter (1985), Grosse and Behrman (1990; 1992), and Brewer (1992) (Luo 2004: 432). The bargaining model is defined as:

A pragmatic approach in which the benefits of FDI to the host country are contingent on each deal. MNCs and host countries bargain over the distribution of benefits from FDI, and the bargaining power of each side is determined by its bargaining sources (Levy and Prakash 2003: 141).

Ramamurti adds:

The bargaining model assumes that MNC entry into developing countries involves negotiations on a case-by-case basis, with the actual entry conditions depending on the bargaining power of the two sides, which, in turn, depends on their respective strength (2002: 103).

The main assertion of the bargaining model is that the outcomes of MNC-host government interactions are derived from the relative bargaining power of MNCs and host governments, which is, in turn, dependent on the bargaining resources of each party. According to this model, parties with greater levels of bargaining power are likely to

obtain more favourable terms in the negotiation process.<sup>10</sup>

The bargaining model focuses on the relationship between the MNC and the nation state; in this relationship the host government's aim is to maximize national wealth, whereas the MNC focuses on maximizing its own interests. Bargaining basically arises from a conflict of interests: where their goals overlap, the two sides may exhibit cooperative behaviour but in areas where they have conflicting goals, relations can be strained. In many cases, the interests of MNCs and host governments are different; whereas the MNC's interests are mainly focused on economic efficiency and profitability, the host countries' interests focus not only on economic growth but also on political goals such as the distribution of the benefits from FDI or the maintenance of national sovereignty. Conflicts in bargaining are caused by the differences between the interests of the two sides and the outcomes of the bargaining depend on the respective resources of the parties involved.

The bargaining power of the host country arises from location-specific advantages such as domestic market size, natural and human resource endowment and industrial infrastructure, which are constantly in a state of flux. The bargaining power of

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<sup>10</sup> The bargaining model has much in common with the game theory in that two or more players are involved in the negotiation process. However, there are significant differences between two theories. Firstly, the bargaining model has been developed especially for analysing relationships between host governments and MNCs, while the game theory is concerned with the general relationships between the competing subjects. Secondly, the bargaining model deals mainly with the power relationships between the players and the sources of their power whereas the major concerns of the game theory are the strategies that players employ to win the game. Thirdly, certain studies of the bargaining model have used mathematical methodologies whereas most game theorists have preferred the mathematical model. These separate focuses seem to derive from the difference between main concerns of both theories. That is, the bargaining model concerns the power of the players, which is an abstract and comprehensive concept thus difficult to apply to the mathematical model, while the chief focus of the game theory is the strategies of the players, upon which it is relatively easier to build a mathematical formulation. As mentioned above, the aim of this study is to analyse power relationships between host countries and foreign companies. Specifically, it is to examine the sources of power of host countries rather than examine strategic decisions in certain situations, which was the basis of the bargaining model to be applied to this study. Fourthly, in the game theory, information plays an important role in making strategic decisions. However, in the bargaining model, information is treated as one of resources that players possess, which lowers the significance of the role of information in the model (Montet and Serra 2003).

the MNC derives from the possession of firm-specific advantages such as capital, technology and management skills. Given that bargaining inherently assumes an opponent, bargaining power is a dynamic and relative concept. The merit of the bargaining model is that it enables us to observe both sides of the bargaining process at the same time. In the following section, the historical development of the bargaining model is reviewed and a new framework constructed that synthesizes the key elements of existing models.

### The Obsolescing Bargaining Model

In the 1960s and 1970s, relations between MNCs and host governments were often confrontational; developing countries were concerned about the negative effects of MNC activity such as economic dependency, political intervention and the weakening of the position of domestic companies and so screened MNCs' entries, regulated their operations and, in extreme cases, expropriated or nationalized their assets. The obsolescing bargaining model was introduced by Raymond Vernon in 1971, in an attempt to explain the relationship between MNCs and host governments in this context. The model describes how developing countries and MNCs negotiate the conditions of entry and operations for MNCs and how those conditions are determined by the respective strengths and weaknesses of the bargaining partners.

Many scholars agree that the bargaining model was developed from the idea of 'obsolescing bargain' presented in Raymond Vernon's *Sovereignty at Bay* (Luo 2004, Eden and Molot 2002, Ramamurti 2001). In the obsolescing bargain model, Vernon (1971) described patterns of investment in the natural resource industries of developing

countries and observed the shifts in power between MNCs and the host governments. Prior to an MNC's entry into a market, its bargaining power is greater than that of the host country, as it has freedom of choice in terms of location and must bear the risks associated with the investment; this gives the MNC an advantage when bargaining with the host government. The decision as to whether or not the investment will take place remains the responsibility of the MNC, affording strong bargaining power to the MNC and leading to the provision of concessions by the host government. However, once the investment has been made, bargaining power shifts to the host government. As Vernon (1971: 47) observes:

Almost from the moment that the signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eyes of government.

After the investment is made, the associated risks and uncertainty dissipate if the project proves successful. The capital invested by an MNC becomes a sunk cost, the host country becomes less dependent on the MNC for capital and technology as these resources diffuse through the host country, and the bargaining power of the MNC begins to obsolesce. Ultimately, the host government demands a renegotiation of the original bargain in order to secure more benefits (Vernon 1971).

The creation of the obsolescing bargaining model was an outcome of the polarization of the debate regarding the effects of FDI on developing countries in the 1970s (Levy and Prakash 2003). At that time, as we have seen, dependency theory was the dominant argument in the developing countries of Latin America; created as a counter argument to this theory, the obsolescing bargaining theory argues that the

dependency theory exaggerates the power of MNCs and ignores the power of developing host countries. The obsolescing bargaining theory focuses on the role of host governments and stresses the autonomous power of host countries. Moran (1985: 6) sees the obsolescing bargaining model as a breakthrough in several respects; first, it adds more dynamism to the understanding of relations between MNCs and host governments; second, it provides a model of economic nationalism based on rational self interest rather than an interpretation of the world system based on Marxist views or irrational waves of anti-foreign emotions; finally, it offers an optimistic view of the future for Third World nations in that it anticipates the eventual strengthening of the power of their governments.

### Testing the Bargaining Model

The obsolescing bargaining model has been tested using data from a number of extractive and manufacturing industries and has proved valid in many cases in the extractive industries. The problem of sunk costs and investment risk typically appear in the extractive sectors, such as the oil, copper and diamond industries, which require large capital expenditures under highly uncertain conditions. The nature and characteristics of the extractive industries seem to be the reason why Vernon developed the obsolescing bargaining model to explain shifts in bargaining power relating to the operation of natural resource extraction ventures.

In his study of the Chilean copper industry, Moran (1974) demonstrates the validity of the obsolescing bargaining hypothesis by analysing the process of the nationalization of US copper companies. He argues that, although the dependency

theory assumes that the power of MNCs increases in developing countries, the power of US copper companies in Chile declined continuously and, eventually, they were nationalized by the Chilean government. Moran points out that this process of shifting power is derived from the nature of extractive industries which need a large lump-sum investment under conditions of high risk and uncertainty.

However in the manufacturing sector, MNC-host country bargains are less likely to obsolesce because investments tend to be smaller, more mobile, and less uncertain compared with those in the extractive sectors (Grosse and Behrman 1992). Bennett and Sharpe (1979), Grieco (1982), Kobrin (1987) and Vachani (1995) test the obsolescing bargaining model on manufacturing investments in developing countries and draw different conclusions. Bennett and Sharp (1979) and Kobrin (1987) question the validity of the obsolescing hypothesis in manufacturing industry but Grieco (1982) and Vachani (1995) provide evidence of obsolescence in the manufacturing sector.

In their study of bargaining procedures between the Mexican government and MNCs in the automobile industry, Bennet and Sharpe (1979) conclude that the bargaining power of MNCs does not obsolesce in manufacturing sectors as it does in the extractive industries. Observing negotiations between the Mexican government and automobile multinationals, they discover that the MNCs' bargaining power actually increases after they enter the market. In the initial stages, the host government appears to have more power than the MNCs due to the would-be investors' demands for concessions, but, with time, the power shifts in favour of the multinationals. Moreover, technology transfer can also be an important element in preventing a decline in the erosion of MNCs' bargaining power, as long as the host economies remain dependent on these technologies.



Kobrin (1987) measures the bargaining power of MNCs and host countries using data from 49 countries and 563 subsidiaries. He indicates that the occurrence of 'obsolescing' depends on the characteristics of the technology possessed by foreign manufacturing companies. If the foreign companies' technology is mature or widely available, a power shift takes place but if the company has advanced technology and upgrades it continuously, the company can avoid obsolescing and maintain or even strengthen its bargaining power. Kobrin concludes that, generally speaking, the obsolescing bargaining model is valid as long as it considers the relative demand for resources and the constraints on the power of the parties involved, but notes that obsolescence does not always occur in every industry (Kobrin 1987: 635-636).

In contrast with Bennett and Sharp (1979) and Kobrin (1987), both Grieco (1982) and Vachani (1995) conclude that the obsolescing of bargaining does occur in the manufacturing sector. Grieco (1982) examines the experience of India's computer industry in order to assess the power of governments relative to MNCs. Evidence of India's success in bargaining with MNCs in possession of advanced technology would give strong support to the bargaining school argument, whereas a lack of evidence would give validity to the dependency theory. From his analysis, Grieco finds that, over time, the Indian government significantly increased its power to manage relations with MNCs in the computer industry and he concludes that the Indian case supports the bargaining school hypothesis. Vachani (1995) analyses changes in patterns of ownership of MNCs in India between 1973 and 1987, following the end of fifteen years of restrictive FDI legislation in 1973. He observes the changes of foreign ownership levels during the period and discovers that the average share of foreign ownership tends to decline and confirms that the obsolescing bargaining hypothesis is valid.

As these studies show, there is no general agreement on the obsolescing hypothesis as it relates to the manufacturing sector. However, it is generally accepted that the obsolescing bargaining argument is more likely to have validity in extractive industries due to the characteristics of high sunk costs and levels of risk than in the manufacturing industry, where MNCs can avoid the obsolescing of their power because of their technology and the nature of their integration into the local economy. However, in her study of Canada's National Energy Program, Jenkins (1986) demonstrates that obsolescence may not occur even in extractive industries. She concludes that the obsolescing argument lacks validity in this case; MNCs can manage to maintain their positions through alliances with domestic companies and reliance on their home country's power, which means that the bargaining power does not shift to the host government. Jenkins argues that the theory of the obsolescing bargain is an oversimplification and, as such, can not explain the complicated relationship between the host government and MNCs. The host government does not have sufficient power to dictate to MNCs and, for their part, MNCs are not so weak that they have to submit to pressure from the host government as the theory suggests. In her view, the theory overestimates the power of the state and underestimates the capacity of MNCs; in an increasingly interdependent global economy, host governments find it difficult to persist with policies that are hostile to MNCs.

### Refining the Bargaining Model

As we have seen above, many empirical studies have demonstrated that the obsolescing bargaining model, which claims that the bargaining power of host governments can be

expected to increase over time, has all but lost its validity. Stopford and Strange (1991: 215) also conclude that governments' bargaining power *vis-à-vis* MNCs has gradually declined as competition among nations to induce FDI has intensified. Many international business scholars argue that the obsolescing bargain model is no longer valid for explaining relations between MNCs and host governments (Dunning 1993a, Stopford 1994). This sceptical view, which is derived from the empirical studies summarized above, also challenges the basic assumption of the bargaining model – that relations between MNCs and host governments are based on conflict – because of changes in the global economic situation.

Generally speaking, after the mid 1970s, the relationship between MNCs and host countries began to change from one based on confrontation to one based on cooperation. Dunning (1998a) suggests two reasons for the shift in attitudes on both sides; firstly, declining economic growth combined with technological development has forced countries to seek to attract FDI and, secondly, intense competition is driving MNCs to seek the most cost-efficient locations for production. Weigel *et al* (1997: 6) describe two different phases of FDI in developing countries: the first phase was the 1960s and 1970s, when developing countries pursued closed economic models of development out of a fear of becoming economically dependent on industrialized nations. This led to protectionism which, in turn, resulted in inefficient economies because insulation from the global economy led to a decrease in exports and massive balance of payments deficit. The second phase was during the 1980s and 1990s, when developing countries realised the cost of being isolated from global economic expansion and adopted more open, market-friendly FDI policies, which led to a significant increases in inward investment. According to a report by UNCTAD (1998: 57), between

1991 and 1997, 94 percent of national FDI policies were revised in favour of foreign investors, with only six percent remaining unfavourable to inward FDI. Host governments of developing countries became increasingly MNC-friendly and even began to compete with each other to attract FDI into their territories; the obsolescing bargaining model, which basically assumes conflictual relationships between MNCs and host governments, appeared to have faded away.

However, some scholars continue to advocate the value of the obsolescing bargaining model; Eden *et al* (2005) and Ramamurti (2001) argue that, with slight modifications, the model is still a powerful tool for analyzing MNC-host government relations. Eden *et al* (2005) assert that, as long as the core insight of the model – that bargaining outcomes are dependent on the resources of both parties – has validity, the life of the model should be extended. This can be achieved by removing ‘obsolescing’ from the model. As we have seen, the obsolescing bargaining model argues that the bargaining power of MNCs gradually decreases after entry, and that the bargaining power of MNCs can be measured by the initial ownership level. However as many empirical studies demonstrate, obsolescence does not occur in many cases. Moreover, few countries now place restrictions on inward FDI and so there is little formal bargaining over entry conditions between MNCs and host governments. Eden *et al* (2005) suggest re-conceptualizing the obsolescing bargaining model to create a ‘political bargaining model’, in which the focus shifts from ownership level at the entry stage to an iterative bargaining process over government policy during the life of the investment.

Ramamurti (2001) also argues that it is too early to discard the obsolescing bargaining model because, even if relations have become cooperative, there still are

some restrictions on inward FDI. In his view, the inward FDI policy of developing country governments is better understood as a process of transition, in which there are various stages from restriction to liberalization, rather than as a completed process. He argues that, while the liberalization of the FDI policies of developing countries is partly spontaneous, we have to be aware that changes in policy have also been forced by international actors, institutions and agreements. He presents a two-tier model for understanding these non-voluntary changes; the 'two-tier bargaining model' retains the original bargaining model as one tier (Tier 2), where host governments negotiate with MNCs, but adds another tier (Tier 1) where host developing countries bargain bilaterally with home countries and multinational institutions such as the International Monetary Fund (IMF), the World Bank and the World Trade Organization (WTO). Whereas market forces drive the original tier (Tier 2), it is political power that drives Tier 1. Ramamurti (2001) argues that the outcomes of Tier 1, which are influenced by macroeconomic and political variables, govern the macro rules of FDI and also constrain Tier 2 negotiations between MNCs and host governments.

Loewendahl (2001) proposes a 'political economy bargaining model' which is derived from Bacharach and Lawler's (1981) dependence approach to bargaining power.<sup>11</sup> Bacharach and Lawler (1981) argue that bargaining power comes from dependence: that is, the more A depends on B, the more bargaining power B has over A. In other words, the power of one party in the bargaining process is based upon the other party's dependence, which is in turn determined by the alternatives available to both

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<sup>11</sup> Bacharach and Lawler (1981) have presented three different theories of bargaining power: (1) the attribution theory of bargaining power, (2) the control theory of bargaining power and (3) the dependence theory of bargaining power. Bargaining power in this context is not related to the bargaining model of International Political Economy (IPE) and 'dependence' is a different concept from that used by the dependency school of IPE. For a fuller discussion of this issues, see Bacharach and Lawler (1981: 52-79).

parties and their commitment to the bargaining objectives. The fewer the alternatives available to B and the stronger commitment B has, the greater the bargaining power that A can wield.

Loewendahl (2001) applies Bacharach and Lawler's 'dependence approach' to bargaining power to the relationship between MNCs and host governments and equates their alternatives and commitment to the flexibility and demands of MNCs and governments. As far as governments are concerned, their alternatives depend on the number of potential investors, and their commitment reflects not only domestic demand for the MNCs' resources but also their perception of the value of FDI in the national economy. For the MNCs, the alternatives are other locations which provide similar locational advantages and their commitment reflects their demand for the host country's resources (Loewendahl 2001: 128-129). In addition he argues that the existing bargaining model plays down the role of pressures from interest groups and the competence and willingness of bargaining institutions.

Loewendahl criticises the existing model on the grounds that it focuses only on the bilateral relationship between MNCs and governments, and neglects the other actors who influence the external and internal bargaining process. Loewendahl argues that an understanding of the policy-making process surrounding the implementation of bargaining power is crucial for interpreting specific MNC-government relations and so includes in his model the variables of external pressure from interest groups and the strength of internal bargaining institutions. The pressure from interest groups is demonstrated in the political and economic constraints imposed on governments and MNCs by interest groups, and the strength of bargaining institutions is seen in their ability to control the bargaining process. Loewendahl provides us with a crucial insight:

that one party's power is dependent on the other party's demand for its resources. However, with his model, it is difficult to identify the reasons for the weaknesses and strengths of the bargaining power of the parties involved, because bargaining resources, which are the source of power, do not appear in his model. Bargaining resources are, in fact, crucial to an explanation of the dynamics of the power relationship. In this section principal arguments on the bargaining model are reviewed. The following section will construct a Neo Bargaining Model which will form the framework for this thesis by taking into account recent developments and arguments in the debate on government-MNC relations.

### **The Neo Bargaining Model**

In this section, the Neo Bargaining Model will be constructed to provide a fresh insight into current state-MNC relations. As the basic concept and structure of the new framework is derived from the Grosse and Behrman bargaining model (1992), we first present Grosse and Behrman's model, and then, based on this, construct a new model.

#### **Grosse and Behrman's Bargaining Model**

Grosse and Behrman (1990; 1992) criticise international business theories on the grounds that they disregard the government factor. They argue that, despite the fact that government intervention is central to international business, most international business theories do not take the government factor into consideration as one of the variables but regard governments as a 'given condition' or an 'undesirable actor.' According to them,

the basic difference between domestic and international business is home and host government intervention.<sup>12</sup> Therefore, international business theory must include government interventions, and explain market distortions that arise from these interventions. In their efforts to include government elements in the international business disciplines, they present a bargaining model that they believe to be appropriate for analysing MNC-government relations. They seek to develop a formal analytical model of the bargaining relationship between MNCs and governments and call it ‘an explicit bargaining model’. In creating this model, they clarify the basic concept of the bargaining relationship (1992: 100).

The bargaining relationship will lead to outcomes based on the efforts of the two sides to achieve their own goals, constrained by their own limited resources, on their interdependence and on their relationships with other relevant groups.

Grosse and Behrman build a framework, beginning with the presentation of given conditions, objectives and constraints of both parties (see Table 1.1). Based on these preconditions, they develop a model that consists of a goal and three dimensions: relative resources, relative stakes, and similarity of interests. In the model, the government’s goal is the imposition of restrictions, while the firm’s goal is the avoidance of restrictions. Therefore, the stronger the government’s bargaining power, the more restrictive it is in its treatment of the firm. Conversely, the stronger the firm’s bargaining power, the fewer restrictions the firm faces. In terms of dimensions, the first dimension is relative resources, which refers to the resources possessed by each party.

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<sup>12</sup> It seems that Grosse and Behrman (1992) assume that there are few government interventions in the domestic market.



The resources of host governments are the market and factors of production, while the resources possessed by MNCs consist of the elements for improving the host government's internal balance (for example, income and employment), the factors for improving the host government's external balance (for example, balance of payments) and the factors for achieving non-economic goals.

Table 1.1 Grosse and Behrman Model: Given Conditions

	Party	Given conditions
Objectives	Government	economic efficiency; equity in TNCs; distribution of benefits; participation in ownership, management, technology, R&D and so forth; stability (economic, political, social); acceptable interdependence, preservation of environment, and so on
	TNC <sup>13</sup>	access to markets; access to inputs; reduction of risks; freedom of decision-making and operations
Constraints	Government	inadequacy of resources; fragmentation of power in a country; pressure to achieve economic goals more rapidly; relationship with other governments; lack of information; inexperience of negotiations, and so on
	TNC	dependence on governments to permit access; activities of competitors; limited resources; lack of information, and so forth

(Grosse and Behrman 1992: 99-100)

The second dimension consists of the relative stakes that a government and a firm have in a given bargaining situation. The relative stakes indicate possible losses that each side could suffer if successful bargaining were not attained. Stakes for governments would include the possible loss of access to resources that firms offer,

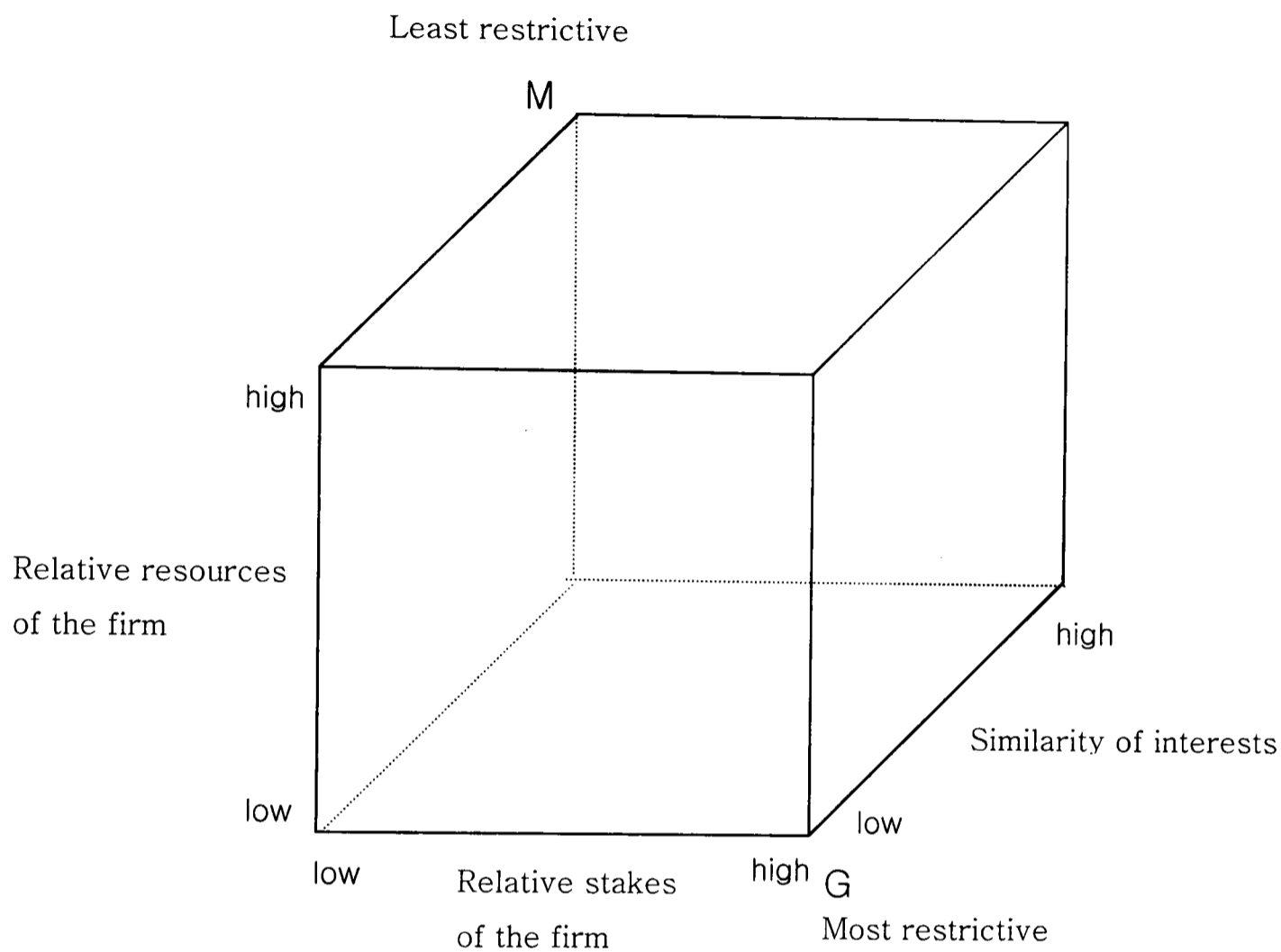
<sup>13</sup> Grosse and Behrman use TNCs (transnational corporations) referring to MNCs.

whereas stakes for a company would mean the inability to gain from the government's resources.

The third dimension is the similarity of interest between the two parties. The more comparable the goals of a government and a firm, the less likely it is that a government would impose regulations or place undue pressure on an MNC. Conversely, when the goals of each side differ greatly from one another, the bargaining process is likely to be more difficult and there will be more of a tendency for the government to impose restraints on an MNC's activity. Grosse and Behrman argue that a firm with high relative resources, low relative stakes and a high similarity of interest is likely to face low levels of government restriction. Conversely, if the firm has low relative resources, high relative stakes and a low similarity of interest, it will encounter highly restrictive policies.

This model, which was the first formal analytical framework for the bargaining relationship, enables more analytical observations of the relationships between MNCs and host governments than theories that do not take government interventions into consideration (Lowendahl 2001: 127). The advantages of this model are as follows; firstly, it explicitly incorporates a government dimension and so offers an insight into the perspectives of both bargaining parties: the host government and the MNC. Whereas theories of international business or neo-classical economics assume the standpoint of the MNCs, this model includes both perspectives. Secondly, the model enables the bargaining parties to diagnose the weaknesses or strengths of their bargaining power and develop strategies to compensate for their weaknesses. If a party wants to increase its bargaining power, it has to examine its bargaining dimension and identify its vulnerable points.

Figure 1.1 Grosse and Behrman Model: Conceptual Schemes



However, Grosse and Behrman's bargaining model has several weaknesses; firstly, the basic assumptions and perceptions of host-MNC relationships contained in the explicit bargaining model are somewhat out of date. The model was developed in the early 1990s but now the situation is very different, not only in terms of the realities of international business but also in terms of theoretical interpretations of host-MNC relationships. In the 1990s, countries started to realise the need to cooperate with MNCs due to the increasing pressures of global integration, declining economic growth and intensified competition to attract foreign investment. The general relationships between

host governments and MNCs have shifted from adversarial and confrontational to non-adversarial and cooperative (Dunning 1998a: 281-282). However, in the model, the bargaining goal is restriction (for government) or the avoidance of restriction (for firms), in which the underlying assumption is one of conflicting relationships between hosts and MNCs. As Luo (2004) argues, today's host-MNC relationships contain not only competitive aspects such as control and conflict, but also cooperative features including mutual accommodation and collaboration; these relationships are more complicated than those in the 1990s. Therefore, the model must now be updated by incorporating current circumstances and recent discussions.

Secondly, the constraints factor should be included as an explicit variable in the model. Although the Grosse and Behrman model regards constraints as given conditions, constraints are not always fixed and may be manageable by governments or MNCs; thus, they are variables rather than conditions. Furthermore, the influence of constraints is increasingly critical in the process of the bargaining as the global economy becomes more closely integrated. It is evident that the factors of constraints such as agreements with international institutions can directly affect the bargaining power of both parties. Yet, in Grosse and Behrman's model, there is no channel in which constraints affect bargaining power because they are not included as one of the variables. Therefore, the constraints factor should be included as an explicit variable in the model to reflect the relevance of current circumstances.

Thirdly, the dimension of similarity of interest is flawed and should be eliminated. This dimension seems to relate more to whether the negotiations will be successful or not, rather than to bargaining power. A high degree of congruence between both parties' interests can increase the possibility of agreement but is not capable of

showing the changes of bargaining power. For example, if a government that possesses the perfect environment for high-tech business and that is looking a high-tech firm, negotiates with a company that has advanced technology and is seeking the kind of location offered by the host country, then both sides have a high level of common interest, which is highly likely to result in successful negotiation. However, in this case, it is not clear whether the close similarity of interest strengthens the bargaining power of the host government (or the firm). Therefore, if each dimension of the model represents the factors affecting the extent of the bargaining power of parties, the dimension of the similarity of interest should be removed or replaced with another relevant factor. The last point presents the inappropriateness for this study rather than the weakness of the model. The standpoint of the model is from a firm's perspective rather than that of a government because the model was developed within business economics disciplines. The model, of course, includes a governmental perspective but its focus is on firms rather than governments. However, the perspective of this thesis is that of the government, and thus the focus of the model should be changed from firm to government. In the following section, Grosse and Behrman's bargaining model will be reshaped to overcome these weaknesses and to increase its relevance by incorporating recent discussions about government-MNC relations.

### The Neo Bargaining Model (NBM)

The Neo Bargaining Model has been developed to overcome the shortcomings of Grosse and Behrman's model (1992) and to explain the government-MNC relationship more pertinently. While retaining the fundamental structure of the Grosse and Behrman

model, the system of elements has been replaced with more appropriate and updated ideas. The key elements of their model are a goal and three dimensions, which are resources, stakes and congruence of interests. These elements have been revised by incorporating other vital insights discussed in international business, such as the ‘coopetition’ perspective described below (Luo 2004), the dependence theory of bargaining power (Bacharach and Lawler 1981), the political economy bargaining model (Lowendahl 2001), the two-tier bargaining model (Ramamurti 2001, 2002), and the political bargaining model (Eden *et al* 2005).

### Perspectives

Although Grosse and Berhman’s bargaining model includes the government factor, its perspectives are those of firms. The model is basically a firm-centric model seeking ways to increase the firms’ bargaining power *vis-à-vis* governments and means to avoid host governments’ restrictions. However, the aim of this study is to find ways to enhance the bargaining power of states *vis-à-vis* MNCs. Therefore, a government-centric model is required to approach government-MNC relations from the perspective of the government. Accordingly, the Neo Bargaining Model shifts its viewpoint from that of firms to that of governments.

### Bargaining goals

According to Grosse and Behrman’s bargaining model, the government’s goal in bargaining is imposing restrictions on the MNC’s entries and activities, while the MNC wants to bargain for fewer restrictions. The model’s underlying assumption is that relationships between MNCs and host governments are confrontational and their goals

are likely to conflict with each other. This assumption might have been valid in the 1960s and 1970s, but has been challenged since the 1980s as relationships have become more complex as we have mentioned.

In the NBM, the goal of each bargaining party is to achieve a strong position from which it can impose its will on the other party. Of course, the respective goals government and MNC's may go beyond this to include the maximisation of their wealth or their interests. However, at least in the context of bargaining, their immediate goals are the attainment of strong positions in order to serve their ultimate goals. The strength of a party's position can be interpreted as its level of competitiveness in a competing world. Governments make many efforts to strengthen their position, including the creation of a pool of highly-educated workers, building an efficient physical infrastructure, establishing industrial harmony, and maintaining a well-organised bargaining institution system. Such efforts enhance the country's competitiveness and also strengthen its position in dealing with global firms. In this vein, a strong position serves not only as a means for regulating but also for attracting foreign investors. Governments have dual positions in that they have to make themselves attractive to global firms, but also need to regulate the firms to maximise government gain.

This dualistic attitude on the part of governments is a reflection of current state-MNC relationships. As Luo (2004) argues, relationships between MNCs and host governments in today's world contain elements of both cooperation and competition, which function simultaneously – a phenomenon that Luo terms 'coopetition'. In areas where their goals overlap the two sides may exhibit cooperative behaviour but in the remaining areas where they have conflicting goals, relations can be strained. Their relationship is not always characterized by conflict, nor is it always cooperative: the

goal of bargaining is not only to impose regulation but also to advance cooperation. Therefore the bargaining goal for each party is best defined as strengthening its position by increasing its competitiveness.

### Bargaining resources

According to Grosse and Behrman's model (1992), governments possess two resources sought by MNCs, namely a market and factors of production, while MNCs have three attributes sought by governments, which are factors for improving the host country's internal balance, enhancing its external balance, and achieving non-economic goals. Their view regarding the resources of the host country and the firms seems to be outdated, especially on the government side. In their model, the MNC's goal is limited to market-seeking or resource-seeking motivations. Given that motivations for FDI have shifted increasingly from market- or resource-seeking FDI to efficiency- or strategic asset-seeking investment, the notion of the government's resources should be expanded (UNCTAD 1998, Dunning 1998b). To incorporate recent changes, a more comprehensive view and definition is required.

Bargaining resources are defined as the resources possessed and required by each party in order to achieve their respective goals. In the NBM, each party's goal is to enhance its competitiveness; thus, bargaining resources can be described as the resources possessed by each party that can serve to enhance the other party's competitiveness. Therefore, in the NBM, host countries' bargaining resources are the factors which can satisfy not only traditional demands (such as market or factors of production), but also the growing demand for factors that promote business efficiencies



(including created assets or presence of clusters).<sup>14</sup> These can be best captured by the concept of location-specific advantages (Dunning 1993b, 1998b). On the other hand, MNCs' bargaining resources are defined as the elements that can assist in the enhancement of host countries' competitiveness. Therefore, a firm's specific advantages, which could contribute to the host country's economic strength, are the resources of MNCs. Bargaining resources are the means that enable one party to force the other party to compromise or cede ground. Therefore, a higher level of relative resources produces a greater degree of bargaining power.

### Bargaining stakes

Grosse and Behrman (1992: 103) describe relative stakes as the possible losses that each side could suffer if successful bargaining were not achieved, and enumerated a long list of factors contributing to the stake of the host government (or firms). These are as follows: the availability of other firms (or markets) to replace the one in question; the importance of the situation to the government's (or firms') interests; the importance of this negotiation in the government's (or firms') dealings with the given firm (or country); the relationship between this situation and the country's (or firms') overall interests. In total, they identify eight factors that influence the size of the stakes of host governments and MNCs. This notion of stakes, we argue, can be best conceptualised by drawing on Bacharach and Lawler's (1981) 'dependence approach of bargaining power'. Bacharach and Lawler (1981: 59-79) regard one party's dependence on the other as its

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<sup>14</sup> UNCTAD (1998: 113-114) suggests several factors that may serve to attract FDI including as non-traditional determinants such as created assets, agglomeration economies and infrastructure facilities. Created assets are assets made by human beings (as distinct from natural resources) such as technology or innovative capacity. 'Agglomeration economies' refers to the beneficial effects from spatial clusters of related activities or specialized support services within a country or a region.

main source of power when two parties negotiate. The level of dependence is in turn determined by the alternatives available to both parties, together with their commitment to the bargaining objectives. Loewendahl (2001: 128-129) applies Bacharach and Lawler's dependence approach of bargaining power to his model.

According to Bacharach and Lawler (1981: 57), the concept of dependence refers to the extent to which each party has a stake in the bargaining. Thus Bacharach and Lawler's dependence concept can be equated with the concept of stake in the NBM; A's high degree of dependence on B's resources can be seen as A's high stake in B's resources and, in the same way, A's low level of dependence on B's resources can be equated to A's low stake in B's resources. The level of dependence is determined by the alternatives available to each party and its commitment to the bargaining objectives. Therefore, A's stake is determined by A's alternatives and commitment; if A has many alternatives available and a low level of commitment to the negotiations, A's stake will decrease and its bargaining power will increase. Applying this concept to the government-MNC relationship, it can be seen that if a host government has a considerable number of potential investors and regards FDI as an unimportant factor in its economy, the government will have a low stake in the bargaining, which translates into strong bargaining power.

In short, the level of stakes is determined by the alternatives available to, and the commitment from, each party and this can influence the level of bargaining power of each party. The more alternatives there are and the lower the level of commitment to the negotiations that a party exhibits, the lower the stake level. This lower stake level creates a higher level of bargaining power.

### Bargaining constraints

Grosse and Behrman (1992: 100) regard constraints as a given condition to bargaining between hosts and MNCs and provide a long list of such constraints (see Table 1.1). As argued above, the concept of constraints in Grosse and Behrman's model has several shortcomings. Firstly, although they acknowledge that constraints can influence the bargaining relationship and include them in the given conditions for the bargaining relationship, they do not apply these factors as variables that can have an effect on bargaining outcomes. As Figure 1.1 shows, their model consists of three dimensions: relative resources, relative stakes and similarity of interests. According to this model, bargaining outcomes are determined by these three variables, and constraints cannot influence these outcomes. Secondly, many of the constraints in their model overlap with other variables. For example, the inadequacy of resources (a government constraint) or limited resources (a MNC constraint) are redundant with regard to the relative resources variables because those factors are basically problems of resources. They present an ambiguous concept of constraints. Thirdly, most of the constraints in their model are endogenous (for example, inadequacy of resources and lack of information). Since the 1990s, exogenous constraints, such as pressure from non-government organizations (NGOs) and agreements between home countries and multilateral institutions, have become increasingly important and can influence the formulation of government policies (Ramamurti 2002, Levy and Prakash 2003). However, Grosse and Behrman focus on endogenous factors only and fail to consider exogenous restrictions, even though the latter have come to have a more crucial impact on bargaining outcomes.

In the NBM, constraint factors are regarded as crucial elements of bargaining outcomes, and so are incorporated explicitly into the model as one of the sets of

variables. In addition, a more relevant concept of constraints is developed, using Loewendahl's (2001) 'political economy bargaining model' and Ramamurti's (2002) 'two-tier bargaining model'. In the NBM, constraints are categorized as internal and external factors; internal constraints are derived from Loewendahl's model, and external constraints from Ramamurti's model. Loewendahl (2001: 114) argues that although an understanding of the policy-making process surrounding the implementation of bargaining power is crucial for interpreting specific MNC-government relations, the existing bargaining model treats MNCs and governments as 'black boxes' that produce outcomes mechanically. Therefore, he includes in his model the variables of pressure from interest groups and the strength of bargaining institutions. He succeeds in highlighting the importance of interest groups and bargaining institutions in the bargaining process, but fails to consider the influence of external factors, such as the actions of home countries and multilateral institutions.

Ramamurti (2001, 2002) stresses the role of external factors in the formulation of governments' policies. He argues that the FDI policies of developing countries are influenced by international actors, such as the International Monetary Fund or the World Bank. Furthermore, in many cases, developing countries are forced to change their FDI policy by the home countries of MNCs or by international institutions. Ramamurti (2001) argues that the macro rules of FDI are determined in negotiations between host governments and home governments, or between host governments and supranational institutions (Tier 1 bargaining), and the outcomes of these negotiations can act as a constraint on bargaining between host governments and MNCs (Tier 2 bargaining). We have adopted this idea as one of the external constraints in our model and suggest that pressure from interest groups and the strength of bargaining institutions can serve as an

internal constraint, while pressure from home governments and supranational institutions serves as an external constraint.

To summarize, bargaining constraints are negative factors that restrict the exercise of potential bargaining power. Bargaining constraints have two facets: internal and external. Internal constraints refer to pressures from interest groups and the strength of bargaining institutions, whereas external constraints refer to pressures from home governments and supranational institutions. The lower the level of constraints the bargaining party faces, the greater the bargaining power the party possesses.

### Bargaining outcomes

In Grosse and Behrman's model, the level of a host government's intervention in the business activities of an MNC, or the avoidance of intervention, are viewed as bargaining outcomes. If an MNC has strong relative bargaining power, it may minimise restrictive interventions from the host government but if that government has strong relative bargaining power, it can impose restrictive measures on the MNC's activities. The assumption of bargaining outcomes in their model is one of the most outdated perceptions of the relationship between MNCs and host governments. Today's government-MNC relations are more complicated, thus simple assumptions can not be applied to the relationships.

Eden *et al* (2005) argue that bargaining outcomes can be defined by comparing the final outcomes with the original goals of each party. According to this argument, bargaining outcomes should be measured by the extent to which goals are achieved, rather than by the extent of government intervention. Both parties will consider the bargaining process a success if they see the outcome as beneficial for them and as

unsuccessful if they are not satisfied with the outcome. Applying this concept of bargaining outcomes to the NBM, bargaining outcomes are defined as the extent to which competitiveness is enhanced by attracting MNC investment (for host countries) or by entering a foreign market (for MNCs).

### The Advantages of the Neo Bargaining Model

In constructing the NBM, Grosse and Behrman's 'explicit bargaining model' has been revised by incorporating recent developments and new concepts of international business in order to increase the model's relevance to the current increasingly global economy. In this way, the NBM retains the advantages of Grosse and Behrman's model, in that it includes both government and MNC perspectives and enables the bargaining parties to diagnose their weaknesses and strengths. In addition, the NBM overcomes the various shortcomings of Grosse and Behrman's model; it does this firstly by including constraints as one of the variables in bargaining outcomes. As Figure 1.1 shows, Grosse and Behrman's bargaining model excludes the constraints factor, making it difficult to assess the influence of constraints on the bargaining process. In recent years, the power of interest groups in domestic economies has increased to the point where these groups have become significant actors in the bargaining process. The role of bargaining institutions, such as inward promotion agencies (IPAs), is becoming more important for promoting inward investment (Encarnation and Wells 1985a, 1985b) and international agreements between host governments and home governments, or between host governments and supranational institutions, increase every year (Salacuse 1990). In order to reflect these developments, we have incorporated constraints as a variable that

has an impact on bargaining outcomes (See Figure 1.3).

Secondly, the Neo Bargaining Model removes the inherent redundancy between the variables of Grosse and Behrman's model. Among their three variables, the concepts of relative stakes and similarity of interest overlap because similarity of interests – that is, a high level of interdependency – entails high stakes for each party. As the variable of similarity of interests can be absorbed into the variable of relative stakes, in the new bargaining model, the similarity of interests dimension is removed and replaced by the dimension of constraints.

Thirdly, the NBM renews outdated concepts in the Grosse and Behrman model. Despite its superior insight into business-government relations, it does not reflect recent changes. The NBM revises the old model and makes it more relevant in terms of today's reality. Moreover, the new model develops appropriate concepts of dimensions such as resources, states and constraints, which were not defined, and so were somewhat ambiguous in Grosse and Behrman's model. In their model, these elements are explained by a long list of examples without clear definitions. The NBM develops more relevant and comprehensive concepts, which can capture universal reality in firm-state relations, by accommodating recent debates.

As we have already mentioned, the Neo Bargaining Model can be used for analysing the weaknesses and strengths of each party's bargaining power. Figure 1.2, which is constructed from the perspective of host countries, shows that their bargaining power is dependent on resources, stakes and constraints. According to the NBM, in order to increase its bargaining power, a host government should increase its bargaining resources, decrease its stakes and remove or minimize constraints. The point S indicates the point at which the government maximizes its bargaining power and achieves its goal.

This model enables host governments to identify the sources of its weakness in terms of bargaining power, and offers an appropriate prescription by providing a general framework for interpreting the relationship between MNCs and host governments. Figure 1.3 shows how bargaining outcomes arise from interaction between MNCs and host governments, encompassing bargaining goals, resources, stakes and constraints.



Figure 1.2. Neo Bargaining Model: Conceptual Scheme (1)

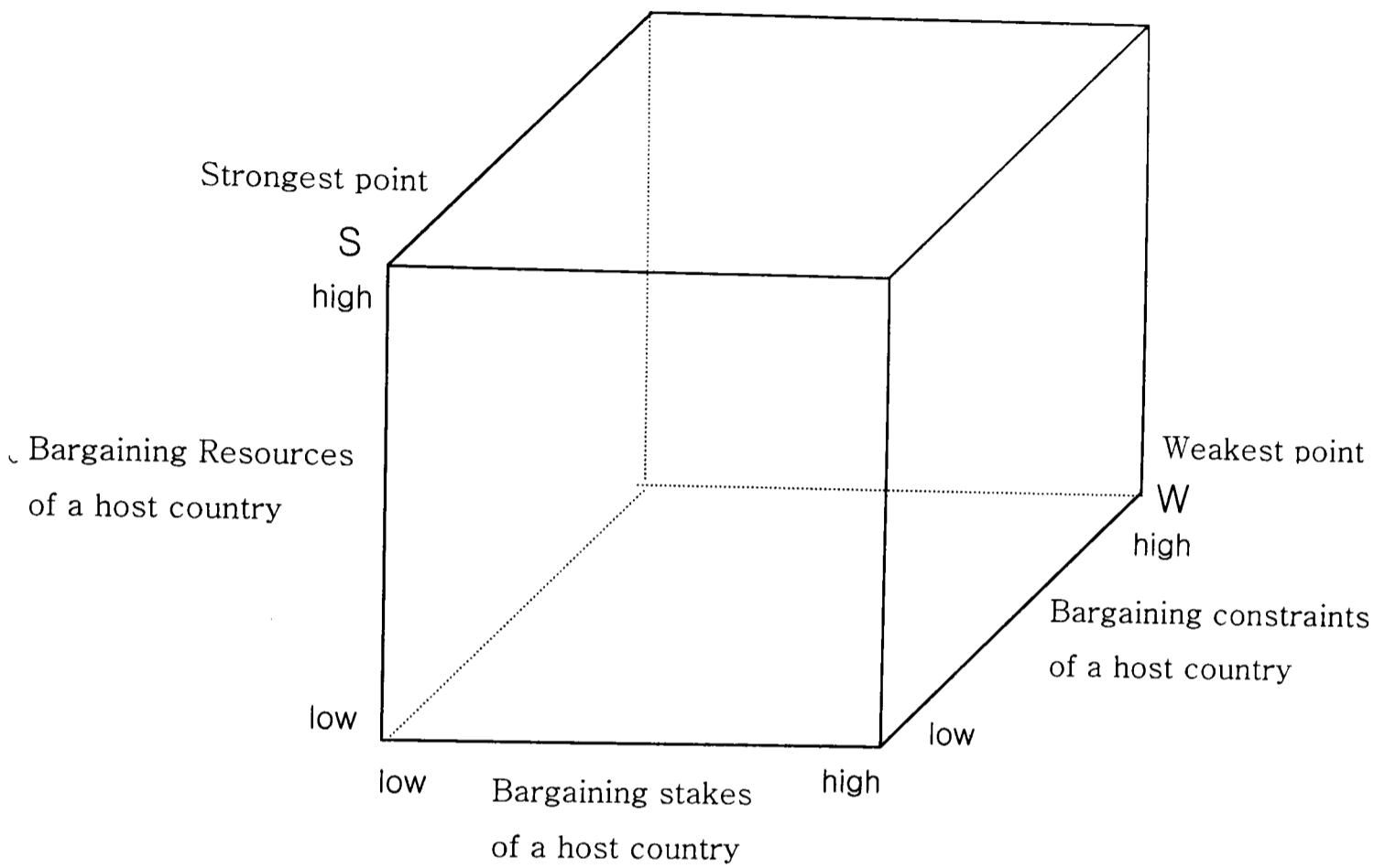


Figure 1.3 Neo Bargaining Model: Conceptual Scheme (2)

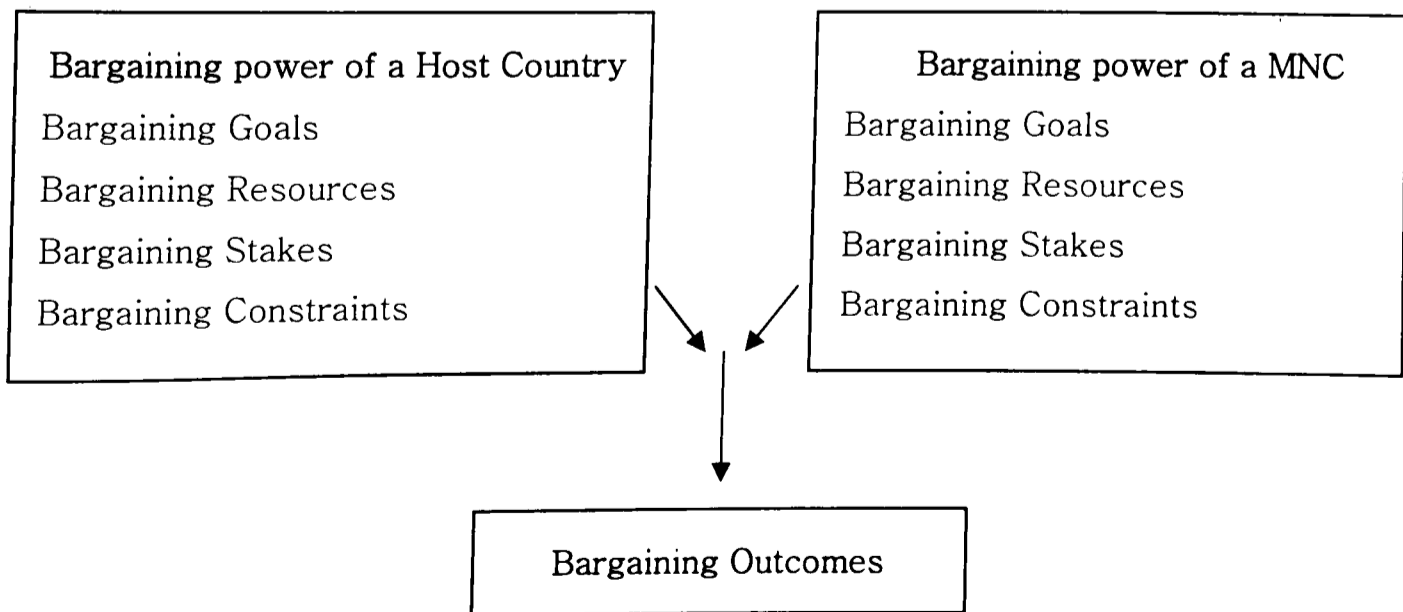


Table 1.2 Neo Bargaining Model: Concepts of Elements

Elements		Concepts
Relations		Competition and Cooperation
Goals	Host	Ultimate goal: maximisation of national wealth
	Country	Immediate goal: strengthening its position to realise its ultimate goal
	MNC	Ultimate goal: maximisation of firm's interest Immediate goal: strengthening its position to realise its ultimate goal
Resources	Host	Location specific advantages
	Country	- factors contributing realisation of a firm's ultimate goal e.g. size of market, quantity and quality of factors of production
	MNC	Firm specific advantages - factors contributing to realisation of a country's ultimate goal e.g. capital, technology, management know-how, marketing network
Stakes	Host	Alternatives
	Country	- presence of alternative economic development options Commitment - country's demand or attached importance on foreign resources
	MNC	Alternatives - presence of locations substitutable Commitment - firm's demand or attached importance on a country's resource
Constraints	Host	Internal
	Country	- pressure from interest groups, institutional strength External - home countries, multilateral institutions
	MNC	Internal - pressure from interest groups, institutional strength External - home countries, multilateral institutions
Outcomes		Extent to which goals are achieved

(Bacharach and Lawler 1981, Grosse and Behrman 1992, Dunning 1993a, 1998b, Loewendahl 2001, Ramamurti 2002, Luo 2004, Eden *et al* 2005)

In the first section, the Neo Bargaining Model was created. In the following section, we will explore the various arguments relating to development state in order to justify governments' intervention in their economies and thus strengthen our model.

## **2. The Developmental Capitalist State**

### **The Diversity of Capitalism**

Since the end of the Cold War, capitalism has been in the ascendancy and free market principles seem to be the sole basis for managing economies. However, with close observation, differences can be found among market capitalist nations in terms of the way they manage their economies. In fact, there are varieties of capitalism among market economies according to the institutional arrangements in place for managing their market systems.

Gilpin (2001) categorises national systems of political economy into three groups: American, German and Japanese. While the American, British and other Anglo-Saxon economies can be grouped into the same category of 'market-oriented capitalism', the German economy shares many features of a corporatist-type 'social market capitalism' with continental Europe, and the Japanese economy has provided the 'developmental capitalism' model for its East Asian neighbours. Hall and Soskice (2001) classify capitalist states into two groups, as either 'liberal market economies' or 'coordinated market economies'. According to them, the United States, the United Kingdom and other Anglo-Saxon countries are 'liberal market economies', while Japan, Germany and other continental European countries are grouped as 'coordinated market

economies'. Cerny (2000) places contemporary states into one of three categories: 'developmental state', 'neo-liberal state' or 'neo-corporatist state'.

This diversity of capitalism raises the question: why have the economies of capitalist countries developed in different ways? According to Gerschenkron (1962), the timing of industrialisation is a key factor determining the mechanism of capital accumulation and the overall structure of a nation's economic system. He argues that the difference in the development path followed by Britain, Germany and Russia can be attributed to the timing of their industrialisation. In contrast to Britain, which was the pioneer of industrialisation and which did not face strong international competition, Germany and Russia had to industrialise from positions of disadvantage and needed to compete with the forerunners. This late industrialisation urged them to fashion a different economic system, which relied more on banks and states.

Gerschenkron's historical insight offers an important message that there is no regularity of economic progress, as modernisation theorists argue. Circumstances differ among nations and, consequently, their methods of dealing with challenges to their economic progress cannot be identical. Efforts to adapt to challenges in different contexts have given rise to the variety of economic systems among nations. The success of Germany, Japan and Newly Industrialising Countries (NICs) in 'catching up' reveals that their institutional efforts were appropriate for a sudden great 'leap forward'. In fact, there is no orthodox system or superior system; there are only successfully adapted systems in given circumstances. A certain type of economy is not always the sole path to prosperity; in the 1970s, Germany was the miracle model but in the 1980s, attention shifted to Japan and in the 1990s the United States was the best performer. Therefore, it is hard to say that one economic system is superior to others and there are good reasons

why each successful system has developed as such (Gilpin 2001: 175-176). In the following section, a discussion of the political economic system developed by Japan and the East Asian NICs, which has been called ‘developmental state capitalism’ seeks to identify the reasons for their success.

### **The Developmental State Arguments**

From the 1980s, the economic success of East Asia – specifically Japan and the NICs – became a focus of attention for both academics and policy makers. Since the 1960s these countries have achieved impressive economic performance that was characterised by high growth rates, macroeconomic stability, thriving exports and relatively egalitarian distribution (O’Brien and Williams 2004: 263). Their success was distinctive because it was achieved a time of economic recession for the rest of world in the 1970s and 1980s. The success of these economies spurred a debate concerning the reasons for their achievements.

The debate was dominated by two competing schools, namely the neo-liberal school and the developmental state school. The neo-liberals interpret the success of the East Asian economies as deriving from market-conforming economic development strategies and adherence to market principles. In other words, the East Asian countries were economically successful because they followed neo-liberal policy prescriptions; they opened their economies, limited the state’s role to activate the market function properly and promoted export-led growth (Hughes 1989). However, this interpretation of the success was challenged by the developmental state school that emphasised the role of the state in the ‘catch-up’ process seen in East Asian countries.

The theory of the developmental state is a collection of several important ideas. The seminal works are Chalmers Johnson's *MITI and the Japanese Miracle* (1982), which introduced the concept of the developmental state to academia; Gordon White's *Developmental State in East Asia* (1988); Alice Amsden's *Asia's Next Giant* (1989), which deals with the industrialisation of Korea; Robert Wade's *Governing the Market* (1990), which explains Taiwan's economic success; Peter Evans' *Embedded Autonomy* (1995); Weiss and Hobson's *States and Economic Development* (1995) and Ha-Joon Chang's *The Political Economy of Industrial Policy* (1996). Although these works varied in terms of the focus of their interest and their interpretations of the success were different, the common theme from the analysis of each country is that the state played a great part in its economic development, which is contrary to the neo-liberal interpretation.

In his study of the Japanese government's role in Japan's economic success, Johnson (1982) conceptualises the developmental state by distinguishing the plan-rational system of the developmental state from both the plan-ideological system in the Soviet command state and the market-rational system in the regulatory state. From this classification, the core concepts of the developmental state can be extracted: firstly, it has the explicit goal of development (developmental); secondly, it relies more on the state's decisions for managing economic affairs (planned); nevertheless, thirdly, its economic decisions are rational, namely, market-conforming and thus do not contradict market principles (rationality). The plan-rational economic system of the developmental state is the combination of a planned economic system which has long-term goals and a market system that guarantees efficient resource distribution. Therefore, when the system works well, it possesses both the advantages of the effectiveness of planned

systems and the efficiency of market systems. What is the secret to making the system function well? Johnson identifies four essential features: a powerful, competent bureaucracy; a political system in which the bureaucracy is given sufficient power; a cooperative relationship between the state and business that enables the government's intervention to be market-conforming; and the presence of a pilot agency to drive the developmental agenda.

White (1984, 1988) views the ideology of developmentalism as associated with the idea of the interventionist state and categorises developmental states into three types: state capitalist; intermediate regimes; and state socialist regimes. Among these, he argues that what is really meant by the developmental state is a 'state-capitalist' developmental state where the relationship between state and private capital involves both control and collaboration and in which the state itself acts as an economic entrepreneur and exercises a wide range of direct and indirect controls over the economic actors. He argues that the strength of a developmental state is dependent on three basic factors: its social nature; the state's politico-administrative capacity; and the modes of involvement of state organisation in social and economic processes to further industrialisation. He considers the economies of Taiwan and South Korea to be 'guided market economies' where the market is guided by the concept of long-term investment as formulated by government with the ultimate goal of national development.

Amsden (1989) constructs an interpretation of Korean economic success based on several findings that run contrary to neo-liberal principles. Firstly, the Korean state was actively involved in the management of economic affairs by acting as an entrepreneur or a banker; secondly, it distorted the price structure to stimulate economic activities instead of getting the relative price 'right' as dictated by market principles;

thirdly, it disciplined business by using subsidies and other forms of support and used them to achieve the government's goal of industrialisation. Amsden's main argument, however, is that Korea's success was not based on the adoption of free market principles, as the neo-liberals insist, but on the creation of appropriate institutions for late industrialisation, as Gerschenkron's late developers did.

Wade (1990) proposes a 'governed market' theory from a study of the Taiwanese industrialisation process. The factors in the success that the theory points out are: firstly, the high level of productive investment, which produces high level growth; secondly, greater investment in certain key industries than would have occurred in the absence of government intervention; and thirdly, the exposure of industries to international competition. The first and third factors of the above explanation are no more than the usual reasons cited by neo-classical economists for the success of the East Asian economies. The crucial insight of Wade's theory is the second element which emphasises state-directed investment to achieve long-term goals. He argues that without the governments' effort to spread or to socialise the risks associated with long-term investment, large-scale investment in strategic sectors would have been unlikely to take place. Wade further argues that the creation of the governed market in East Asian countries derives from the authoritarian characteristics of their political regimes; Korea and Taiwan can be seen as 'hard authoritarian' while Japan can be called 'soft authoritarian'. In short, the theory says that the authoritarian nature of the political system confers the state with enough autonomy to allocate resources in line with long-term national interests. This raises two questions: firstly, what is the mechanism that prevents powerful bureaucrats in authoritarian regimes pursuing their own interests and encourages them to make the right decisions for an unpredictable future? Secondly, does



the end of an authoritarian regime mean the demise of the developmental state? Definitive answers to both questions cannot be provided from his argument; the answers appear in the works of Evans (1995) and Weiss and Hobson (1995).

Evans (1995) introduces the concept of 'embedded autonomy' which, he argues, must exist if the state is to be successfully involved in industrial transformation. Autonomy is an indispensable condition for achieving state goals, insulating states from particular interests. Yet, it is not sufficient in itself and must be combined with 'embeddedness', which implies a concrete set of connections that links the state and non-state actors, through which the state is able to coordinate the economy and implement developmental objectives. A state that is only autonomous would be despotic or incapable because it would lack the ability to prevent individual incumbents from pursuing their own goals or it would require source of intelligence and ability to implement its policies. This can be called 'predatory state'. Only when embeddedness and autonomy are entwined in a balanced combination, can falling to the predatory stage be avoided and developmental tasks achieved. Therefore, Evans answers the first question, regarding mechanisms to control the bureaucrats' behaviour, by saying that it is 'embedded autonomy' that can not only stop their pursuit of self interest but also provide them with sufficient information and access to channels of implementation. Regarding the second question, he might reply 'yes': that is, the end of an authoritarian regime does indeed mean the demise of the developmental state. In fact, his concept of developmental states seems to have an authoritarian tinge in which a capable state leads a relatively weak society. He argues that the process of achieving a state's developmental goals is the course that breeds its 'gravediggers' (Evans 1995: 229). In other words, as a state undergoes economic development, the social groups which were

once obedient, following the state's directions find their voices and increasingly challenge the state's authority. Following this logic, a developmental state is inherently doomed to collapse. However, he rejects the idea of dismantling a developmental state; instead, he recommends the reconstruction of the state by accepting the 'gravediggers' into the system.

Weiss and Hobson (1995) stress the 'governed interdependence' between an autonomous state and a well-organised business sector as the underlying institutional basis for effective market governance. They argue that when a state achieves governed interdependence, the state has the highest form of strength with the peak of infrastructural power, power which is enhanced by more institutionalised and cooperative relations with civil society. Governed interdependence, which has arisen from a strong society's linkage with the insulated state, could afford the coordination based on long-term calculation and the channels and intelligence that enable the successful design and implementation of transformative tasks. Therefore, for Weiss and Hobson, the answer to the first question regarding the successful mechanism of the state is the 'governed interdependence'. This is in a similar vein to Evans. However, as for the second question which concerns the future of developmental states, Weiss and Hobson hold a different view from Evans. According to them, as the private sector (the 'gravedigger' in Evans' terminology) becomes strong, the outcome is not necessarily the weakening of the state. The state is able to maintain its high capacity in terms of achieving its transformative tasks, even though society's capacity to resist is also high. In fact, for them, this is the ideal stage that every state seeks to attain, in which a strong state links with a strong society. Therefore, according to their theory, even as democratisation progresses the developmental state does not collapse. On the contrary,

it upgrades to a flexible state which is the best form of state for economic development.

Chang (1996, 1999a) provides an analytic discussion of industrial policy and an economic theory of developmental states. He argues that state can coordinate complementary investment decision to prevent coordination failures, and can intervene in industries especially at the earlier phase of the product cycle. Such coordination and intervention would serve to increase the dynamism of the capitalist economy rather than diminish it. Moreover, he proposes necessary functions that successful developmental states have demonstrated, which are: coordination of investment plans; formulation of long-term vision; participation in institution building and mediation in conflicts that arise in the development trajectory. Finally, he posits the case of Korea as good example of how active intervention by a strong developmental state can minimise static inefficiency while maximising the dynamic efficiency of the economy.

In summary, two major characteristics of developmental states can be abstracted from the debates discussed above: autonomy and capacity. Autonomy is crucial because it prevents a state from being held hostage by special interests and enables the state to pursue long-term goals. Capacity means a state's capacity to make the right decisions — practically and morally — for attaining its goals. Therefore a state's capacity is achieved when it has well-functioning institutions that design and implement policies effectively and efficiently and also when it has a mechanism that guarantees that public servants will serve public interests. The major discordances among the developmental state theorists are derived from the differences in their proposed methods of attaining this capacity. Johnson (1982), Amsden (1989) and Wade (1990) regard competent bureaucrats and powerful pilot agencies as the origins of state capacity, while Evans (1995) and Weiss and Hobson (1995) highlight the strong inter-relationship between

state and society as the main source of the capacity. However, there is a clear consensus in these works and among these scholars that autonomy and capacity are core elements of the developmental state.

### **The Interpretations of the Asian Economic Crisis**

In the above debate regarding the interpretation of East Asia's economic success, supporters of the state appeared to have triumphed over the proponents of the free market economy with the widespread and growing acknowledgement — even at the World Bank (1993, 1997), the home of the neo-liberals — of the role played by East Asian governments in the region's economic success. However, the Asian economic crisis re-opened the debate about the role of the state in the region's industrialisation. Neo-liberals argued that the main reason for the crisis was government intervention and that East Asian governments should not intervene in the economy but should rather adopt the neoclassical development model based on the free market. According to them, moral hazard and overinvestment, which were caused by the close ties between government, banks and industry, ultimately led to the crisis. Krugman (1998a) argued that 'long-standing' government protection in the market led corporations and financial intermediaries to undertake excessively risky investment and indeed, over-investment, so causing overall inefficiencies of the economy that finally caused the crisis.<sup>15</sup> Min (1999) concluded that the crisis was a direct result of financial vulnerability, which was caused by moral hazard with the absence of prudential regulation in the process of

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<sup>15</sup> Krugman (1994) even rejected the existence of an 'East Asian miracle' and argued that the developmental experience of these economies was not miraculous but was simply a neo-classical growth model of development at work in which their economic success was merely fuelled by mobilising resources rather than innovation and productivity growth.

market liberalisation. Flynn (1999) and Henke and Boxill (2000) also pointed out the limitations of, and problems inherent in the developmental state model in the wake of the crisis.<sup>16</sup>

In contrast, for proponents of the developmental state, the main reason for the crisis was not an excess of government intervention but rather a lack of government regulation. Amsden and Euh (1997) argued that the crisis was mainly caused by overly rapid liberalisation of the financial sector; and that the freeing up of the foreign exchange market had resulted in overvalued exchange rate, which eventually rendered the economy susceptible to speculative attack. Johnson (1998) was against the view that ‘crony capitalism’ was the main reason of the crisis and argued that the meltdown was caused much more by under-regulation than by corruption or any other side effects of an overly close relationship between businesses and the government. In a similar vein, Weiss (1999) and Chang (1999b) argued that the crisis was provoked by uncontrolled rapid capital inflow and outflow, which resulted from the premature liberalisation of financial markets and capital accounts without adequate monitoring and supervision. Therefore, in their view, the cause of the crisis was the demise of the developmental state rather than the developmental state itself.

These differing interpretations by both schools raise an important question about the cause of the Asian crisis: was it the outcome of the system’s inherent problems or the result of a simple malfunction? The neo-liberals take the former view and argue that the system should be abandoned. However, the developmental state theorists contend

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<sup>16</sup> Maswood (2002) criticised the developmental state argument on the grounds that it failed to define state intervention and to establish cogent theoretical justification for such intervention. He argues that there is confusion as to how to define state intervention as the main characteristics of the developmental state in terms of its type and level among developmental theorists and also the theorisation of the developmental state model, which was mainly based on the empirical example of East Asian countries, was neither sophisticated nor consistent.

that, as the crisis resulted from a malfunction of the system, the system has to be fixed if it is to function well. These interpretations are closely related to the predictions of the future of the developmental states.

### **The Future of Developmental States**

It appears from the literatures that there are three possible future incarnations for the developmental states: regulatory state, social corporatist developmental state and transformative state. The first viewpoint is based on neoclassical convergence theory: as economies grow and economic globalisation progresses, national differences will disappear and the economies will converge into Anglo-American regulatory states. In a regulatory state, a state acts as a regulator and an umpire for economic activities. The state places emphasis upon the establishment of legal institutions in order to let the market function well. The proponents of this standpoint argue that the East Asian economies, which are mutations of capitalism, have inherent drawbacks in their system. The crisis was, they argue, pre-destined because of the developmental state's flawed structure which inevitably entails moral hazard and inefficiency; moving away from the state-led development model is inescapable, and globalisation will drive them towards a neo-liberal regulatory model (Maswood 2002, Pirie 2005).

The second scenario emphasises the state's role in conflict management, considering the possibilities of a social corporatist developmental state (Evans 1995, Johnson 1994). According to Evans (1995), the developmental states created exclusive connections with businesses in order to focus on industrial transformation projects during the industrialisation process. Although embeddedness in this context involved

only states and businesses, embeddedness does not necessarily, he argues, take the form of exclusionary ties to industrialists; it could be enlarged and include labour. The basic idea of this argument is that bringing in social corporatism could make the developmental state more sustainable by correcting the innate imbalance in the developmental state. These views may be more wishful thinking than an accurate description of the current situation. However, there is a clear possibility to make the developmental state more sustainable by strengthening the relationships between government, business and labour.

The third view is the continuation of the developmental state (Weiss and Hobson 1995, Weiss 1998, Weiss 2000, Chang 1999b). In contrast with the convergence argument, they argue that national differences are likely to become more pronounced as globalisation progresses and that developmental states will continue, charged with different tasks, rather than fading away. In their view, the developmental state is not a transitional form which arose and disappeared in the process of progression to a mature form of capitalism, but rather one variety among many diverse forms of capitalism. According to Weiss and Hobson (1995), as the developmental state becomes mature, it turns into a flexible state, an upgraded version of the developmental state, which has different goals, relations and behaviour pattern but still possesses long-term vision and engages in institutionalised collaboration. This state acts as entrepreneur by providing a vision for the future of the economy and coordinating resources. The developmental state was created to enable economies to 'catch up' but catching-up does not mean the end of the developmental state. The state will have new tasks to perform such as 'keeping up' or 'staying ahead', thus Weiss (2000: 29) prefers the term 'transformative state' to 'developmental state'.

The future path of the developmental state seems to depend on the viability of the state's role in the market; when the role of the state is denied by the market, the state tends to be a regulatory state; when the role of the state is accepted in the market, the state is likely to be a corporatist or transformative state. The next section will provide the justifications for an active state role in the market by comparing the views of neo-liberals and developmental theorists.

### **Legitimizing the Active Role of States in the Market**

To predict the viability of the developmental system, the state's activity in the market, which is the essence of the developmental state model, should be justified. If a government's intervention continues to produce disastrous consequences like the 1997 Asian crisis and developing mechanisms to prevent those disasters is impossible, as neo-liberals argue, the developmental state system should be abandoned. However, if there are devices that can prevent the negative effects of government intervention, such intervention can correct the weaknesses of a neo-liberal economy.

As far as the role of the state in the market is concerned, the neo-liberal view is that the state's role should be minimised for smooth operation of market forces. To the neo-liberals, less intervention produces better economic performance. There are three major components in their view of the role of states. Firstly, the state should limit its role to that of night-watchman. Secondly, the state is seen as an agent who serves the interests of a powerful group of insiders and outsiders, thus the activities of the state can be captured by particular interests. Thirdly, there are government failures such as lack of information and the rent-seeking cost of private agents. Due to this, state intervention is



likely to produce inefficiencies in allocation and rent-seeking waste rather than correction of market failures (Chang 2003: 47-48). Simply put, according to neo-liberals, the state should not intervene in the markets because the state can be captured by special interests and government failures can occur.

However, the neo-liberal economy in which the market dominates is also argued to have many drawbacks (Chang 1999a). Firstly, neo-liberals underestimate the extent of market failures. Secondly, neo-liberal economies can lead to 'short-termism' because they are based on the belief that achieving short-term efficiency will automatically lead to the realization of long-term goals. Thirdly, the neo-liberals want to separate politics from economics, which can lead to undesirable social effects such as the concentration of wealth, because they regard politics as an irrationality that inhibits rationality in the economy. These problems can be solved by active government intervention. Governments can prevent market failures by providing public goods, curbing the non-competitive market and compensating externalities. Governments can drive forward long-term goals which sometimes demand the sacrifice of short-term efficiency and economic policies with political consideration can produce more desirable social outcomes. The problem lies with the costs and benefits of government intervention. The neo-liberals content that the costs of government intervention are greater than its benefits and that the costs cannot be reduced. However the developmental theorists maintain that the costs of government intervention can be lessened and that this can lead to a situation that the benefits outweigh the costs.

The key is how the state creates appropriate institutions to remove or reduce the possible problems arising from state intervention. According to the developmental theorists, the key is achieving 'autonomy' and 'capacity'. By attaining autonomy, the

state is able to avoid being captured by special interests and can pursue long-term development goals. Through enhancing capacity, the state can overcome the pitfalls of government failures. Developmental theorists believe that many institutional arrangements contribute to the enhancement of state capacities including powerful pilot agencies, competent bureaucrats, ‘embedded autonomy’ and ‘governed interdependence’. Such institutions reduce information costs and rent-seeking waste, and increase intelligence and implementation efficiencies. A huge amount of empirical evidence for how the state realises autonomy and capacity is shown in developmental state literature (Johnson 1982, Amsden 1989, Wade 1990, Evan 1995, Weiss and Hobson 1995). This state intervention, from which the potential negative effects are removed (or reduced), succeeded in solving the shortcomings of the neo-liberal economy and resulted in the region’s achievements in terms of ‘catching-up’. However, the developmental states do not need to stop their developmental tasks; they still need to keep up or stay ahead (Weiss 2000). Insofar as the negative effects of state intervention can be minimised by various creative institutions, the role of the state as an entrepreneur and a coordinator of the market can be continued.

### **3. Combination of the Neo Bargaining Model and Developmental State Theories**

In this chapter, the first section constructed the Neo Bargaining Model and the second section legitimated the active role of the state in the market. Although these two views are ostensibly isolated from each other, in this study, the two different developments

complement each other. First, the NBM was strengthened by developmental state theories. This novel model was developed to provide an analytical framework for business-government relations, based on the assumption that FDI does not have universal effects and that those effects are dependent on the host countries' bargaining power. The advantage of the NBM is that it enables a government to diagnose its strengths and weaknesses, and to find ways to increase its bargaining power. Therefore, the NBM presupposes that the government can intervene in the market to increase state bargaining power. However, there are some misgivings about state intervention in economic activities; these argue that the state's intervention is futile or harmful. If the state's efforts are in vain, the bargaining model is useless. Therefore, theories of the validity of state intervention are needed, namely developmental state theories whose arguments justify government interventions. This rationalisation of government intervention confers viability on the bargaining model.

Secondly and conversely, the developmental state theories could be enhanced by incorporating the NBM. As has been pointed out above, most developmental theories have largely focussed on state-domestic capital relations rather than state-MNC relations. The arguments of the 'disciplined market' (Amsden 1989) and 'governed market' (Wade 1990) emphasise state domination over domestic capital and the theories of 'embedded autonomy' (Evans 1995) and 'governed interdependence' (Weiss and Hobson 1995) stress the cooperative aspects of government-business relations. Their concerns principally concentrated on relationships between governments and domestic capital. However, currently, the influence of MNCs in the domestic economy is becoming stronger, and also, domestic companies are themselves becoming multinationals by locating their subsidiaries in various countries. State-MNC relations

are increasingly important and draw greater attention from academics and policy makers. Thus, how the state deals with global capital is becoming a more important subject in developmental state theories.

In this context, some developmental theorists (Chang 2003, Weiss 1998, 2003a) are concerned with the state's role in the globalising era and conclude that the state will have a more important role in the market as the globalisation process intensifies, opposing the orthodox view of the demise of state power. The NBM is in line with their views and complements their thesis by providing an analytic tool for investigating state-MNC relations. Using the NBM, how the developmental state has strengthened or weakened its power *vis-à-vis* MNCs or what factors have affected power shifts can be identified. Moreover, the NBM offers prescriptions to states for how they can strengthen (or avoid any weakening of) their bargaining power *vis-à-vis* MNCs. These could help states to restore (or sustain) their developmentalism in a globalising world where MNCs are playing a larger role in many economies. In summary, this chapter contributes to both theories of the bargaining model and the developmental state by providing insights that complement each other. Next, the Neo Bargaining Model developed in this chapter will be applied to the rise and decline of the Korean developmental state.

## **Chapter Two: Economic Context**

In this chapter, we briefly review Korea's modern political economy from a historical perspective to provide the context for the discussion of inward foreign direct investment (IFDI) in Korea in the following chapter. We begin by constructing a periodisation of the time span covered by this study and then, using this as a foundation, we briefly analyse Korea's economy in each of the three periods.

### **1. Periodisation**

'The miracle on the Han River' refers to Korea's rapid economic growth over the past 50 years. In the first half of the 20th century, Korea suffered from a succession of tragedies: occupation by the Japanese (1910-1945) as a result of imperial competition in the 19th century, the division of the Korean peninsula into South and North (1945) in the aftermath of the Second World War, and the Korean War (1950-1953), the first 'hot' conflict of the Cold War. During the Japanese colonial occupation, as the Korean economy took on the characteristics of an implanted colonial capitalism, Korea turned into a supplier of raw materials as well as a market for manufactured Japanese goods. With all economic policies implemented for the benefit of Japan rather than Korea, the industrial growth achieved during Japanese colonial rule was almost negligible as well as meaningless for the majority Koreans (Lee 2004: 48-52).<sup>17</sup> Furthermore, the war

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<sup>17</sup> Suh (1978) calculated economic growth on the Korean Peninsula during the Japanese colonial period at approximately 3 percent with little fluctuation. Although he acknowledged there were significant contributions by Japanese colonial rule to the economic growth of Korea, he argued that the majority of inhabitants in Korea were largely deprived of any benefits resulting from the overall growth of the economy as a whole. This, he reasoned, was because growth without accompanying modernisation of the social structure and organisational framework was bound to create total exhaustion of resources. He

destroyed nearly two thirds of the Korea's production capacity and killed almost one million civilians, or five percent of the total population. After the war, Korea relied heavily on foreign aid to support its impoverished economy; between 1953 and 1961, foreign aid amounted to USD 2 billion, equivalent to 16 percent of Korea's gross domestic product (GDP) of USD 13 billion during the period (Sakong 1993: 96-102). However, Korea, which was one of the poorest countries in the world in the 1950s, grew to be the world's 12th largest economy in 2005 (NSO 2006). In 1953, when the Korean War ended, Korea's gross domestic product (GDP) was a mere USD 1.3 million and *per capita* income stood at just USD 67; by 2005, GDP had soared to USD 787.5 billion while *per capita* income had increased to USD 16,291 (see Table A).<sup>18</sup> In the latter part of the 20th century Korea's economic performance was truly remarkable.

The takeoff of the Korean economy started in 1962, a year that is significant for several reasons. Firstly, 1962 was the first year in which the first Five-year Economic Development Plan was implemented.<sup>19</sup> The Korean government was determined to develop its economy using a set of goals and detailed action plans. The series of five-year development plans implemented between 1962 and 1996 provided a road map for Korea's economic development. Secondly, in 1962 the government started an export-oriented development strategy under the banner of 'nation building through exports' (*suchool ipkuk*). Thirdly, the first case of inward foreign direct investment (IFDI) was registered in Korea in 1962. As foreign aid from the United States (US), which had been

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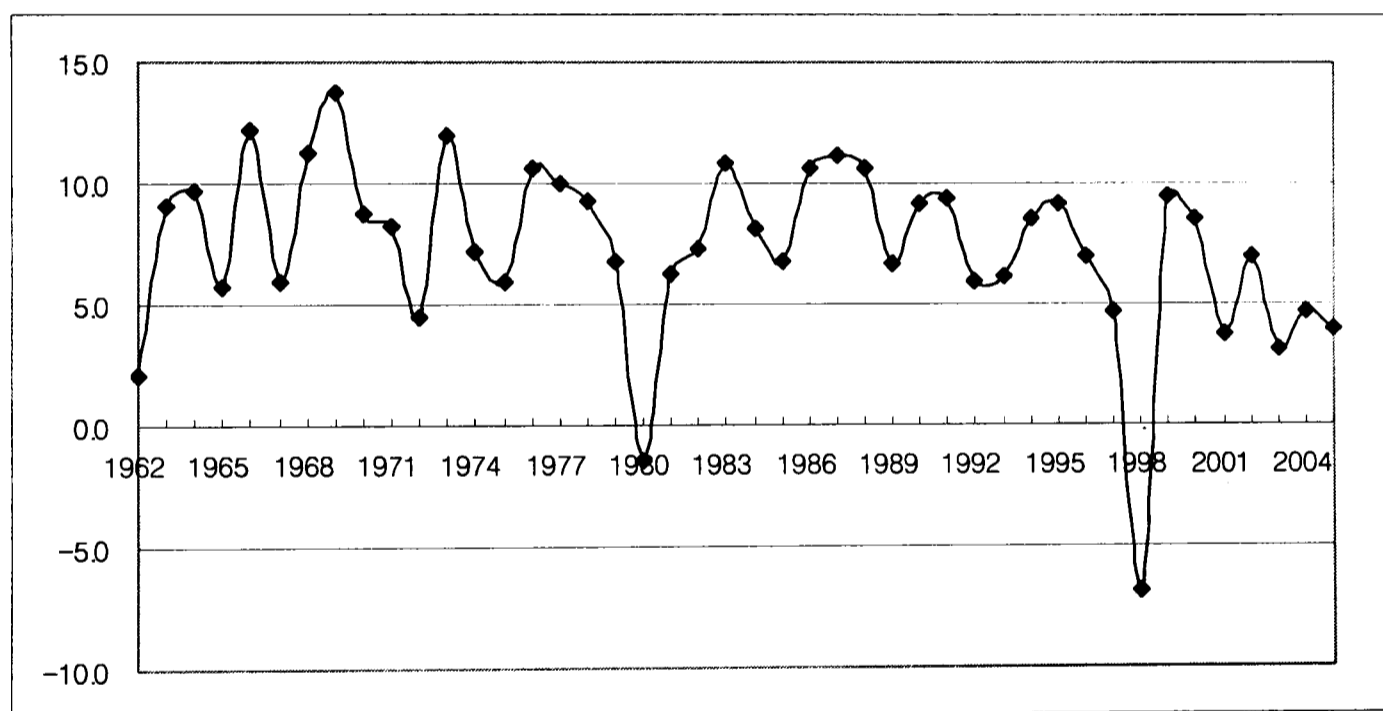
concluded that the colonial development produced both contributions and impediments to the Korean economy that became apparent after national liberation in 1945.

<sup>18</sup> Table A, B, C, D and E are available in Appendices.

<sup>19</sup> The Korean government established five-year development plans from 1962 to 1996. In all, there were seven five-year development plans between 1962 and 1996: the first (1962-1966), the second (1967-1971), the third (1972-1976), the fourth (1977-1981), the fifth (1982-1986), the sixth (1987-1991), and the seventh (1992-1996). From 1982, the official name of the plans was changed from 'Five-year Economic Development Plan' to 'Five-year Socio-economic Development Plan.' For more details on the five-year development plans, see Gang Gwang-Ha (2000).

a major source of support for the Korean economy after the Korean War, decreased following a shift in US aid policy after 1960, the Korean government needed foreign capital in a form other than aid to sustain the economy and promote economic development. The government enacted the Foreign Capital Inducement Promotion Act in 1960 and took measures to promote IFDI and induce foreign loans. In view of these developments, we use 1962 as the starting point for our examination of the relationship between the state and the market and between the state and MNCs.

Figure 2.1 Korean Economy: Annual Growth Rates 1962-2005 (Unit: %)



Source: BOK 2006

Since 1962, the Korean economy has grown rapidly; between 1962 and 2005, the average GDP growth rate was 7.5 percent, the average *per capita* income growth rate was 11.0 percent, and the average export growth rate was 24.3 percent (BOK 2005). As can be seen in Figure 2.1, the Korean economy grew at a rate of more than 5 percent *per annum* during most of the period, although it underwent ten periods of economic

fluctuation and, in 1980 and 1998, Korea recorded negative rates of economic growth of minus 1.5 percent and minus 6.9 percent, respectively. These were not just cyclical economic downturns but were actual economic crises that were triggered by a combination of internal structural problems and external shocks. The crisis in 1980 occurred when the innate problems of a state-led economy in the 1960s and 1970s were compounded by the second oil shock. The economic crisis in 1998 was triggered by the Asian financial crisis in 1997, coupled with the gradual loss of latecomer advantages from the beginning of the 1990s.<sup>20</sup>

These two crises led the Korean government to make fundamental changes in economic policy, creating the momentum for changes in the relationship between the state and the market. During the process of recovery from the crises, the nature of the Korean economy changed fundamentally; before 1980 (during the presidency of Park Chung-Hee between 1962 and 1979) the state dominated the market and virtually controlled the economy (Amsden 1989). The years from 1980 to 1997 were a transitional period that saw the beginnings of a shift away from a state-led economy towards a market-oriented economy, with both models competing with each other for dominance (Park 2005). Since 1998, the government's role in the economy has diminished while market principles have been reinforced by the reform and restructuring programmes implemented after the 1997-8 crisis (Pirie 2005). In this most recent era, the market has dominated the state. It can be argued that the crises of 1980 and 1998 were turning points that mark critical changes in the characteristics of the economy. Thus, this thesis divides the 43 years between 1962 and 2005 into three

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<sup>20</sup> The Asian economic crisis that began in Thailand and spread to Korea in late 1997, triggering the Korean financial crisis that year and resulting in numerous bankruptcies, soaring unemployment, and negative growth in 1998 (Go 2005: 177). As the financial crisis in 1997 turned into an economic crisis in 1998, in this thesis we include both 1997 and 1998 in the crisis period.



phases, using the crisis years of 1980 and 1998 as milestones:

- (1) State over market (SOM) phase (1962-1979)
- (2) Transitional phase (1980-1997)
- (3) Market over state (MOS) phase (1998-2005)

## **2. Economic Context**

### **State over Market Phase (1962-1979)**

During the 1960s and 1970s, Korea's economic performance was outstanding: the average annual growth rate between 1962 and 1979 was 9.8 percent and *per capita* gross national income (GNI) soared from USD 87 in 1962 to USD 1,676 in 1979. As the industrial structure changed dramatically, the proportion of the economy accounted for by primary industries diminished from 37.0 percent in 1962 to 20.9 percent in 1979, while the manufacturing sector's share expanded from 16.4 percent to 25.9 percent in the same period. Exports grew at an average annual rate of 40 percent, rising from USD 55 million in 1962 to USD 15.1 billion in 1979 (BOK 2005, BOK 2006).

If developmental states are defined as states that pursue their developmental goals with appropriate capabilities (Leftwich 1995: 401),<sup>21</sup> then Korea during President Park Chung-Hee's term of office (1962-1979) was a typical model of a developmental

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<sup>21</sup> Leftwich (1995: 401) defines developmental states as such: 'states whose politics have concentrated sufficient power, autonomy and capacity at the centre to shape, pursue and encourage the achievement of explicit developmental objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organising it directly, or a varying combination of both'.

state. The government set clear goals for development, planned the provision and distribution of resources through the competent pilot agency, and used a variety of intervention measures to drive companies in the desired direction. The government often set various prices including exchange rates, interest rates, and prices for consumer and agricultural products, and used a system of rewards and punishment to discipline business and entrepreneurs. Thus, the market was manipulated and distorted in accordance with the state's goals (Amsden 1989).

This phase can be divided into two distinct periods: the first from 1962 to 1971 and the second from 1972 to 1979 (Woo 1991). In the first period, the Korean government pursued export-oriented industrialisation focusing on labour-intensive light industry; in contrast, the second period is characterised by a shift in policy emphasis from labour-intensive to capital-intensive industries. From 1962 the Korean government started an 'export-oriented development strategy', which was influenced by the nation's factor endowments in this early stage of Korean industrialisation. In this period, the only resource the country possessed was abundant and low-cost labour; accumulation of domestic capital had not yet taken place and technology remained undeveloped. In this situation, the government's strategic exploitation of the country's comparative advantage of cheap labour was a natural and rational approach to its goal of industrialisation. The state encouraged firms to produce labour-intensive light industrial products such as textiles and shoes and export them to the world market. This was an effective strategy at the time, but simply exploiting the comparative advantage of cheap labour was not enough. The government created additional comparative advantages in order to make Korean exporters more competitive. Throughout this period, the government put all its efforts into boosting exports, to the extent that one consider its

economic policy to have been more of an export policy. The state restricted imports while manipulating exchange and interest rates to provide incentives to exporters; commercial banks that had been nationalised offered favourable loans to exporters and many special-purpose banks were established to support export industries.<sup>22</sup> As a result of these concerted efforts, the government achieved an average annual growth rate of 39 percent for exports between 1962 and 1971 (BOK 2006).

However, despite the rapid expansion of exports, the country's current account showed a deficit throughout the 1960s, primarily because of the rapid growth of imports. This was a reflection of Korea's industrial structure at that time, as higher levels of production of finished goods entailed greater imports of capital and intermediate goods. The government realised that, without investment in capital-intensive industries, and specifically in heavy and chemical industries, imports of capital and intermediate goods would remain at high levels and the balance of payments situation would not improve (Kim and Kim 1997: 22). In addition, changes in international relations in East Asia in the early 1970s, including the adoption of the Nixon Doctrine in 1969 and the subsequent rapprochement between the United States and China in 1972, prompted the Korean government to realise the necessity of building a domestic defence industry for its own survival.<sup>23</sup> The development of a national defence industry required, in turn, investment in heavy and chemical industries (Oh 2006: 221).

Thus, from the early 1970s onwards, the government actively promoted the development of heavy and chemical industries and for this reason, government

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<sup>22</sup> President Park nationalised all commercial banks when he took office in 1961 and established state banks including the Korea Development Bank (KDB), the Korea Export-Import Bank (KEIB), and the Foreign Exchange Bank to serve specific government goals. The privatisation of these banks began in the 1980s during the presidency of Chun Doo-Hwan. For more detailed discussion, see Chapter Three

<sup>23</sup> President Nixon declared in a press conference in Guam on July 25, 1969 that the United States henceforth expected its allies to take care of their own military defence (Cha 2004: 143).

economic policy in the 1970s is characterised as a ‘Heavy and Chemical Industry Policy’ (HCIP). The strength of the policy lay in selection and concentration: that is, the careful choice of industries and the concentration of investment in them. The Park government selected and invested heavily in six key industries: steel, nonferrous metals, machinery (including automobiles), shipbuilding, petrochemicals, and electronics (Lee 2005: 439). Investment in these industries accounted for 57 percent of total manufacturing investment in the first half of the 1970s and 64 percent in the latter half of the decade (Kim and Kim 1997: 22). In order to implement the HCIP, the government mobilised the necessary resources including capital, technology, technical manpower, and industrial sites and channelled these resources to selected firms. The government offered preferential long-term financing and generous tax incentives to the companies concerned; it was through this process that selected companies grew into conglomerates or *chaebol*. The *Chaebol* acted as agencies for realising government goals in the SOM period. The state designated strategic industries and selected companies to carry out the task of industrialisation while providing them with subsidies and protection. The government also nurtured domestic capital by restricting foreign companies’ access to the local market and regulating market entry (Shin and Chang 2003: 13).

Thanks to the massive investment in the heavy and chemical industries in the 1970s, Korea was able to achieve high growth and capital accumulation throughout the decade. However, the government’s HCI policy also resulted in high inflation and substantial foreign debts. Throughout the 1970s, due to a long period of excessive demand, the annual average increase rate for the GDP deflator was 20.6 percent (see Table A). Substantial investments in the heavy and chemical industries, combined with the Middle East construction boom for Korean firms after the first oil shock, led to

increasing excess demand pressure (Sakong 1993: 4). In addition, the government's dependence on foreign loans as a source of capital for funding the HCIP led to a rapid increase in levels of foreign debt as companies continued to invest in the heavy and chemical industries. Korea's foreign debt increased almost six-fold from USD 3.5 billion in 1972 to USD 20 billion in 1979. Meanwhile, the second oil shock hit the global economy in 1979, and Korea encountered an economic crisis in 1980, resulting in negative growth for the first time since 1960. Many companies that had invested heavily in the heavy and chemical sectors became insolvent as operating rates fell, provoking criticisms that the HCIP had led to a waste of resources and that the government's HCIP had failed (Lee 2005: 477).<sup>24</sup> As we shall see, the crisis in 1980 led to a new phase in the development of the Korean economy.

### **Transitional Phase (1980-1997)**

The second phase runs from 1980 to 1997, a period in which the presidential office changed hands from Chun Doo-Hwan (1980 to 1988) to Roh Tae-Woo (1988-1993) and finally to Kim Young-Sam (1993-1998). This phase began with the severe economic slump of 1980, when the Korean economy recorded a negative growth rate of minus 1.5 percent. In addition, the inflation soared and the current account deficit reached a record level of USD 5.3 billion (Sakong 1993: 4). As we have seen, Korea's problems in 1980 were amplified by economic and political issues that occurred at the end of the 1970s:

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<sup>24</sup> The rate of operation in the manufacturing sector plunged from 82 percent in 1979 to 72 percent in 1980. The decline was greater in the heavy and chemical industries, where the operation rate fell from 60 percent to 42 percent in the machinery industry and from 69 percent to 57 percent in the electrical equipment industry. A total of 45 percent of companies in the heavy and chemical industries were making a loss in 1980 (Lee 2005: 477).

the second oil shock in 1979 and the assassination of President Park in 1979. Put simply, Korea in 1980 was in crisis.

From the beginning of transitional phase, the power of the Korean developmental state began to wane due to the growth of social and market forces; that is, the state's power weakened while the market's power was reinforced (Evans 1995: 229-234). As the big business conglomerates or *chaebol* continued to expand and diversify, they tried to break free from government control. Furthermore, increases in the power of civil society, including resistance from labour unions and students, increased, led to a further weakening of the power of the state. As proponents of free market principles increased in number in the Korean bureaucracy, economic policy swung between state-centred and market-centred approaches. However, developmental policies did not disintegrate completely during this transitional period even as the state's power gradually weakened; rather the relationship between the state and the market evolved into a more equal and competitive one.

President Chun Doo-Hwan took power during the political turmoil that followed the assassination of President Park in 1979. With the onset of the Chun administration (1980-1988), a group of US-trained economists emerged who opposed state-led, growth-oriented protectionism and valued stability and market function (Amsden 1994). With the implementation of the policies formulated by these economists, the focus of the government's economic efforts moved from growth to stabilisation, bringing the economy into a new phase. However, President Chun was not himself a neo-liberal and developmental state ideology continued to permeate the system during his administration (Shin and Chang 2003: 67).

The stabilisation measures implemented in the early 1980s proved successful;

the average annual rate of inflation, which had averaged 25 percent in 1980-1981, decelerated to 2-3 percent between 1983 and 1988 (Kim and Kim 1997: 34). Furthermore, growth was not sacrificed for stability and the annual GDP growth rate between 1981 and 1987 was 8.7 percent. The Korean economy also recorded current account surpluses during 1986-1988; the rapid rate of economic growth and the improvement in the balance of payments situation were due to favourable international circumstances known as the 'three lows': the low value of the dollar relative to the Japanese yen, low international interest rates, and low international oil prices (Lee 2005).

The appreciation of the Japanese yen after the Plaza Accord in 1985 allowed Korean companies to gain price competitiveness in almost all their products that competed with Japanese goods in the world's export markets. Oil prices, which rose sharply during the second oil shock in 1979, plummeted in the mid-1980s as the United Kingdom (UK) embarked on oil exploration in the North Sea, and Iraq increased production to prepare for the Iran-Iraq War. Since crude oil was Korea's biggest import accounting for 15 percent in 1985, the decrease in oil prices contributed significantly to the improvement in Korea's international balance of payments. Finally, lower international interest rates, which were caused by falling interest rates in the United States (US) in the mid-1980s, eased the burden of interest and principal repayments on Korea, which, as we have seen, had high levels of foreign debt (Lee 2005: 478).<sup>25</sup>

This favourable environment in the mid 1980s solved the problems that had appeared in the late 1970s, such as the overcapacity in the heavy and chemical

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<sup>25</sup> Korea's foreign debts continued to increase after it started to promote the heavy and chemical industries in the 1970s. As of 1985, Korea was the fourth largest debtor nation in the world with foreign debts of USD 46 billion, accounting for 48 percent of its gross national product that year (MOF 1991b: 15).

industries and foreign debts. Between 1986 and 1989, the Korean economy recorded a substantial trade surplus for the first time in its modern history and average 11 percent of GDP growth (BOK 2006). Heavy and chemical industry factories that had lain idle at the end of the 1970s began to operate at full capacity and the products of the heavy and chemical industries, such as steel, ships, automobiles and electronics, became Korea's main export items.

Problems surrounding the legitimacy problem of the Chun administration, which had come to power through a military coup after the assassination of President Park in 1979, erupted in massive demonstrations in the late 1980s. This democratic movement forced the government to issue the '6.29 statement' in June 1987, promising significant democratisation measures, including the holding of direct presidential elections, the formation of free and effective trade unions, and measures to promote political democratisation. As we shall see, the 1987 democracy movement had significant implications for the continuing development of the Korean economy.

When President Roh Tae-Woo (1988-1993) took office in the wake of the democracy movement of 1987, he inherited a stable and rapidly-growing economy from the previous administration. Although the Chun government had simultaneously achieved the conflicting economic goals of growth and stability, this economic success had come at a price and the new president faced challenges at home and overseas. With the economy performing well, workers who had endured low wages under the previous authoritarian regimes, began to demand their share of the benefits of economic growth as the new democratic regime was established (Koo 2001). In addition, the *chaebol*, which had grown rapidly thanks to government protection and preferential treatment, now wished to escape the government's control as they continued to expand their



business empires (Kim 1994). The United States, which had provided economic assistance to its poorer ally during the Cold War, started to put pressure on Korea to open its markets to foreign goods and services as the Cold War military confrontation relaxed and its trade deficit with Korea grew (Hart-Landsberg and Burkett 2001: 408).

After the economic boom of the late 1980s, GDP and export growth rates dwindled, the balance of payments situation deteriorated, and the rate of inflation increased from 1989 onwards. The immediate cause of the economic slowdown was the increase in and intensification of labour disputes; these were closely related to the political democratisation process in Korea described above which provided the momentum for unions' demands, hitherto suppressed, for political participation and economic benefits. Labour disputes spread rapidly throughout the country, increasing from 276 cases in 1986 to 3,749 in 1987 and this growing labour movement resulted in massive increases in wages, prompting not only foreign companies but also Korean companies to reconsider their investment plans for Korea (Kim and Sung 2005). The increase in labour costs was inevitable as the economy developed and democracy progressed and, in order to adapt to the new business circumstances, companies should have endeavoured to shift their production to more technology-based structures through investment in capital infrastructure and research and development (R&D). In the 1960s, 1970s, and 1980s, technology had not been a key factor in Korea's economic development; at that stage, mature or standard technology sufficed, and it was relatively easy to obtain from developed countries (Amsden 1989). Economic development in these periods was predominantly enabled by increases in labour and capital input. However, entering a new stage with relatively high labour costs, Korean companies required newer and more advanced technologies, which developed countries were

reluctant to transfer. Since the 1990s, the development of new technology has been a crucial factor in further development for Korean companies that could no longer rely on latecomer's advantages. However, rather than investing in R&D, the *chaebol* were seeking easier ways to sustain their business by speculative investment in real estate and the diversification of their businesses. Although the government sought to force businesses to sell their non-commercial real estate and refrain from excessive diversification (Gang 1994, Go 2005), the *chaebol*, had grown to the point where they could challenge the state and would not follow the government's guidance.<sup>26</sup> Instead, they publicly demanded that the government retreat from the market (Bishop 1997: 110) and the government was unable to channel resources to support its plans and policies due to its weakened autonomy and capacity.

President Kim Young-Sam (1993-1998) took office amid a post-Cold War atmosphere: the Berlin Wall was torn down in 1989, the Soviet Union collapsed in 1991, and the Uruguay Round was concluded in December 1993, foreshadowing the launch of the World Trade Organisation (WTO) in 1995. A key policy objective for the Kim government was seeking membership of the Organisation for Economic Cooperation and Development (OECD) in 1996, which would require comprehensive liberalisation measures. In accordance with the changes in the international environment, the Kim administration placed globalisation (*Segyehwa*) at the top of its policy agenda and announced a 'globalisation road map' in November 1994, a month before the National Assembly ratified the joining of the WTO. President Kim's globalisation road map

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<sup>26</sup> For instance, the *chaebol* were reluctant to follow the demands for 'the compulsory sale of non-business real estate owned by conglomerates' made by the Roh Tae-Woo administration, and they filed a civil suits or unconstitutionality suits against the state (Gang 1994: 65). The Kim Young-Sam administration tried to implement measures relating to the diversification of ownership and the specialisation of *chaebol* businesses, but made little progress since the measures were either shelved or diluted in the face of the powerful *chaebol* lobby (Go 2005: 98).

included economic liberalisation policies such as the opening of the domestic goods and capital markets, the easing of regulations, the privatisation of parts of the public sector, and the creation of a flexible labour market.

One drastic change was the implementation of financial liberalisation measures in 1993. From the early 1990s, the government was put under pressure by the United States and the *chaebol* to liberalise the domestic financial markets; the American government was eager to open up the Korean financial sector to US financial institutions, while the *chaebol* wanted to benefit from the interest rates in international capital markets that were lower than those offered by domestic lenders.<sup>27</sup> Moreover, financial liberalization was a prerequisite for joining the OECD; considering these circumstances, liberalisation measures were inevitable. After 1993, the government removed a considerable number of restraints related to short-term foreign loans: restrictions on foreign borrowing by the *chaebol* and financial agencies were lifted and the *chaebol* were allowed to set up merchant banks. However, a major problem was that these liberalisation measures were implemented without first establishing any systems for control and regulation resulting in an inward surge of short-term foreign capital and a drastic increase in foreign debt levels (Lee 1999, Weiss 2000, Shin and Chang 2003).<sup>28</sup> This became one of the major reasons for the financial crisis in 1997 which caused serious problems for the country and resulted in massive changes in the nature of the Korean economy (Weiss 2000: 31).<sup>29</sup>

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<sup>27</sup> The US government continuously pressured for an opening of the Korean financial market and the Korea-US financial policy consultations held in 1992 actually influenced the financial liberalization measures implemented in 1993 by the Kim Young-Sam administration (Lee Kang-Kuk 2004: 63-64).

<sup>28</sup> In October 1997, the merchant banks' foreign debts reached USD 20 billion, out of which 64 percent or USD 12 billion, was short-term debt due in under a year. With these funds, they lent as much as USD 16.8 billion or 84 percent of their total debt in long-term loans over one year due (Gang 2005: 429).

<sup>29</sup> There are two competing perspectives regarding the cause of the crisis in 1997: the neo-liberal interpretation and the developmental state view. For more details, see chapter one and Burkett and Hart-Landsberg (1998).

### **Market over State Phase (1998-2005)**

The third phase runs from 1998 to 2005, a period when Kim Dae-Jung (1998-2003) and Roh Moo-Hyun (2003-present) served as president of Korea. The financial crisis in Korea peaked in late 1997; the central bank's foreign reserves were almost exhausted, leaving the country on the verge of default, and many financial agencies and companies went bankrupt. The Korean economy fell into a comprehensive crisis caused by the immediate problems of a lack of foreign exchange liquidity and fundamental problems in the nation's economic structure. As a result, the economic growth rate in 1998 plunged to minus 6.9 percent *percapita* income dropped by 34 percent and the unemployment rate rose to 7 percent. The won-dollar exchange rate more than doubled between the end of 1996 and late 1997, and stock prices were cut in half. The Korean economy, which had been the forerunner of the East Asian economic miracle, fell into a serious crisis (BOK 2006).

The third phase started in 1998 when Korean economy suffered after the 1997 financial crisis. In 1997, the Korean government asked the International Monetary Fund (IMF) for bailout loans in order to overcome the financial crisis as the value of the Korean currency plummeted and foreign exchange reserves dwindled sharply. In exchange for the rescue funding, the IMF demanded that the Korean government undertake massive reform and restructuring measures (IMF 1997). The restructuring programmes included neo-liberal reforms that put emphasis more on market function than on the state's role. The restructuring, which began in 1998, resulted in massive market-driven reforms and openness in the financial, corporate, labour, and public sectors. These reforms significantly changed the nature of the Korean economy, and the

role of the Korean state was reshaped according to the ideals of neo-liberalism (Shin and Chang 2003). This was the 'Market over State' phase, in which the state's role weakened while market principles predominated.

After the crisis in 1998, the Korean economy recovered rapidly, recording growth rates of 9.5 percent in 1999 and 8.5 percent in 2000. Once the government had repaid its loan to the IMF in its entirety in August 2001, the crisis appeared to be over and the Korean economy was expected to regain its momentum. However, since 2001, the performance of the Korean economy had been disappointing; the GDP growth rate had remained at the 3 to 4 percent level, which was low compared with the previous periods, and levels of capital investment had decreased substantially.<sup>30</sup> Unemployment stood at around 3 to 4 percent; although this did not appear to be particularly high, the job market cannot be said to be stable given that half of all employees were temporary workers. Entrepreneurship, which flourished in the periods of rapid growth, seemed to have disappeared; as many companies are reluctant to expand their business, preferring to focus on short-term profit, and few are willing to take on adventurous and risky projects. The Korean economy seemed to have lost its former vigour, prompting the question; why has the economy lost its dynamism?

If, as Hall and Soskice (2001) argue, the Anglo-American system is characterised by such factors as a flexible labour market, financial markets in which firms' current profitability is regarded as the critical factor for lending, and corporate

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<sup>30</sup> As an economy matures its growth rate tends to slow. Thus, the growth rate of Korea since 2001 can be regarded as the general trend of mature economies. However, as Singapore and Taiwan, which are competitors of Korea, recorded growth rates of over 6 percent when they attained per capita incomes of USD 10,000 (1989 for Singapore, 1992 for Taiwan), the growth rate of Korea since 2001 can not be considered satisfactory (Park and Hur 2004: 12). In addition, according to the KDI report, while the rate of increase of total factor productivity (TFP) in the manufacturing sector between 1995 and 1999 was 1.66 percent, the rate of increase between 1999 and 2003 was 5.78 percent mainly due to post-financial crisis restructuring efforts. This implies that the TFP was not a critical factor in the slow rate of growth in the Korean economy since the crisis (Shin and Han 2006: 443).

behaviour that emphasises short-term profits rather than long-term market share, then the post-crisis Korean economy has been transformed into something more akin to the Anglo-American system. Firstly, the labour market became more flexible with the revision of labour laws in 1998, allowing for the creation of a layoff system and the employment of temporary workers. Although, before the crisis, large firms traditionally offered lifetime employment to their workers, following the revision of the labour laws, firms were able to dismiss permanent workers and to hire cheaper, non-union temporary workers, which resulted in relatively higher rate of unemployment after the crisis and higher numbers of temporary workers (see Table E).<sup>31</sup> The concept of lifetime employment has faded and the job market has become more flexible (Kim and Sung 2005: 461).

Secondly, the financial system changed after the crisis. The Korean developmental state was characterised by the ‘state-banks-*chaebol* nexus’ that allowed close cooperation among government, commercial banks, and large firms. This system also made large-scale and long-term investment possible by sharing financial risk among the state, banks, and the *chaebol* (Shin and Chang 2003: 119-121). Before the crisis, bank loans were the principal source of industrial capital, and the banks’ major clients were corporations. The banks offered capital resources to industries in line with the government’s goals rather than on the basis of firms’ short-term profitability. However, after the crisis, the banks did not want to take risks because the risk sharing system had been dismantled. Therefore, they radically reduced the riskier practice of corporate lending and instead increased their levels of household lending, which was

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<sup>31</sup> In 2000, 52.4 percent of workers had irregular jobs, including workers with temporary contracts and part time jobs, while 47.6 percent of workers had permanent contracts (Crotty and Lee 2001: 18).

seen to be a relatively safer line of business.<sup>32</sup> Financial institutions became more concerned about their profits than before and channelled their efforts into safe and profitable investments. Accordingly, when banks offered loans, they focused on the current profitability of corporate clients as a guarantee of repayment.

Thirdly, Korean companies began to focus on short-term profits rather than long-term growth after the crisis, a development that was also related to the collapse of the Korean developmental system. Under the developmental state in which the state, banks, and businesses worked in close cooperation, the *chaebol* could undertake large-scale investments with high levels of risk, in the knowledge that they were protected by the state and the banks. However, the crisis of 1997 disrupted this coalition as the state officially announced a 'hands-off the market' policy. Without government protection, companies pursued safe and short-term profits instead of more risky long-term investments (Shin and Chang 2003: 119-121). In these new circumstances, firms could only secure financial resources or protect themselves from hostile takeovers through good short-term profit performance.

In the MOS period, the Korean economy appeared to lose its vitality and aggressiveness. Between 1998 and 2005, the average annual GDP growth registered a rate of 4.2 percent, notably lower than that of the SOM (8.5 percent) and transitional phases (7.6 percent). When considering the growth rate of capital investment, the difference is even more substantial: the average rate of fixed capital formation in the MOS phase was just 1.5 percent, much lower than that of the SOM (20.3 percent) and transition phases (9.4 percent). This low level of investment is considered to be one of

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<sup>32</sup> Banks increased their household lending activities while reducing corporate lending: in 1997, the respective shares of bank loans accounted for by corporate lending and household lending were 64.5 per cent and 32.6 percent, compared with 53.0 percent and 45.5 percent in 2003 (Cho 2004: 125).

the prime factors in low economic growth rate and unstable employment, prompting concerns and misgivings about the future of the Korean economy.

### **3. Periodisation Used in This Thesis**

We have argued that the history of the Korean economy can be divided into three periods according to the relationship between the state and the market, namely the ‘State over Market,’ ‘transition’ and ‘Market over State’ phases. As one period was replaced by another, the state’s power diminished while market forces became stronger. During the State over Market phase (1962-1979) the state dominated the market, while in the transition phase the relationship between the two became more competitive. Finally, in the Market over State phase, the state was overwhelmed by the market.

Despite the fact that Korean economic history since 1962 can be grouped into these three periods, this study will deal with only two phases: State over Market and Market over State. The transition phase will be omitted because we regard it simply as an evolutionary stage between the developmental and neo-liberal states. The nature of the state in the transition phase was ambiguous and had overlapping characteristics with both the SOM and MOS periods. In contrast, the SOM and MOS phases have the distinctive characteristics of developmental and neo-liberal states, respectively. Considering that one of the principal aims of this study is to provide an insight into the relationship between the state and MNCs, we argue that the discussion should focus on the typical developmental state phase in which the state regulates MNCs and the typical neo-liberal period when MNCs dominate state power. Therefore, the following analysis



will focus on a comparison of these two distinct phases in order to highlight the changing nature of the state and to emphasise the shifts in the relationship between the state and multinational corporations.

## Chapter Three: The Bargaining Power of the Korean Government

In Chapter One, the Neo Bargaining Model (NBM) was set up and combined with developmental state theory. This chapter will apply the NBM to the Korean government in the SOM and MOS periods and, by so doing, will answer the following questions: firstly, how has the Korean government's bargaining power *vis-à-vis* MNCs shifted? Secondly, what factors have affected the strength and weakness of the government's bargaining power?

Before undertaking a closer examination of the bargaining relationships between the Korean government and multinationals, we first provide a brief review of the NBM. The key point of the Neo Bargaining Model is that the outcomes of MNC-host government interactions arise as a result of the relative bargaining power of MNCs and host governments. In other words, parties with a greater level of bargaining power are likely to obtain more favourable terms in the negotiation process (Levy and Prakash 2003: 141). From this primary understanding of bargaining models, the three fundamental components of the model can be considered: host governments; MNCs; and bargaining outcomes. Based on this, an analytical framework for the bargaining relations between a host government and MNCs was developed: the Neo Bargaining Model.

The NBM comprises three dimensions: resources, stakes, and constraints. *Bargaining resources* are the specific advantages that are possessed and required by each party in order to achieve its respective goals; for host governments, location-specific advantages are its bargaining resources, whereas firm-specific advantages are the bargaining resources for MNCs. Resources are the means by which one party can

force the other to move closer towards its position. Therefore, a higher level resources (relative to the other party) produces a greater degree of bargaining power. The term *Bargaining stakes*, in turn, refers to the degree of importance placed on the bargaining objectives by each interested party; they are determined by evaluating the presence or absence of alternatives and commitment. Alternatives represent other options a party has to gain access to the resources it needs, while commitment represents how much a party is willing to pay the other party to get those resources. The more alternatives there are, and the lower the level of commitment to the negotiations a party exhibits, the lower the stake level; this, in turn, creates a higher level of bargaining power. Finally, *bargaining constraints* are the negative factors that restrict the exercising of potential bargaining power. In the NBM, constraints have two facets: internal and external constraints. Internal constraints refer to the pressures from interest groups and the strength of bargaining institutions, whereas external constraints refer to the pressures from home governments and supranational institutions. The lower the level of constraints the bargaining party faces, the greater the bargaining power the party possesses. This chapter applies these dimensions of the NBM — resources, stakes and constraints — to the Korean government in both the SOM and MOS periods, evaluates and compares the bargaining power of both periods, and finally draws the causes of the shift in the bargaining power of the state.

## **1. State over Market**

From 1962 to 1979, when President Park Chung-Hee was in office, Korea was a typical

model of a developmental state and this era was dominated by ‘plan rationality’, represented by the Five-Year Economic Development Plans.<sup>33</sup> At that time, the state was strong enough to both dominate and nurture the market. The state was not only an apparatus that reflected the interests of leading social groups but also an institution that set independent goals with autonomy and had the capacity to mobilise resources and unify interest groups for its goals using appropriate bureaucratic and policy measures. The state led and controlled the market by distributing resources according to its plans with the ultimate goal of economic development. In the 1960s and 1970s, the private sectors were minimal in Korea; thus, the state’s plan practically replaced a market function. The state at that time was able to lead the private sector in accordance with state policy goals and plans through its ownership of the financial sector. In addition, the state exerted direct control by means of various administrative regulations, thereby forcing companies to fall in line with and achieve the state’s policy goals and plans (Amsden 1989).

As was mentioned in Chapter Two, the SOM period can be divided into two distinct parts: the first from 1962 to 1972 and the second from 1972 to 1979. In the first, the Korean government pursued export-oriented industrialisation focusing on labour-intensive light industries while, in the second, the government shifted its emphasis from labour-intensive to capital-intensive industries. Although the focus of economic policy changed slightly in accordance with the government’s long-term plans, the national development strategy — which can be summarised as ‘government-led’, ‘outward-looking’ and ‘growth-first’ (Sakong 1993: 50) — remained unchanged throughout the SOM period. FDI was considered to be one of the resources available to realise the

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<sup>33</sup> For an account of ‘plan rationality’, see Johnson (1982: 17-34)

government's goals. In this section, we examine the bargaining power of the Korean government in the SOM period in terms of bargaining resources, stakes, and constraints. In the SOM period, the level of bargaining resources was low because of limited markets and poor natural resources. However, the Korean government could maintain a relatively high level of bargaining power because of its low level of stakes and constraints. We analyse the reasons behind these levels in this section.

### **Bargaining Resources**

According to UNCTAD (1996: 97-98), FDI can be classified by objective: traditional and non-traditional. *Traditional FDI* refers to market-seeking or resource-seeking FDI, which is determined by traditional resources such as market size, natural and human resources. On the other hand, *non-traditional FDI* means efficiency-seeking FDI for which non-traditional resources including created assets, agglomeration economies, infrastructure facilities, or specialised workforces are becoming more important.<sup>34</sup> In the SOM period, Korea had few such non-traditional resources. In fact, the Korean government had few resources coveted by MNCs in the SOM period other than cheap labour and the small but rapidly-growing domestic market. According to a survey conducted in 1979 by the Economic Planning Board (EPB) (1981: 23-24) on the motivations of foreign investors in Korea, 33 percent of respondents cited 'cheap and abundant labour' as their major motivation for investing in Korea, while 23 percent said that the Korean market was the main reason for investing. These survey results

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<sup>34</sup> For further discussion about the determinants of FDI, see Root and Amed (1979), Agarwal (1980), Kravis and Lepsey (1982), Scheider and Frey (1985), Culem (1988), Weeler and Mody (1992), Lucas (1993), Singh and Jun (1995), Gastanaga *et al* (1998), UNCTAD (1998), Noorbakhsh *et al* (2001), Dunning (2002) and Blomström and Kokko (2003).

confirmed that labour and the domestic market were the most important resources of the Korean government in the SOM period.

Until the late 1950s, developed countries' investments in developing countries were mostly made to exploit natural resources such as oil, copper, tin, and rubber (Jones 2005: 33). Thus, access to natural resources was the decisive motivation for MNCs' investment in developing countries. Although the importance of natural resources declined after the 1960s, the natural resources of developing countries were still the crucial attraction for MNCs. Therefore, countries in the Middle East and Latin America with plentiful natural resources could maintain a strong level of bargaining power *vis-à-vis* foreign extractors and developers in the 1960s and 1970s. In contrast, Korea is poorly endowed with natural resources: there are no energy sources such as oil and natural gas, most coal deposits are located in North Korea, and output of tungsten, which is the metal available in commercially significant amounts, stopped in 1993 (EIU 2005: 18). That is, Korea was the last country in which any MNC would have been interested in investment for the purpose of extracting and developing natural resources. Thus, natural resources had little potential as a source of bargaining power for the Korean government.

However, there were plentiful human resources in Korea during the SOM period. According to statistics published by the Bank of Korea (BOK) (2005), the unemployment rate in Korea in 1963 was 8.1 percent; the rate of unemployment in rural areas stood at 3 percent while the unemployment rate in urban areas was higher at 16 percent. At that time, 64 percent of the population was engaged in primary industries such as agriculture and fisheries while the rest were engaged in manufacturing and service industries. Given the nature of agriculture, levels of unemployment could have

been understated and it is possible that real overall unemployment was much higher (Kim and Hong 1997: 8-9). Amsden (1989: 191) stated that there were almost two million people unemployed in 1960, a fifth of the economically active population in Korea. Thus, there was an almost unlimited supply of workers in industries and, at that time, the labour class had not formed and labour unions were not active at all. Furthermore, there was no pressure of wage increases due to the oversupply of unskilled workers in the 1960s.

Table 3.1 Growth of Real Wages and Productivity in the Manufacturing Sector(Unit: %)

Year	1962	1963	1964	1965	1966	1967	1968
Growth of Real Wages	-1.2	-7.9	-6.5	0.8	10.9	10.9	14.1
Growth of Productivity	2.4	10.0	8.8	17.5	4.0	17.7	19.9
Year	1969	1970	1971	1972	1973	1974	1975
Growth of Real Wages	19.3	9.3	2.4	2.1	14.3	8.8	1.5
Growth of Productivity	26.5	12.6	9.7	8.7	8.8	11.4	11.6

Source: Kim and Sung, 2005: 94

However, in the 1970s, unskilled workers were gradually absorbed into industries, resulting in wage increases (see Table E). As is shown in Table 3.1, although there had been continuous increases in real wages since 1965, they lagged the rise in labour productivity. This was because the Korean government coercively suppressed wage increases in order to sustain Korea's export competitiveness. In 1971, the Korean government established the 'Special Measures Law Concerning National Security' restricting the rights of workers to bargain collectively and to take strike action. In 1972, the government amended the National Constitution bringing in comprehensive

restrictions on the basic rights of workers.<sup>35</sup> The oversupply of labour and government suppression of the labour movement kept wage levels low, and these low wage levels were attractive to foreign companies seeking to lower their production costs.

Apart from the abundance of human resources, the education level of workers was comparatively high. According to Amsden (1989: 215-222), Korea recorded higher ratios for high school and tertiary education entry, and for education abroad than Singapore, Argentina, Brazil, Mexico, Turkey, and India in the 1960s and 1970s. In 1963, the illiteracy rate of Korean workers was almost zero; middle school graduates accounted for 53 percent of the workforce and high school graduates for a further 34 percent. The average education level was much higher than might have been expected based on Korea's *per capita* income at that time. Korea's high educational attainment was attributed to some key factors: firstly, Koreans placed great emphasis on education due to their Confucian legacy, and secondly education offered the opportunity to move up the ladder in Korean society because social stratification had not been established after the collapse of the traditional social class structure during the Japanese occupation. The oversupply of labour, low wages, and higher education levels enabled foreign companies to secure high-quality labour at lower costs, thereby serving as a motivation for MNC investment in Korea as well as a source of government bargaining power.

Market size and growth potential are also essential factors in MNC investment abroad; in particular, market-seeking FDI is determined by the growth potential and the size of the market. Therefore, a host country with a fast-growing and large market will enjoy strong bargaining power *vis-à-vis* MNCs. In the 1960s and the 1970s, the size of

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<sup>35</sup> On 17 October 1972, President Park proclaimed martial law and enforced an amended constitution. The amended constitution, called the Yushin Constitution, allowed the President an unlimited term of office and gave him extensive powers. In October 1980 when President Chun Doo-Hwan took office the constitution was revised through a referendum.



the Korean market was relatively small; statistics published by the Bank of Korea (BOK) (2005) show that the population of Korea in 1970 was 32 million, GDP was USD32 billion, and *per capita* income was a mere USD254 (see Table 3.2).

Table 3.2 Population, GDP and GNI per capita: Korea 1962-1979

	Population (million)	GDP (USD billion)	GNI per capita (USD)
1962	26.5	2.3 (N/A)	87 (N/A)
1965	28.7	3.0 (N/A)	105 (N/A)
1970	32.9	7.8 (39/188)	254 (126/188)
1975	35.3	21.5 (33/188)	602 (114/188)
1979	37.5	63.3 (29/190)	1,676 (85/190)

Note: Korea's world ranking shown in parentheses

Source: BOK 2004, BOK 2005

In 1970, Korea's GDP was ranked 39<sup>th</sup> and *per capita* income was 126<sup>th</sup> out of 188 nations around the world (BOK 2004: 16). According to Maddison (2003), the total national income of Korea in 1960 was less than that of several Asian countries such as the Philippines, Indonesia and Pakistan (see Table 3.3). In a word, Korea in the 1960s and the 1970s was one of the poorest nations in the world, and so MNCs seeking markets had little interest in Korea. However, market growth was incredibly rapid in Korea: from 1960 to 1970, the average economic growth rate was 8.6 percent, and between 1970 and 1979 it was 10.3 percent (UN 1983) making Korea one of the fastest-growing countries in the world in the 1960s and 1970s. According to the UN (1983), Korea was one of just three nations that recorded an annual average economic growth rate of more than 10 percent in the 1970s, the other two being Saudi Arabia and Syria. As oil producers, both Saudi Arabia and Syria could achieve high rates of growth in the 1970s; in fact, Korea was the only nation that achieved more than 10 percent growth

other than oil producing nations.

Table 3.3 Total and Per Capita National Income: Selected Countries 1960 and 1970

	GDP		Per Capita GDP	
	1960	1970	1960	1970
	(million 1990 international Geary-Khamis dollars)		(1990 international Geary-Khamis dollars)	
Korea (South)	27,398	62,988	1,105	1,954
Egypt	21,010	33,235	783	990
Nigeria	34,081	60,814	869	1,233
South Africa	52,972	91,986	3,041	4,045
Argentina	114,614	174,972	5,559	7,302
Brazil	167,397	292,480	2,335	3,057
Mexico	121,723	227,970	4,320	5,293
Philippines	42,114	68,102	1,475	1,761
Indonesia	97,082	138,612	1,019	1,194
Pakistan	32,621	62,522	647	952
US	2,046,727	3,081,900	11,328	15,030
Japan	375,090	1,013,602	3,988	9,715
UK.	452,768	599,016	8,645	10,767

Source: Maddison (2003)

In summary, during the State over Market period, Korea had few natural resources and a small domestic market, but could provide plenty of inexpensive labour. Korea was attractive to firms seeking cheap labour whose priority lay in simple assembly production. For market seekers, Korea was too small to be attractive; accurately described pre-industrialisation Korea as

truncated into a half a country, with almost no natural resources, a thoroughly uprooted and aggrieved population, no domestic capital to speak of and a minuscule domestic market (Cumings 1997: 300).

## **Bargaining Stakes**

The bargaining stake dimension is comprised of two elements: commitment and alternatives. The Korean government's bargaining stakes in FDI will be analysed in terms of commitment (how much the object of bargaining is valued) and alternatives (how many other options exist). In this period, the government could maintain a low level of stakes because of the low commitment level, which was derived from the industrial policy of the Park Chung-Hee government, and high level of alternatives, which were attributed to the 1960s and 1970s international political economy.

### **Commitment**

A host country seeks to attract FDI in order to acquire the benefits that investment by foreign companies can bring; thus, its commitment level to FDI is determined by the demand for the potential benefits that FDI can bring to a host country. In other words, the greater the host country's demand for the firm-specific assets possessed by MNCs, the higher its commitment to attracting FDI. In the SOM period, the Korean economy was in desperate need of foreign capital. This might suggest that there was strong demand from the Korean government on FDI, which could raise the level of commitment. However, the Korean government could maintain the low level of commitment to FDI because in this period the government put more priority on promoting domestic capital under the strong industrial policy and this consideration lowered commitment to FDI, which could undermine the economic autonomy of the state.

In the 1960s, Korea was experiencing dire poverty, low levels of income led to low savings rates, resulting in low levels of investment which, in turn, perpetuated the low income situation. In order to break this vicious circle, increased investment would have to boost income, leading to higher savings which, in turn, would serve as financial resources for expanding investment.

To expand investment, it was necessary first of all to increase the savings rate; however, with the national savings rate was at a low level in the 1960s, the inducement of foreign capital was inevitable. Foreign capital contributed to the quantitative expansion of the Korean economy by bridging the gap between domestic savings and funds needed for investment and thus boosting the utilisation of the labour force. Therefore, the Korean government desperately sought foreign capital in the SOM period. The government was primarily interested in the capital transfer effect of FDI and regarded inward investment as one of the means of capital transfer together with loans and foreign aid. In the 1960s and 1970s, the technology of Korean industries remained at a low level, which might suggest that there was strong demand among Korean companies for foreign firms' technologies. However, the demand was not as high as might be assumed because the technologies required by Koreans firms were of a standard or matured form, easily transferable in various ways (Amsden 1989: 20).<sup>36</sup> Generally speaking, as factories imported outdated machinery and employed labour-intensive processes using inexpensive labour, high-level MNC technology was not in great demand among Korean companies. As low-level technologies were accessible and most technologies were embedded in the imported machines, the demand for MNC technology was

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<sup>36</sup> Amsden describes the Korean way of obtaining technology as follows; "They visit international expositions, attend conference and lectures, read technical journals, hire experienced workers, visit overseas plants, engage foreign technical assistants, consult machinery suppliers, and buy, borrow, beg and steal foreign designs (1989: 20)."

Table 3.4 Foreign Capital Inflows: Korea 1955-1979

(Unit: million USD)

Year	Aid	Borrowing <sup>37</sup>	FDI <sup>38</sup>	Technical Licence
1955	236	-	-	-
1956	326	-	-	-
1957	382	-	-	-
1958	321	-	-	-
1959	222	-	-	-
1960	245	-	-	-
1961	199	-	-	-
1962	232	3	23	-
1963	216	67	-	-
1964	149	24	-	-
1965	131	40	-	-
1966	103	183	-	-
1967	97	230	98	1
1968	105	378	5	1
1969	107	579	3	2
1970	82	507	9	2
1971	51	738	1	4
1972	5	670	518	7
1973	2	913	5	12
1974	1	1,206	2	18
1975	1	1,478	6	27
1976	1	1,683	5	30
1977	0.9	2,177	143	58
1978	0.1	3,058	181	85
1979	0.2	4,189	195	94
Total	3,562	18,123	1,194	341

Source: BOK 2006, Lee 2005, MOF and KDB 1993

<sup>37</sup> Borrowing statistics show the sum total of public loans, commercial loans and bank loans.

<sup>38</sup> The Korean government collects statistics on both notification and arrival bases. The notification-based statistics are compiled according to the investment amount reported when foreign investors are registered as a foreign investment company. The arrival-based statistics are compiled according to the actual amount of money transferred from the home country to Korea to start the business after reporting. Therefore, arrival data is more correct than notification data. The figures in the table are based on arrival.

relatively low in the SOM phase.

President Park, who seized power in 1961 in a military coup, put economic development at the top of his agenda in order to secure a political foothold and to escape the severe post-war poverty. Although President Park was committed to banishing poverty across the nation, he had few resources with which to develop the country. As we have seen, the grant-type aid which had bolstered the Korean economy in the 1950s started to decrease in the 1960s due to the shift in US aid policy from giving grants to providing loans (Krueger 1979, Sakong 1993: 102).<sup>39</sup> An economic development plan was established, but the resources to implement the plan were minimal. Since the only abundant resource that Korea possessed in the 1960s was labour, economic progress was only practicable through the export of labour-intensive light industrial products. Raw materials and machinery were required in order to produce goods for export, but the government's foreign reserves were not sufficient imports of these items. Mobilisation of capital was the crux of realising the goals of the economic plan and, as we have seen, the beginning of the 1960s, the mobilisation of domestic savings was not a viable solution. The Korean government had accumulated few savings and private savings also were minimal during the first half of the 1960s (Kuznets 1994: 43). Table A shows that the saving-investment ratio in the 1960s remained at around 51 percent due to the low levels of domestic savings.<sup>40</sup> Since the government put the highest priority on economic development, it needed capital and, with few domestic financial resources

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<sup>39</sup> President Kennedy, who took office in 1961, gradually replaced the grants to less developed countries with loans in the belief that short-term grants would not help the economic development of the beneficiaries (Jung 2000: 69-76).

<sup>40</sup> The 'saving-investment ratio' is the ratio of gross savings to gross fixed capital formation, which means the ratio of domestic savings spent on domestic fixed capital formation. If the ratio is 100 percent, it means domestic gross capital is solely funded by domestic savings, and if the ratio is less than 100 percent, foreign capital is needed to fill the gap between domestic savings and domestic fixed capital. When the ratio is more than 100 percent, it means that there is an outflow of domestic savings.

available for economic development in the 1960s, the Korean government inevitably turned its gaze overseas.

This dependence led to a high commitment to foreign capital during the 1960s, and this was reflected in foreign policy. Upon taking office in 1961, President Park paid a visit to the United States to obtain American support for his economic plans (Cha 2004: 108-109) and in 1965, when national anti-Japanese sentiments were still strong after the liberalisation from Japanese occupation two decades earlier, President Park pushed for the normalisation of diplomatic ties between Korea and Japan in order to gain access to Japanese economic support. The Korean government also dispatched 300,000 troops to the Vietnam War to ensure continued US economic assistance and the United States paid USD1 billion from 1965 to 1970 in return for Korea's military support (Woo 1991: 94; Cumings 1997: 321). Thus, in the 1960s, Korea had to make significant sacrifices to earn the foreign capital that the Korean government desperately needed. Although the government's main concern was foreign aid and loans, it endeavoured to attract FDI as well. In 1960, the Korean government established the 'Foreign Capital Inducement Promotion Act' to provide a legal basis for the inducement of foreign capital including FDI and, in 1962 the EPB established a department responsible for FDI. As we shall see in the following chapter, at this time, there were few restrictions on the ratio of investment or on the type of businesses available for foreign companies doing business in Korea, making it easier for them to enter the Korean market (EPB 1981: 29-30).

However, in the 1970s, the external political and economic environment made the Korean government's policy more nationalistic in nature, which lowered the level of commitment of the government. In terms of the external political environment, there

were changes in the international political order caused by the Nixon Doctrine in 1969 and the subsequent 1972 Sino-US rapprochement. President Nixon declared in 1969 that Asian countries should take primary responsibility for their own security (Cha 2004: 143). Under the Nixon Doctrine, 20,000 troops (one infantry division) were withdrawn from Korea in 1971; this was roughly one third of all troops stationed in Korea. In 1973, the US government withdrew all soldiers stationed in Vietnam and, in 1972 the United States and China issued the Shanghai communiqué, formally establishing diplomatic ties seven years later. With the formalisation of diplomatic relations between the United States and China, the US government severed diplomatic relations with Taiwan by abrogating the mutual defence agreement between the two nations and pulling US military establishments and troops out of Taiwan. Such changes in international relations in East Asia in the early 1970s made the Korean government realise how fragile its security dependence on Washington was and how important economic independence was for survival.

The changes in the international political order threatened Korea's national security, thereby prompting President Park to make his top priorities 'economic independence' (*Jarip Gyeongje*) and 'self-reliant defence' (*Jaju Gukbang*). For these reasons, President Park decided to promote the development of the heavy and chemical industries in the 1970s.<sup>41</sup> In other words, the Korean government's nurturing of the heavy and chemical industries in the 1970s resulted from political and security concerns (Weiss and Hobson 1995: 189). Until the early 1970s, the North Korean economy had surpassed that of South, which had been under constant threat from its economically

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<sup>41</sup> On January 12, 1973, President Park declared the 'promotion of heavy and chemical industries' at the first news conference of the year (Oh 2006: 206).



and militarily superior neighbour in the 1960s and 1970s.<sup>42</sup> With North Korea continuing its policy of aggressive provocation, South Korea naturally became anxious when the US government, on which Seoul relied for its defence against North Korea's aggression, announced the Nixon Doctrine and began overtures to communist China. President Park endeavoured to remove this sense of insecurity by achieving economic independence and strengthening the nation's defence capability. He saw the heavy and chemical industries as a solution to achieving both goals because of its close links with the defence industry.<sup>43</sup>

The nurturing of the heavy and chemical industries, by its nature, required enormous capital, something the Korean government did not possess at that time. However, the Korean government believed that neither the defence industry nor the heavy and chemical industries should be under foreign control. Although several government officials, who had a US academic background, recommended cooperating with MNCs, President Park equated these ideas with the relinquishment of industrial sovereignty to foreigners (Cumings 1997: 324-325). Since 1973, FDI had been allowed in Korea only when a business type was on the list approved by the Korean government, and full foreign ownership of a company operating in Korea investment was, in principle, not allowed. Even when the government allowed FDI, it attached conditions

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<sup>42</sup> The North Korean economy grew an average of 10 percent annually for the decade after the Korean War. For the 20 years after the Korean War ended in 1953, North Korea's economic growth exceeded that of South Korea (Cumings 1997: 433-434). Examples of North Korea's acts of provocation include a surprise attack on the South Korea presidential office by North Korean spies on 21 January 1968 and the kidnapping of the 83 crew members of the US naval vessel, *Pueblo* by the North Koreans two days later.

<sup>43</sup> After President Park announced the development plans for the heavy and chemical industries on 12 January 1973, he directed his senior economic advisor, Oh Won-Cheol, to explain the close relationship between the heavy and chemical industries and the defence industry to cabinet members, as a way of encouraging them to cooperate in his development plans for those industries. Oh Won-Cheol (2006: 221) claimed that the heavy chemical industry and the defence industry were two different sides of the same coin, saying: "The heavy and chemical industries and defence industries are the same industries. Weaponry is the product of the heavy and chemical industries; heavy and chemical industrial plants make industrial machinery in peace time and produce weaponry in war time."

such as export quotas and technology transfers (EPB 1981: 31). This is the political background to the low level of commitment of the Korean government in the SOM period. In addition, there were economic reasons.

Economic factors in relation to the shift of FDI policy can be found in the sudden increase of Japanese investment in the early 1970s. Japan's FDI activity in Korea was slow in the 1960s but started to rise dramatically in the early 1970s. In particular, in 1973, Korea recorded unprecedented FDI inflows of USD 318 million, which was eight times greater than the levels seen in 1971. Japanese investment accounted for 94 percent of FDI in 1973 while US and European firms supplied only five percent and one percent, respectively (Invest Korea 2006). The Korean government was alarmed at the sudden increase in FDI and even more concerned at the fact that Japanese investment was the main reason for the rise in inward investment. Japan became the leading investor in Korea ahead of the US in the early 1970s for two main reasons: firstly, Japanese companies began to look for a low-cost production base due to wage increases in Japan's manufacturing sector after the second half of the 1960s (Jones 2005: 93) and, secondly, Japan severed diplomatic ties with Taiwan because of the country's normalisation of diplomatic relations with China in 1972, which channelled Japanese investment from Taiwan to Korea (MOF and KDB 1993: 152). As Japan's FDI in Korea increased, the Korean government became aware of the possible dependence of the Korean economy on Japan's capital and technology. Therefore, the Korean government revised the 'Foreign Capital Inducement Law' in 1973 to strengthen restrictions on foreign investment.

In short, the circumstances described above called for a shift in the government's attitude to FDI, which we will discuss in the following chapter. Although the Korean

government had a strong need for foreign capital to fund economic development in the SOM phase, there was no overriding demand for FDI before the late 1970s, which consequently lessened the level of commitment of the government in the SOM period.

### Alternatives

As discussed earlier, the main focus of the Korean government with regard to FDI in the SOM period was on the capital transfer effect of FDI rather than other benefits that FDI could bring to a host country. In other words, the government's commitment to FDI mainly came from the need for capital from MNCs. This section will examine alternatives to FDI as a source of capital in the SOM period. The bargaining power of a host country *vis-à-vis* MNCs differs according to how many alternatives to FDI it has. Alternatives to FDI imply means for a host country to obtain capital, technology, and jobs other than FDI. In the SOM period, Korea had a strong demand for MNCs' capital as the accumulation of domestic capital and domestic savings remained at a low level. However, demands for capital could be fulfilled through foreign loans, which contributed to diminishing the stakes in FDI.

It is no exaggeration to say that the Korean economy in the 1950s entirely relied on foreign aid; from the liberation from Japanese rule in 1945 until the late 1950s, Korea's sole source of foreign capital was grant-type foreign aid, most of which came from the US and the rest from the United Nations. However, as we have seen foreign aid from the US started to decline in the latter part of the 1950s and so foreign borrowing became more important as a source of import financing. As Table 3.4 shows, the amount of aid was higher than foreign borrowing up until 1965, but foreign

borrowing started to exceed aid after 1966 and, as foreign borrowings increased, Korea's foreign debt rose rapidly from USD8.9 million in 1962 to USD1.8 billion in 1969. After the first oil shock in 1973, debt levels grew even faster; in the 1970s, foreign debts increased rapidly due to the import of capital goods for the promotion of the heavy and chemical industries, pushing total foreign debts to USD20 billion by 1979 (see table D).

Table 3.5 Foreign Borrowing: Korea 1962-1979 (Unit: million USD)

Year	Public Loans	Commercial Loans	Bank Loans	Total
1962	3	0	0	3
1963	43	24	0	67
1964	12	12	0	24
1965	5	35	0	40
1966	73	110	0	183
1967	106	124	0	230
1968	70	268	40	378
1969	139	410	30	579
1970	115	367	25	507
1971	303	345	90	738
1972	324	326	20	670
1973	403	461	49	913
1974	385	603	218	1,206
1975	477	801	200	1,478
1976	713	839	131	1,683
1977	636	1,241	300	2,177
1978	817	1,913	328	3,058
1979	1,089	1,578	1,522	4,189
Total	5,713	9,457	2,953	18,123

Source: Lee 2005: 624-625

Some foreign loans were provided to the Korean government by international

institutions or foreign countries (public loans), some came from foreign individuals, companies or private financial institutions to Korean companies (commercial loans), and others were loans from foreign financial institutions to Korean banks (bank loans) (MOF and KDB 1993). There were three factors that helped the Korean government to obtain loans in the SOM period.

Firstly, the Cold War provided Korea with favourable circumstances under which to access loans; in the 1960s, when competition heightened between the US and the Soviet Union, the Soviet Union was strengthening its foothold in less developed countries by increasing economic aid. The Kennedy administration regarded the Soviet's economic aid to less developed countries as more threatening to US security interests than the military threat posed by the country. President Kennedy believed that building a self-reliant economy was the best way for less developed countries to protect themselves from the communist threat and, therefore, he put more emphasis on economic aid than military aid. As for the means by which economic aid was delivered, he introduced a 'national development programmes' approach to ensure that the provision of aid was more consistent. In Kennedy's opinion, previous aid programs merely aimed to deal with crisis situations or achieve short-term political objectives and, as a result, they did not help the economic development of recipient countries (Gardner 1962: 150). The new approach aimed to draw on the self-help efforts of recipient countries; the recipients set sensible targets and the US government would provide development loans in line with the beneficiaries' goals.<sup>44</sup> The shift of US aid policy was partly due to US financial restrictions and partly due to the intention of encouraging

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<sup>44</sup> From the mid 1950s onwards, there was intense debate about US aid policy in Congress and academic circles, which led to the adoption of the 'Rostow line' foreign aid policy by the Kennedy administration in the late 1950s. The main idea of the Rostow line was to separate economic aid from military aid and to provide development loans based on recipient countries' long-term development plans (Jung 2000: 1).

recipient countries to increase capital productivity (Jung 2000: 69-76). In line with this policy, the US government provided public loans worth USD 311 million to Korea, which accounted for 69 percent of total public loans received by Korea in the 1960s (MOF and KDB 1993: 198).

The second factor that served the Korean government in accessing foreign loans in the SOM period was the Korean government's efforts to secure loans; President Park paid a visit to President Kennedy in 1961 and to the West German President Heinrich Lübke in 1964.<sup>45</sup> As we have seen, Park normalised diplomatic relations with Japan in 1965 and sent Korean troops to Vietnam between 1965 and 1973, partly in order to get loans from the US government. Such efforts were successful in that they led to more loans on better conditions; moreover, by guaranteeing repayments, the government improved private companies' access to loans. In the 1960s, the Korean economy was so unstable and weak that Korean companies could not access commercial loans on the basis of their own credit. Thus, the government enacted the 'Law for Payment Guarantee of Foreign Borrowing' in 1962, making it easier for Korean companies to earn loans from abroad. Between 1962 and 1979, public loans from foreign governments and international institutions accounted for 31 percent of Korea's total foreign debt, while commercial loans guaranteed by the government took a share of almost 52 percent. Therefore 83 percent of all loans were public loans or government-guaranteed commercial loans, which meant foreign lenders took a smaller risk in making loans to Korea. During the 1960s and 1970s, the confidence of Korea continued

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<sup>45</sup> Taking power in May, 1961, President Park ordered his aides to draw up economic development plans in June of the same year; Park established the Economic Planning Board in July, finalised the development plans in August and visited President Kennedy in November. This suggests that the purpose of the economic development plans was mostly to acquire aid and loans from the United States (Oh 2006: 59-60).

to increase due to the strong growth of the Korean economy and the country's good debt service performance, which raised the creditworthiness of the Korean economy and, in turn, enabled the Korean government and Korean companies to access more loans from abroad (Sakong 1993: 109-113).

Finally, the situation in the international financial market in the 1970s made it more affordable for Korean financial institutions to borrow money from international financial institutions (Stopfold and Strange 1991: 14). After the first oil shock in 1973, substantial amounts of capital flowed from the OPEC nations, who were benefiting from higher oil prices, to the European dollar markets, where they waited for potential borrowers (O'Brien and Williams 2004: 237). Due to the oversupply of money, borrowers drove the international financial markets in the 1970s and Korea, which was experiencing steady and fast economic growth, was considered to be a reliable borrower. The international political economy in the 1970s facilitated the government's securing of foreign loans, which expanded alternatives and consequently lowered levels of stakes in the SOM period.

With foreign loans, the Korean government was able to fill the savings gap that was caused by the discrepancy between domestic savings and investment. Thus, the government's demand for FDI was at a low level as long as foreign loans served as a good source of capital, particularly because the government regarded FDI only as one of a number of potential sources of capital. In fact, the government preferred foreign loans to FDI as a source of foreign capital for a number of reasons; firstly, there was a general fear of foreign domination of Korean industries. This fear is rooted in Korea's history of Japanese colonisation. The Japanese occupation in the early 20th century made Koreans sensitive to any potential loss of industrial sovereignty or domination by a foreign

power, a sensitivity that lasts to this day (Sakong 1993: 119). Foreign loans enabled companies to maintain ownership control as long as they paid their debts, while FDI usually involved the loss of ownership.

The second reason for preference for foreign loans was that the government could reinforce its control over domestic companies through control of foreign borrowings. As has been mentioned earlier, Korean companies in the 1960s could not qualify for loans from foreign banks or companies on the basis of their own credit. To solve this problem, the Korean government established a law in 1962 that enabled the government to co-sign the foreign loans for the private sector and required companies to obtain the government's approval and guarantee when they applied for foreign loans.<sup>46</sup> In the 1960s and 1970s, the government maintained high domestic interest rates to encourage domestic savings and so domestic interest rates were much higher than international interest rates.<sup>47</sup> Thus, access to foreign loans was profitable and was considered a preferential favour for Korean companies. The authority regarding the approval and guarantee of foreign loans enabled the government to strengthen its control over companies (Gang 1995: 63); the foreign loans reinforced the government's dominance over domestic companies while FDI might weaken government's power to control the economy.

Thirdly, in the 1960s and 1970s the Korean economy was at a fledgling stage, focused mainly on producing labour-intensive goods and not in need of the advanced

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<sup>46</sup> This law was included in the Foreign Capital Inducement Law in 1966; in its revision in 1973, the co-signatory changed from the government to financial institutions. However, as all financial institutions at that time were owned by the government, it was no different from the guarantee being made by the Korean government.

<sup>47</sup> Nominal interest rates in Korea ranged between 15 and 17 percent from 1961 to 1965, increased to 20-26 percent between 1965 and 1971, and declined a little but maintained an average of 15 percent between 1972 and 1980 (Lee 2005: 621). Comparing domestic and international real interest rates, domestic rates were higher by 3.1 percent from 1966 to 1970, 4.1 percent from 1971 to 1975 and 3.7 percent from 1976 to 1980 (Woo 1991: 104).



technologies, sophisticated management, or marketing skills that FDI could offer. These circumstances changed as Korean industry advanced but, in the SOM phase at least, the sophisticated technology or management that usually accompanied FDI was not crucial to businesses (Sakong 1993: 119). In conclusion, the Korean government and Korean companies in the SOM period did not favour FDI as a source of capital because they had other options for raising foreign capital and this presence of alternatives reduced the government's stake level.

### **Bargaining Constraints**

In the NBM, the dimension of relative constraints comprises two elements: internal and external constraints. Internal constraints include pressure from interest groups and the capabilities of the government agency responsible for FDI. The ability to deal with pressure from interest groups is closely related to the autonomy of the state; greater autonomy is likely to produce stronger bargaining power *vis-à-vis* MNCs because it can reduce obstacles in implementing its policy. As for the capabilities of the government agency, several factors such as its capabilities for coordination, implementation and resource mobilisation together with the level of decision making affect the bargaining power of a host country. External constraints include pressure from the home country and international institutions, which is closely related to the international political and economic order. In this section we consider the internal and external constraints that the Korean government had to face during the SOM period. In the SOM period, the developmental state could maintain a low level of internal and external constraints. The strong developmental state in the SOM period, which had strong autonomy and capacity,

could control domestic social groups and it could maintain a competent bargaining agency, which enabled it to restrict internal constraints to a low level. In addition, the international political circumstance, that is, the Cold War context, insulated the state from external pressures. We examine that how was it possible for the state to keep low levels of constraints internally and externally.

### Internal Constraints

In the 1960s and 1970s, the Korean developmental state maintained relatively strong autonomy, which offered the power to control domestic social groups. Korea's economic development during the SOM period was characterised as 'state-led economic development'. This was partly because, at this time, social groups lacked the power to challenge the state. After the Japanese occupation in the early 20th century (1910-1945), the US military administration (1945-1948) and the Korean War (1950-1953), the country in the SOM phase was not fully recovered from a period of confusion and destruction. New ruling classes had not yet formed after the collapse of the traditional class system under the Japanese domination and, with the SOM period covering the beginnings of industrialisation in Korea, neither a capitalist nor a labour class had yet established a firm influence (Seo 1991: 78-124).<sup>48</sup>

With the help of the state, the industrial capitalist class appeared during the SOM phase. Immediately after taking office in 1961, President Park accused most industrialists of illicit wealth accumulation.<sup>49</sup> However, realising that their management

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<sup>48</sup> Seo (1991) argued that Korea's industrial capital class emerged in the early 1960s as industrialisation started in earnest and consolidated in 1970s with the implementation of the controversial Heavy and Chemical Industry Policy.

<sup>49</sup> After liberation from Japan in 1945, there were few industrial properties that were owned by Koreans

resources were required to develop the economy, he decided to encourage them to contribute to the country rather than to punish them. After that the state controlled domestic capital in order to achieve its goal of industrialisation; the government deliberately concentrated resources on a small number of businesses (*chaebol*) to develop core industries because it had to achieve economies of scale in order to compete with forerunners despite the limited availability of resources. During the SOM period, the *chaebol* were at such an early stage of development and so nurtured by government support that it was unimaginable for companies to resist the government's directions.

The government controlled the *chaebol* with the traditional 'carrot and stick' method; the government supported specific companies or sectors by offering generous financial subsidies, guaranteed their foreign loans, provided them with 'policy loans' that had lower interest rates, and sometimes even froze the loans of companies when they were in trouble due to high debt levels (Woo 1991).<sup>50</sup> On the other hand, when companies failed to satisfy government criteria or demonstrated incompetence, they were disciplined by the state and were essentially removed from the market (Amsden 1989: 14-15). The main tool of discipline was the banks; when Park Chung-Hee took power in 1961, he immediately made nationalised the existing commercial banks, established special-purpose, state-owned banks, and amended the Bank of Korea Act to facilitate the central bank's cooperation with the state's long-term development efforts

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as the majority of properties were owned by the Japanese. In the 1950s, most Korean companies bought these Japanese properties from the government or participated in aid projects. Trade came to be dominated by politics rather than by competitiveness in the market and, therefore, most companies were involved in corruption (Lee Seung-Hun 2004: 126)

<sup>50</sup> Policy loans refer to those earmarked for specific sectors or industries and provided at lower rates than those of standard bank loans. They are one example of policy measures that aimed to support particular industries (Woo 1991: 12). A typical example of government action to support companies by freezing their loans is the '8.3 Action' or, to give it its official name, the 'Emergency Order for Economic Stability and Growth' announced by President Park on 3 August 1972. He exercised an emergency presidential order to save companies which were suffering from a heavy burden of debt from private money lenders. With the action, private loans were frozen, interest rates were lowered and funds were provided to the companies (Lee 2005: 437).

(Sakong 1993: 33). The government had a firm grip on the nation's financial resources, and, with this, it could mobilise the companies to achieve its goal of industrialisation. The *chaebol* were well aware of their lack of political and economic power and, as long as the state's policy conformed to their interests, the *chaebol* did not have any reason to challenge the state. Therefore, domestic capital was not constraining the power of the government during the SOM period.

Nor could labours challenge the government. In the 1960s, when labour was in oversupply and unemployment stood at more than five percent, there were few labour disputes and, therefore, no necessity to control the labour movement. Entering the 1970s, as the oversupply of unskilled workers gradually diminished and industrialisation progressed, the labour movement began to grow; in turn, the government attempted to rein in labour. To maintain price competitiveness in exports, it was necessary to stabilise wages at a low level and keep industries free from labour disputes. In 1971, the government outlawed the right to bargain collectively and the right to strike when it announced the 'Special Measures Law Concerning National Security'. In 1972, the revised 'Yushin' Constitution comprehensively restricted the basic rights of labour. Especially for foreign companies, the 'Interim Special Law on the Coordination of Labour Disputes and Labour Union of Foreign Companies' was implemented in January 1970, virtually blocking any movement by workers to organise labour unions and stage labour disputes at foreign-invested companies in Korea (Koo 2001: 56-57).<sup>51</sup> The state's power was strong enough to suspend the basic rights of labour while the labour force had not grown to the point where it could challenge the state. The weakness of societal forces and the lack of a dominant class brought about a power vacuum in

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<sup>51</sup> After being revised on two occasions the 'Interim Special Law on the Coordination of Labour Disputes and Labour Union of Foreign Companies' was abolished in 1986.

society, and the state was ready and willing to fill it (Bishop 1997: 71). Under these circumstances, the government was able to carry out its goals without encountering many obstacles from opposing forces; the state in the SOM phase was a strong state, able to remain aloof, to say 'no,' and to impose its will (Weiss and Hobson 1995: 148).

The capacity of bargaining institutions is one of the factors that affects internal constraints. According to Encarnation and Wells (1985a: 52), a government agency's bargaining power increases if the agency occupies a monopolistic or dominant position in the task; if the agency has the authority to evaluate the rest of the government; if the agency has access to resources such as financial revenues or political support; and if the agency has the capacity to integrate all functions within its domain. In other words, a bargaining agency with a superior position and powerful authority increases the host government's bargaining power. The Economic Development Board (EDB) of Singapore and the Ireland Development Agency (IDA), the two most successful bargaining agencies, indicate that competent institutions are crucial in achieving good performance in FDI.

As for bargaining institutions in Korea, there was a powerful and competent institution in SOM period: the Economic Planning Board (EPB). The EPB, created immediately after President Park took office in July 1961, was the key agency with responsibility for economic development. The most powerful institution in the administration, the EPB was in charge of drafting and implementing economic development plans and appropriating budgets for those plans (Sakong 1993: 26). The EPB's extensive duties included planning, resource sourcing, budget distribution, and policy coordination and, in fact, the head of the EPB served concurrently as deputy prime minister to give him the authority to coordinate the different interests of each

ministry and its policies. Ministers in economy-related positions, such as the Minister of Finance and the Minister of Commerce and Industry, were required to consult with the head of the EPB prior to making important decisions. The head of the EPB chaired the Economic Ministers' Consultation, where economic policies were coordinated, reflecting the EPB's dominant status as the pilot agency leading other ministries (Bishop 1997: 56-57).

Because the EPB's major role was to source and distribute resources and because, in the 1960s, the major resource for the economy were foreign capital, the EPB naturally undertook the functions relating to foreign capital. The Department of Foreign Capital Inducement (later renamed the Economic Cooperation Department) was the division in charge of sourcing foreign capital within the EPB (Gang 1995: 145). Its main function was sourcing foreign borrowing because foreign loans were the major source of capital inflows. Nevertheless, FDI was another major source of foreign capital and, accordingly, attracting and screening FDI became one of the functions of the Department. The EPB, as the chief economic planning institution as well as the resource distribution institution, was aware of what resources were required and where to allocate them. The EPB carefully selected the foreign firms and sectors which it wished to attract, negotiated individually and distributed the resources secured to selected domestic firms and sectors (Bishop 1997: 74-75). This strong authority and superiority contributed to boosting the EPB's bargaining power *vis-à-vis* MNCs.

In conclusion, the developmental state in the SOM period demonstrated a high level of autonomy as internal challenges were minimal. In addition, the EPB — with its team of élite officials and strong influence over policy-making — was able to increase the bargaining power of the Korean government.

## External Constraints

The external environments in the 1960s and 1970s acted as favourable conditions rather than constraints for Korea. As a result of its geopolitical location Korea became a significant beneficiary of US assistance during the Cold War; Korea was in the forefront of the Cold War, and the US government wanted Korea to be strong enough to counter the threat of communism. The US provided assistance to Korea with grant-in-aid in the 1950s and with development loans throughout the 1960s and the 1970s and was willing to be a market for Korean products, (Weiss and Hobson 1995: 166). In terms of the economy, once again the Cold War created advantageous circumstances for Korea rather than a threat. From 1946 to 1976, Korea received economic and military aid worth USD 12.6 billion from the US, USD 1 billion from Japan and USD 2 billion from international financial institutions. In terms of per capita aid, Korea ranked third (after Israel and Vietnam). From 1946 to 1976, the American government provided Korea with economic aid and loans worth USD6 billion, which almost equalled its aid to Africa (USD6.9 billion) and amounted to slightly less than half of the aid provided to Latin America (USD14.9 billion) (Woo 1991: 45, Stubbs 2005: 106).

The US government provided Korea with 69 percent of its public loans and 32 percent of its commercial loans in the 1960s, and 28 percent of its public loans and 24 percent of its commercial loans in the 1970s (MOF and KDB 1993). At the same time, the US succeeded in making Japan share its financial burden in East Asia. The American government acted as an invisible hand for normalising diplomatic relations between Korea and Japan in 1965, thereby succeeding in making Japanese funds contribute to Korea's economic development. As a result of the Korean rapprochement

with Japan, Korea received USD 300 million in grant-in-aid, USD 200 million in public loans and USD 300 million in commercial loans as reparations (although Japan refused to call it that, preferring the term ‘grant’) (Woo 1991: 85-87, Cumings 318-322). Until 1979, the sum of public loans provided by the Japanese government to Korea amounted to USD800 million, which accounted for 15 percent of total public loans during the SOM period. Apart from capital assistance, the US served as a major export market for Korea; after 1966, the US was always Korea’s most important export market. In 1962, Korea’s exports to the US accounted for only 22 percent of the total exports, but the share increased to 50 percent by the end of 1960s, which meant that half of Korea’s exports went to the US (Lee 2005: 623).

Against the backdrop of such support, the US government’s motivation for assisting Korea lay not only in the prevention of the Korean peninsula succumbing to communism but also in providing economic compensation for Korea’s dispatch of troops to the Vietnam War. Under US stewardship in the Cold War, the protectionist trade policy of Korea was tolerated and the Korean government could proceed with its regulatory policy regarding FDI without much pressure from outside. Korea deliberately blocked foreign MNC dominance of the Korean market and instead nurtured the *chaebol*. The Park regime faced virtually no significant pressure from external actors for the liberalisation of FDI; as a frontline state and a crucial part of the capitalist world’s strategy, Korea used its geographical situation to insulate itself from external pressure on its domestic policy (Bishop 1997: 77).



## **Evaluation of the government's bargaining power**

So far, each element of the Korean government's resources, stakes and constraints *vis-à-vis* MNCs during the SOM period has been discussed. Based on the findings of that discussion, we will now evaluate the level of each dimension and, using the NBM, will determine the bargaining power of the Korean government during the SOM period.

The model consists of three dimensions: resources, stakes, and constraints. Each dimension includes several elements: the resource dimension is determined by the host country's specific advantages; the stakes dimension is made up of commitment and alternatives; and the constraints dimension consists of internal and external constraints. Each dimension is divided into five levels: 'high', 'medium-high', 'medium', 'medium-low', and 'low'. Each element is categorised into three levels: 'high', 'medium' and 'low'. A high-level dimension refers to a situation where the levels of all the elements are high while a low-level dimension indicates that the levels of all the elements are low. A medium-level dimension refers to a case where each element is at medium level or when two elements are high and low, offsetting each other. Medium-high dimensions have high and medium elements, and medium-low dimensions have medium and low elements.

Firstly, we evaluate the dimension of resources. During the SOM period, Korea did not have an abundance of natural resources and was one of the poorest countries in the world in 1970; thus, Korea was not attractive to MNCs. Therefore, it was natural that there was little FDI aimed at gaining access to Korea's natural resources or market during the SOM period. However, Korea had a large pool of cheap but well-educated labour and these abundant human resources attracted MNCs that were looking for

production bases for labour-intensive industries. From the late 1960s onwards, FDI began to flow from Japan into Korea in labour-intensive industries such as electronics and textiles. At least for companies that wanted to reduce production costs, Korea during the SOM period was a good location in which to invest. In conclusion, Korea's resources were 'low' in terms of the market size and natural resources but 'medium' solely in terms of human resources. In all, the resource dimension can be determined 'medium low'.

Secondly, two elements determine the stakes level for Korea: the Korean government's level of commitment to FDI and the level of alternatives to FDI. Higher commitment and lower alternatives both result in an increase in the level of stakes. In terms of commitment, the Korean government in the 1960s was in desperate need of foreign capital since domestic capital was lacking and this raised the commitment level for all sources of foreign capital including FDI. However, as the Korean government promoted the heavy and chemical industries in the 1970s for security reasons, its commitment to FDI became lower. Moreover, the surge in Japanese FDI in light industries in the late 1960s caused the Korean government to worry about possible domination of the Korean economy by Japanese companies. Thus, the commitment level of the Korean government to FDI during the SOM period can be said to be 'medium'. As regards alternatives, Korea had easy access to loans from the US, Japan and international financial institutions for international political reasons during the Cold War era in the 1960s and 1970s. In addition, oil money from the first oil shock in the early 1970s flowed in the Euro money market, allowing less developed countries to access abundant development funds. Thus, the level of alternatives to FDI for the Korean government can be put at 'high', thus lowering the stakes. If we combine

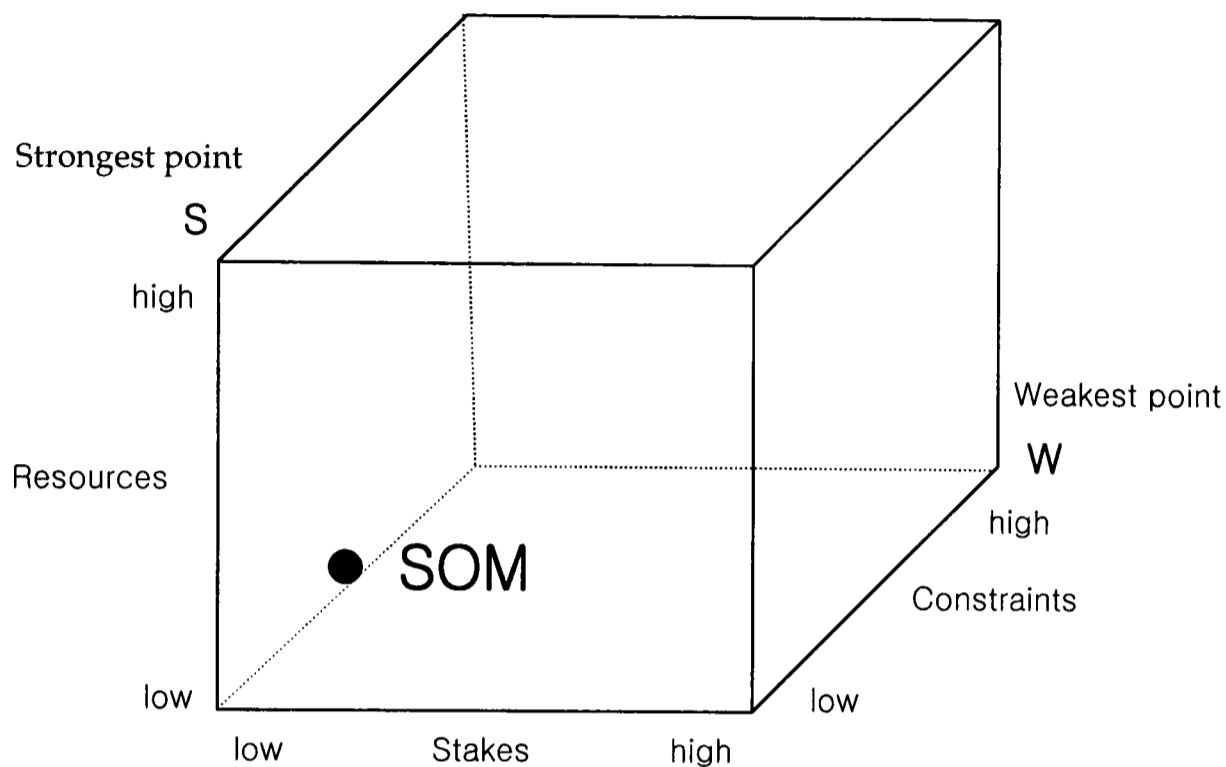
commitment and alternatives to FDI, the Korean government's stake during the SOM period is 'medium-low'.

Thirdly, the level of both internal and external constraints on the Korean government during the SOM period was 'low'. In terms of internal constraints, the Korean government was capable of autonomous decision-making with little interferences from domestic social groups and the bargaining institution of the government in the SOM phase was the powerful EPB. This autonomy and capacity put the internal constraints on the Korean government at a 'low' level. As regards external constraints, the international environment of the SOM period was favourable for the Korean government as the international community at that time was sympathetic to Korea, a poor nation at the frontline of the Cold War and the US government's attitude to Korea was concessive rather than competitive. These circumstances led external forces ignore Korea's protectionist policies and, therefore, the level of constraints on the Korean government during the SOM period was 'low'. Table 3.6 provides a summary of the discussion above.

Table 3.6 Korean Government's Bargaining Power: SOM Phase

Dimensions		Level of Dimensions		Level of Bargaining Power
Resources		Medium Low		Medium High
Stakes	Commitment	Medium	Medium Low	
	Alternatives	High		
Constraints	Internal	Low	Low	
	External	Low		

Figure 3.1 The Position of the Korean Government's Bargaining Power: SOM Phase



The NBM is three-dimensional and allows us to understand the level of each party's bargaining power by analysing their respective bargaining factors. With this model, the strengths and weaknesses of bargaining parties and the bargaining power of each party can be assessed. The Korean government's bargaining power during the SOM period was applied to the model, as is shown in Figure 3.1. When we put into position the levels of dimensions such as resources, stakes and constraints in the SOM phase, Korea's bargaining power is situated at point SOM. Point SOM is quite close to point S, which represents the highest level of bargaining power, but is further away from point W, which represents the lowest level of bargaining power. This implies that the bargaining power of the Korean government *vis-à-vis* MNCs in the SOM phase was relatively 'high'. It also confirms that this stronger bargaining power during the SOM

period can be attributed to Korea's low stake in and the low level of constraints in terms of FDI.

## **2. Market Over State**

The Asian crisis in 1997 forced Korea into the new phase of Market over State. This period began with the severe economic slump in 1998, when the economic growth rate plummeted to -6.9 percent, the unemployment rate soared to seven percent, the value of the Korean currency and stocks was cut in half, and, as a result, national income level fell by 34 percent. After the economic collapse in 1998, the nature of the Korean economy shifted rapidly as a result of these external forces and internal demands. The radical program required by the IMF as a condition for bailout funding brought about massive, market-driven reforms; in addition, the then-President Kim Dae-Jung wanted to use these foreign pressures as leverage to push through delayed domestic reforms (Mathew 1998). These forces completely reshaped the economy into a more neo-liberal model.

Government officials tried to distance themselves, both from developmentalism, identifying it as a cause of the crisis and from the state that brought about the collapse of the economy. Companies became more concerned about shareholders and short-term profits rather than stakeholders and long-term market shares and the banks were no longer the instruments of the state's industrial policy. Now they could focus their attention on securing safe and short-term margins for themselves instead ensuring uncertain but long-term gains for society. The job market was extremely unstable, with

layoffs becoming easier and companies switching to short-term hiring policies. All economic subjects — that is, the state, companies, banks, and workers — were more concerned about their short-term interests instead of their long-term visions and the economy fell into the short-termism.

Under the dominance of neo-liberalism, FDI policies also changed, becoming more open and market-friendly on the basis of this short-term view. The government abandoned its previous long-term approach to FDI and lost the power to implement its wishes. During the SOM period, FDI policy was regarded as an industrial policy; the government selected foreign firms using long-term considerations, and FDI was used as an instrument for realising the state's long-term goals. However, during the MOS period, the government lost its power to control foreign businesses and focused on the short-term goal of attracting certain amounts of FDI regardless its impact on the economy. No longer trying to manage FDI, the government instead tried to see what MNCs wanted, a situation that resulted from the shift in relative power between the government and the MNCs.

In the MOS period, though the bargaining resources of the country were significantly enhanced compared with the SOM period, the bargaining power of the government considerably shrank because of a high level of stakes and constraints. As the nature of the state became more akin to a neo-liberal state, the government increased its commitment to FDI. As the economy no longer enjoyed the advantages of a late developer, the industries required more sophisticated technology from MNCs for further development, which reduced alternatives to FDI. These factors contributed to raising the level of the stake in FDI. As for constraints, the Korean state in the MOS period, almost lost its developmental state attribute, faced with strong challenges from social groups.

At the same time, globalisation pressures acted as serious external constraints. The following section identifies these elements that weakened the Korean government's bargaining power in the MOS phase.

### **Bargaining Resources**

According to the survey carried out by the Korea Trade-Investment Promotion Agency (KOTRA) (1999) of the investment motivations of MNCs in Korea, the highest motivation for investment was the market (67 percent), followed by high productivity and efficiency in production (25 percent), and then by strategic resources such as new production technology (8 percent). These results indicated that market-seeking investment had increased significantly since an earlier survey carried out by the EPB in 1979.<sup>52</sup> Market-seeking investment was becoming the increasingly dominant form of FDI after 1998. In the past, production-oriented investment primarily sought low-cost labour but now, it pursued high productivity and efficiency, meaning that Korea's resources were shifting from the traditional to non-traditional. The advantage of low-cost labour disappeared and was being replaced by non-traditional resources such as infrastructure or specialist workers for efficiency-seeking investors. The following section analyses Korea's attractiveness to MNCs after 1998, focusing on market size, technological and human resources, and knowledge-based resources.

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<sup>52</sup> The EPB and KOTRA surveys were carried out in 1979 and 1999, respectively. In the intervening period, the MOF and KDB carried out a survey in 1993. The result of the MOF and KDB survey (1993: 566-567) showed clearly the transition characteristics of the location motivations. According to the survey, the motivations for foreign companies' investment in Korea were firstly, securing market access (42.6 percent), secondly, access to low-cost labour (26.3 percent) and, thirdly, securing a foothold for moving into third-country markets (16.2 percent).

Table 3.7 Population, GDP and GNI per capita: Korea 1998-2005

	Population (Thousand)	GDP (USD billion)	GNI per capita (USD)
1998	46,287	3,461 (17/210)	7,355 (N/A)
2000	47,008	5,118 (12/210)	10,841 (46/210)
2003	47,849	6,080 (11/210)	12,720 (50/210)
2005	48,294	7,875 (12/210)	16,291 (29/210)

Note: Korea's world ranking shown in parentheses

Source: BOK 2005, NSO 2006

In terms of relative market size, Korea was the 12th biggest market in the world in terms of GDP by 2005, positioning itself as an attractive country in which market-seekers could invest. Although Korea's GDP recorded an economic growth rate of -6.9 percent in 1998 due to the economic crisis, the economy recovered its stability after 1999 (see Table A). In 2005 Korea's GDP was USD 787 billion; *per capita* GDP stood at USD 16,291 in 2005, ranking 29th in the world (NSO 2006). The relatively high *per capita* GDP, the population of 48 million and high levels of consumer sophistication made Korea an attractive market.

Table 3.8 Average Monthly Wages: Selected Countries, Manufacturing Industry (USD)

Year	Korea	Taiwan	China	Japan	US
1998	917	1,086	71	3,113	2,442
2000	1,386	1,241	88	3,773	2,569
2002	1,486	1,106	110	3,207	2,718

Source: KLI 2004: 161

As regards resource-seeking investment, Korea made the transition from a traditional resource base to a non-traditional resource base; this, in turn reflected the transition in



terms of the technological nature of Korean products in the product life-cycle.<sup>53</sup> The period of producing mature or standardized products came to an end during the MOS period. The labour costs of Korea were notably higher than those of China or Southeast Asian countries; as can be seen in Table 3.8, wages in Korea were 13.5 times higher than those of China in 2002. From the late 1980s onwards, surging wage levels in Korea eroded the country's attractiveness as a location for cost-cautious investors. As a result of these high labour costs, Korea lost its competitiveness in the production of the standardized products and has reached a stage where the production of higher value-added, innovative products was demanded. That is, Korea was at a stage where the quality of the workforce was more important than the cost and where technological progress was more significant as a production factor.

As innovation and technology assumed a greater role in economic growth, the quality of human capital became both more critical than its cost and it is also the crucial factor in attracting FDI (Blomström and Kokko 2003, Noorbakhsh *et al* 2001, Porter 1990, Dunning 1998b). Therefore the role of education, which improves the quality of human capital, becomes more and more essential, not only for long-term economic growth but also for inducing FDI. The quality of a country's workforce is in many ways related to the country's educational environment and system because human capital is essentially produced through a country's educational system. Therefore, to assess the quality of the workforce, it is essential to evaluate the educational environment in a country.

In terms of the quality of Korea's human resources, evaluations are mixed in that

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<sup>53</sup> Vernon (1966) claimed in his product life cycle theory that, as the nature of US corporations' products changed from the developing stage to the maturing stage and then to the standardized stage, their production bases also moved from the US to other developed countries and then to developing countries.

they highlight both positive and negative aspects. Assessing the educational achievement in Korea by quantitative criteria, the performance of the educational system was quite positive. Its primary and secondary school attendance was virtually 100 percent, and the tertiary enrolment exceeded 80 percent, which was the second highest in the world (WEF 2005: 538). According to the OECD (2006), Korea invested 7.1 percent of its GDP in education, giving the country a ranking of 5th among the 28 OECD member countries. Furthermore, it should be noted that these figures were based only on the public education sector; when investment in private education was included (estimated to be 3.2 percent of GDP), total investment in education exceeded 10 percent of GDP, which was the highest level in the world (Yang *et al* 2004: 168). According to quantitative criteria, accomplishments in the educational sector in Korea were at the highest level, but, when it came to qualitative standards, the performance of its system receives a negative assessment. According to the IMD's 1999 analysis of 47 countries, Korea ranked 44th in terms of the educational system's contribution to the country's competitiveness, 47th in the quality of university education, 43rd in the availability of qualified engineers, and 40th in the availability of skilled labour (IMD 1999). Despite the highest levels of investment in the educational system, its quality was considered low, and thus the educational system could be considered to suffer from low productivity. The low productivity of the Korean educational system led to high demand for overseas education, and Korean students accounted for the majority of foreign students in the US.<sup>54</sup> However, as can be seen from the high brain-drain rate, it remains

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<sup>54</sup> In September 2006, the number of Korean students at US universities was 87,724, making up 14.4 percent of the total students from overseas — the highest percentage of any single group in the US overseas student community. The Koreans are followed by students from India (68,451 students/12.1 percent), China (54,486 students/9.3 percent), Japan (49,338 students/8.6 percent), and Taiwan (37,627 students/5.6 percent). The ratio of Korean students is remarkably high considering that Korea's population is 4.4 percent of that of India, 3.6 percent of China, and 37 percent of Japan. (*Chosun Ilbo* 2

doubtful whether Korean students overseas would return home and contribute to Korean economy after their graduation.<sup>55</sup> Accordingly, it is wrong to say that MNCs are investing in Korea because of its high-quality human capital.

In the globalizing economy, knowledge-intensive assets are an increasingly critical factor in the enhancement of a company's competitiveness. A company that tries to increase its competitiveness through FDI must seriously consider the issue of access to technology and innovation capacity as well as matters relating to cost reduction or market access (UNCTAD 1998, Dunning 1993b). Korea's knowledge-based assets recently grew rapidly; according to OECD statistics (2006), Korea's investment in R&D in 2003 amounted to 2.36 percent of GDP, positioning Korea as the 6th highest among OECD member nations, while investment in knowledge industries accounted for 5.9 percent of GDP, resulting in a ranking of 4th among OECD nations. Korea, in particular, is showing strength in the ICT industry; in the percentage of households with access to a home computer Korea was ranked 3rd among OECD nations and the investment ratio of the ICT industry as a percentage GDP is 16.4 percent, which is the 11th highest among the OECD member nations (OECD 2006).

While it is true that Korea has experienced rapid growth in knowledge-based resources, it cannot be said that these resources are sufficiently advanced to attract world-class MNCs. Korea's investment in R&D amounted to 2.63 percent of GDP in 2003, which was similar to that of the United States (2.68 percent), but in terms of absolute investment value, Korea accounted for only four percent of the amount invested by the US and 11 percent of that invested by Japan. As for patent, the US held

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November 2006)

<sup>55</sup> According to the IMD (1999), Korea is ranked 33rd of 47 countries in terms of the brain drain, which means that the outflow of gifted human capital in Korea is relatively high.

36.4 percent of the world's patents and Japan held 25.7 percent, whereas Korea's share was only 1.4 percent in 2002.<sup>56</sup> Korea is still highly dependent on foreign technology, which was revealed in the size of the deficit in the technology balance of payments in 2001 (USD2.1 billion or 0.61 percent of GDP), ranking Korea 23rd among the OECD's 24 member countries (Ha 2004: 144, Yang *et al* 2004: 164). In terms of absolute scale or level of the knowledge industry, Korea lagged far behind the United States or Japan and still relied to a great extent on foreign technologies and knowledge for its industries. In 1999 the IMD ranked the overall attractiveness of Korea's R&D activities as 32nd among 47 countries; therefore, it is too early to say whether or not Korea's knowledge assets are working to attract foreign companies.

As MNCs seek to invest in knowledge-intensive industries, they gravitate to spatial clusters of related activities. These industrial clusters create external economies that help to upgrade the competitive advantage of the participating firms, and these externalities, in turn, attract firms to locations where such clusters exist. The presence of a cluster is becoming a critical factor in the choice of location for firms, and the creation of clusters of certain industries has emerged as a critical task for governments seeking to attract foreign companies (UNCTAD 1998: 114). Infrastructure quality and the degree of industrialization are considered to be important factors in the creation of clusters (Wheeler and Mody 1992), and Korea seemed to be strong in both regards.

Firstly, Korea earned a relatively high reputation for the quality of its infrastructure; in 1999 the IMD ranked Korea as 7th among 47 countries in terms of air transportation services, 7th in telecommunications and 8th in terms of the cost of

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<sup>56</sup> The share of patents is based on the 'triadic patent families' which the OECD has developed as a patent indicator. 'Triadic patent families' are a set of patents registered at all three of the major patent office – the European Patent Office (EPO), the Japanese Patent Office (JPO) and the United States Patent and Trademark Office (USPTO) (OECD 2006:134).

electricity for industrial clients (IMD 1999). In 2005, Incheon International Airport was one of the top three airports in the world in terms of cargo handling capacity and Busan port was the 5th largest container port in the world. Korea was also the 10th largest electricity producing country, providing electricity at the lowest cost among the Asian industrialized countries (Invest Korea 2005). Secondly, as for the level of industrialization, Korea's manufacturing industry had a relatively sturdy foundation, showing strength in electronics, automobiles, steel, and shipbuilding. In 2003, Korea's automobile production was ranked 6th in the world, shipbuilding was ranked 1st, steel production 5th and electronic production 3rd (NSO 2005). Other than these traditional manufacturing industries, Korea performed remarkably well in new industries such as the information and ICT fields. The OECD (2006) reported that Korea's ICT equipment exports ranked 4th in terms of value among the OECD member countries in 2004.

However, despite the relatively well-prepared infrastructure and the sturdy industrial structure, there were no outstanding industrial clusters in Korea, which reduced the country's attractiveness as an industrial location. Moreover, unstable labour-management relations were often pointed out as a weakness of Korean industry; in 1999 the IMD ranked Korea 46th out of 47 countries in terms of labour-management relations.

Table 3.9 The Ranking of Major industries: Korea 2003

	Automobile	Shipbuilding	Steel	Electronics	ICT equipment
1	US	<b>Korea</b>	China	US	China
2	Japan	Japan	Japan	Japan	US
3	Germany	China	US	<b>Korea</b>	Japan
4	China	Germany	Russia	Germany	Germany
5	France	Italy	<b>Korea</b>	Malaysia	<b>Korea</b>
6	<b>Korea</b>	Spain	Germany	Taiwan	The Netherlands

Source: NSO 2005, OECD 2006

Korea had many strong factors in terms of resources: the 12th largest market in the world, relatively high purchasing power arising from relatively high income, and a sturdy industrial foundation where traditional and new industries are balanced in terms of their development. These factors are what attract MNCs to Korea, and these are also the bargaining resources for the Korean government. However, the lack of quality human capital as well as leading technology and innovation capacity were the reasons that Korea's attractiveness for foreign investors had not yet turned away from the traditional resource base towards the non-traditional resource base.

### **Bargaining Stakes**

#### **Commitment**

In terms of commitment, the Korean government in the MOS period had high levels of commitment to attracting FDI. In the 1997 presidential election, which took on 18 December amid the confusion of the economic crisis, Kim Dae-Jung was victorious and his government began its five-year term of office in February 1998 at the height of the crisis. President Kim, a proponent of neo-liberal economic policies, had a strong commitment to FDI which is clearly demonstrated in his inaugural address on 25 February 1998:

Our government will make as much effort to attract foreign capital as to promote exports. Attracting foreign capital is the most effective way to pay back our foreign debt, to strengthen local companies and enhance the transparency of our economy (Kim 2004: 22).

As he stated in his inaugural address, Kim Dae-Jung saw foreign capital not only as a means to make up for the lack of domestic capital, but also as a way to accelerate competition among domestic companies, which could promote the strengthening of their competitiveness and the implementation of the corporate restructuring process. This is also clearly stated in the 'Economic Blueprint of the Kim Dae-Jung administration,' which was published early in the administration:

The opening of the economy, which promotes unlimited competition, can lead to a fundamental change in the economic structure in which the structural problems of the economic crisis such as collusion between politics, business and government-dictated-finance, created (MOFE and KDI 1998: 211).

President Kim recognized that the crisis occurred as a result of the legacy of the previous interventionist policy, specifically the strong connection between state, business and banks. In order to dismantle the old system, he needed strong power to break the nexus between them; he found this power outside the system in the form of pressure from the IMF and foreign companies. To Kim, the pressure from the IMF provided strong support for his reforms and foreign companies were the tool for carrying out reforms (Mathew 1998). In this situation, attracting foreign capital was publicized, not just as the means to overcome the crisis, but also as the shortcut for Korea to upgrade its economy (KIEP 1998).

According to the Kim government, the main causes of the economic crisis included the inefficient *chaebol*, operating on the basis of excessive debt, the financial agencies that followed government directions and the previous government's failure to supervise capital movement (MOFE and KDI 1998). Therefore, the *chaebol* and

domestic financial agencies were labelled as the principal offenders in the economic crisis; they became the targets for reform while foreign companies became the means to rescue the Korean economy from crisis (Shin and Chang 2003: 103). The Kim administration carried out policies that favoured foreign companies to such an extent that domestic companies complained they were suffering reverse discrimination and the government's focus on FDI was sometimes seen as an 'obsession for attracting foreign investment' (FKI 2005: 1). Therefore, it is clear that the Kim administration's commitment to FDI was very high.

President Roh Moo-Hyun (February 2003 to present), as Kim Dae-Jung's successor, followed the ideology of the previous administration and there were no great differences in economic policies from those of its predecessor. Initially, the Roh government presented its central goal as 'the establishing Korea as the hub of Northeast Asia' and launched a presidential committee to promote the project.<sup>57</sup> His determination to make Korea the hub of Northeast Asia is shown in his inaugural address on 25 February 2003:

The Korean Peninsula is located at the centre of Northeast Asia. The Korean Peninsula is the bridge that connects China and Japan, the continent and the ocean. This geographical position brought us pain in the past, but today it offers us an opportunity. It demands that we play the central role in Northeast Asia in the 21<sup>st</sup> century. We have gifted minds, creativity and a first-class foundation for the information age. We are also constructing the

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<sup>57</sup> The basic idea of the Roh Moo-Hyun government's vision of the 'Northeast Asia hub' was presented at the press conference of his predecessor, Kim Dae-Jung in January 2002, and therefore the Roh administration's goal of 'building the hub of Northeast Asian economy' is in line with the policies of the Kim Dae-Jung administration. The law governing the policy, the 'Act on the Designation and Management of Free Economic Zones,' was enacted on 30 December 2002 under the Kim Dae-Jung administration. Therefore, the Roh Moo-Hyun government's idea of 'building the hub of the Northeast Asian economy' should be seen not as a new policy but rather as the implementation of a plan that had already been decided under Kim Dae-Jung (Lee and Park 2003: 65-68).



logistics fundamentals in the sky, the ocean and on the land by building Incheon International Airport, Busan Port, Gwangyang Port and producing bullet trains. We are constructing the foundations for the Northeast Asia era in the 21st century. The Korean Peninsula can be born again as the hub of Northeast Asian logistics and finance (Presidential Secretary 2003: 27).

‘Building the Hub of Northeast Asia’ refers to the building up of Korea into the centre of logistics, finance, and economy in Northeast Asia, exploiting its central position between China and Japan (PCNACI 2003). To achieve this goal, the Roh government designated Incheon, Busan, and Gwangyang as special free economic zones, offering a foreign business-friendly environment. The idea was to develop the three regions as international business locations by attracting foreign companies from locations such as Hong Kong or Singapore. At the heart of this strategy stands FDI; the promotion of FDI was central to the Roh Moo-Hyun administration’s goal and, in this sense, the Roh Moo-Hyun government’s commitment to the FDI is also very strong. In summary, during the MOS period since 1998, the Korean government’s commitment level can be said to be high.

## Alternatives

During the SOM period, the government treated FDI as one of source of foreign capital, and concerned itself principally with the capital transfer effects of FDI. However, as the economy developed, the government became more interested in the technology transfer effects of FDI, particularly since the 1990s. Hence, during the MOS period, we should examine the alternatives to FDI in terms of both of these aspects: the capital and technology alternatives to FDI. During the MOS period when the economy was in crisis,

the capital effects of FDI were stressed whereas the technology effects of FDI became more important to the economy when the crisis was over. In both forms of FDI effects, the Korean government could find few alternatives to FDI in the MOS period.

Firstly, with respect to the capital transfer effects, FDI was emphasised as an important source of foreign currency when the country faced an extreme shortage of foreign currency at the beginning of MOS period. In late 1997, there was a rapid outflow of foreign exchange that caused the Korean *won* to depreciate to half its former value and exhausted the foreign capital reserves of the central bank (see Table D). These economic troubles led to a drastic decline in Korea's sovereign credit rating and the downgrading of Korean corporate bonds to junk bond status (MOFE 2002: 55).<sup>58</sup> Foreign financial agencies rushed to redeem their bonds in Korea, and were reluctant to extend credit or issue further credit to Korean interests. By early 1998, the situation had become desperate, as was illustrated by the 'gold gathering campaign' that was launched in January 1998 with the aim of gaining access to gold held in private hands.<sup>59</sup> In this situation, it was extremely difficult and costly for the Korean government or Korean companies to obtain new loans or to issue bonds.<sup>60</sup> When borrowing becomes problematic, the final option is the sale of assets to obtain foreign currency. The government therefore pressured domestic businesses to sell their assets, resulting in the

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<sup>58</sup> Korea's sovereign credit rating decreased from AA before the crisis down to B+ on 23 December 1997, a 10-step drop in the Standard and Poors (S&P) rating. Under Moody's system, Korea's rating dropped six steps, from A1 to Ba1 (21 December 1997). S&P rated Korean bonds as unsuitable for investment from December 1997 to January 1999 as did Moody's from December 1997 to February 1999 (MOFE 2002: 55).

<sup>59</sup> The 'gold gathering campaign' was a public-initiated campaign that aimed encouraged people to sell their gold to the banks, where it was converted into foreign exchange. This campaign raised about USD2 billion from the sale of gold by private owners (*Chosun Ilbo* 19 October 1998)

<sup>60</sup> In response to the instability of the Korean currency, the Korean government issued foreign exchange stabilization fund bonds to the value of USD10 billion worth in New York in April 1998. The spread of the bond became the index of the loan interest of the domestic financial agencies when they obtain foreign loan. The spread of the government-issued foreign exchange stabilization fund bond (FESFB) was 3.55 percent above the US Treasury bond (TB) rate when it was issued first in April 1998. In August 1998, it rose by more than 10 percent but dropped by 3.82 percent in late 1998 (BOK 1998: 78).

high levels of FDI activity shortly after the crisis (Shin and Chang 2003: 104).

Table 3.10 Foreign Debt: Korea 1990-2004

(Unit: USD billion, %)

	Total foreign debt	Net foreign debt	Short-term foreign debt	Foreign exchange reserve	Short-term foreign debt / total foreign debt	Total foreign debt / GDP
1990	31.7	4.8	14.3	14.8	45.2	12.0
1991	39.1	11.9	17.2	13.7	44.0	12.7
1992	42.8	11.0	18.5	17.1	43.2	13.0
1993	43.8	7.8	19.1	20.2	43.7	12.1
1994	89.8	18.2	38.4	25.6	42.8	21.2
1995	119.8	25.4	54.8	32.7	45.8	23.2
1996	157.3	46.2	75.8	33.2	48.2	28.2
1997	174.2	68.0	63.7	20.4	36.6	33.7
1998	163.8	34.5	39.5	52.0	24.2	47.3
1999	152.9	6.8	43.0	74.0	28.2	34.4
2000	148.1	-18.8	49.6	96.1	33.5	28.9
2001	128.6	-34.7	40.2	102.8	31.3	26.7
2002	141.7	-42.0	48.1	121.4	34.1	25.9
2003	157.5	-71.6	50.8	155.3	32.2	25.9
2004	172.2	-111.9	56.3	199.0	32.7	25.3

Source: BOK 2006

In addition, after the crisis the government placed emphasis on the stability of capital because it recognised that one of most immediate causes of the financial crisis was the sudden outflow of large amounts of unstable capital (Lee Jay-Min 2002: 214). The most serious problem was the amount of short-term debt, which exceeded the Korean central bank's foreign exchange reserves. While Korea's foreign debt problem in the early 1980s was due to the volume of foreign debt, which was equivalent to 50

percent of GDP, the 1997 financial crisis resulted from the foreign debt structure, with short-term debt accounting for more than 40 percent of total foreign debt in 1997. As can be seen in Table 3.10, short-term debt in 1996 amounted to USD 75.8 billion and foreign exchange reserves were just USD 33.2 billion (BOK 2006). These short-term loans were recalled or were not rolled over after October 1997, as a result of which the economy plunged into crisis.<sup>61</sup> This painful experience led the government to avoid volatile capital. In contrast, FDI was regarded as a relatively stable way to secure foreign capital because it was assumed that foreign companies make investment decisions in line with their long-term strategies and that, once they make such an investment, it is difficult to withdraw. Therefore, there were few alternatives to FDI as a stable source of foreign capital.

Secondly, FDI became an important means of technology transfer at a time when Korean industry was most in need of new technology. According to Amsden (1989: 20-21), Korea was originally industrialised by means of acquired technology and imitation, and later industrialisation was primarily achieved through the purchase of foreign licences and technical assistance. These methods were possible because the technologies during the SOM period were standard or matured ones. However, during the MOS period, technology became a decisive factor for further development. As the gap in production costs between developed countries and Korea was narrowing, a development strategy based on low labour costs and purchased technology was no longer viable; enhancing productivity and creating innovation were critical for further development.

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<sup>61</sup> In one year in 1997, foreign financial institutions retrieved USD37.6 billion in short-term loans. In particular, during November and December in 1997, USD20.7 billion (55 percent of whole amount retrieved in 1997) was withdrawn. On the other hand, the central bank's foreign exchange reserves were maintained around the USD30 billion level from January to September in 1997 (Gang 2005: 573-575).

Krugman (1994) argued that the economic growth of East Asian countries was driven mainly by increases in factor inputs and not by increases in productivity or technological progress. This is also applicable to the Korean economy as the increase in factor inputs has been main contribution to its economic growth. Sources of economic growth for Korea, the UK and Germany show that Korea's economic growth has been the result of increasing factor inputs rather than improved productivity (See Table 3.11).

Table 3.11 Growth Accounting: Korea, UK and Germany

	GDP Growth	Contribution of Capital	Contribution of Labour	Contribution of TFP
Korea (1966-90)	10.3%	4.7% (46.2%)	4.3% (42.2%)	1.2% (11.6%)
UK (1960-90)	2.4%	1.3% (52.3%)	-0.1% (-4.2%)	1.9% (51.9%)
Germany (1960-90)	3.2%	1.8% (58.7%)	-0.2% (-8.1%)	1.5% (49.4%)

Note: TFP: Total Factor Productivity

Source: Barro and Sala-i-Martin 1995: 380-381

This increase of capital and labour input reached its limit during the MOS period; the marginal productivity of capital continued to decrease, and the input of workers was no longer increasing as in the previous period.<sup>62</sup> The limitations of factor input growth became one of the reasons for the slowdown in the rate of economic growth during the MOS period. Table 3.12 shows that the average economic growth rate between the crisis and 2005 was 4.2 percent, which is a much lower rate than that recorded in the SOM period (1962-1979) and the transition period (1980-1997).<sup>63</sup>

<sup>62</sup> Comparing the US and Korea in 2000, Korea's *per capita* physical capital formulation and *per capita* human capital formulation accounted for 93 percent and 85 percent respectively of the levels seen in the US. However, Korea's productivity was only 50 percent of the level achieved in America (Ha 2004: 141-144).

<sup>63</sup> According to Shin and Chang (2003), the collapse of the developmental state in Korea resulted in the disappearance of economic vitality and the slowdown of economic growth rate.

Table 3.12 GDP Growth Rate and Gross Fixed Capital Formation Increase Rate: Korea

Year	SOM period	Transition period	MOS period
Average of GDP Growth Rate	8.5%	7.6%	4.2%
Average of Gross Fixed Capital Formation Increase Rate	20.3%	9.4%	1.5%

Source: BOK 2006

The Korean economy had reached a stage where it was seeking growth through innovation and technological progress; however, its relatively weak innovation capacity curbed its potential and so Korea had to find a new engine for growth. Furthermore, during the MOS period, Korean companies found it increasingly difficult to obtain technology because they were no longer seeking matured or standard technologies but rather cutting edge, innovative knowledge. Foreign companies did not want to transfer their new technology to Korean companies who were seen as potential competitors (Bishop 1997: 128-129) and this situation limited Korea's alternatives for obtaining technology other than through FDI. In summary, the capital alternatives other than FDI were unstable and costly, and the technology alternatives other than FDI were difficult to access during the MOS period.

### **Bargaining Constraints**

#### **Internal Constraints**

In the MOS period, the state, whose autonomy and capacity was weakened, faced serious challenges from labour and capital, even though their challenges abated for a

while just after the crisis. The strong state's autonomy with regard to social groups during the SOM period started to weaken in the transition period. In accordance with Evans' 'gravediggers' thesis (1995: 227-233), as the developmental state grew, gravediggers emerged within the economy, who eventually would dismantle the developmental state. In the case of the Korean developmental state, private capital and the labour class were the major social groups that posed a challenge to the state.

Firstly, the *chaebol*, who had been obedient in their relations with the state during the SOM period, started to challenge it during the 1990s. This was enabled by several significant changes: firstly, the government's financial control over business was weakened. The government in the SOM phase was able to control businesses by directing financial institutions to follow its bidding but, beginning in the 1980s, the government policy loans while the conglomerates diversified their sources of finance, thus curtailing their dependence on bank loans (Park 2005: 33). Secondly, the *chaebol* were able to move their capital and products around the world as the mobility of international capital increased. This afforded them more liberty and, at the same time, fuelled their desire to escape government control. Private companies began to obtain finance from abroad without the assistance of the government and expanded their production locations, eventually reducing the state's influence over the *chaebol* (Kim Yun-Tae 2003: 307-308). Emboldened by their size and economic influence, the *chaebol* made it clear that they opposed the government's intervention and demanded the government's retreat from the market. Thus, the relationship between the government and the *chaebol* progressively became more equal from the 1990s onwards (Evans 1995: 229).

Secondly, the labour class began to challenge the government from the late

1980s. The labour class, which had grown in power along with Korea's industrialisation, started to demand its due rights, becoming more organised as democratisation progressed. The challenge from labour erupted in the late 1980s; in 1987, labour disputes spread throughout the country, increasing 12-fold compared with 1986 (see Table E). After 1990, labour disputes decreased but the labour movement reinforced its solidarity by creating the radical and combative Korean Confederation of Trade Unions (KCTU), a nationwide progressive labour conference. Meanwhile, the Korean government acknowledged the Federation of Korean Trade Unions (FKTU) — which was relatively moderate and conservative — as the only national labour organisation and suppressed any other movement that aimed to organise a national organisation of labour unions (Koo 2001: 298). Such an intensification and organisation of labour movements made foreign companies avoid Korea (Bishop 1997: 113).

Throughout the 1980s and 1990s, both groups grew sufficiently powerful to challenge the state. However, moving into the MOS period, their power rapidly shrank because they were regarded by the public as major factors in the creation of the crisis. Specifically, they were for the collapse in the competitiveness of Korean industries which led to the increase in the current account deficit and, ultimately, to the crisis. The deterioration of Korea's competitiveness was caused by what is called the 'high-cost, low-efficiency structure' of Korean industry, in which productivity levels were low in contrast to the high cost of finance, land and labour costs. There was a perception that behind this problematic structure stood the *chaebol* and the labour force (Beck 1998).

The *chaebol* and labour — which were both major challengers to the state before the crisis — came to be labelled as the ringleaders that had pushed the country toward economic crisis, and therefore they became the target of public criticism. The IMF



included the *chaebol* and the labour force in its restructuring program, and the Kim Dae-Jung government took advantage of the external pressure and the negative public sentiment to re-establish control over both the *chaebol* and labour. The Kim Dae-Jung government identified the inefficiency and moral hazard of the *chaebol* as the major reason for the crisis and labelled labour's collective action 'collective selfishness' that had reduced the country's confidence.

The Kim Dae-Jung government carried out comprehensive reforms in order to strengthen the regulations relating to the *chaebol* (MOFE and KDI 1998); the conglomerates had to lower their debt-to-equity ratio within a short period of time and were banned from using internal transactions and mutual payment guarantees among their affiliates. The *chaebol* were forced to concentrate their resources on their core business or competitive sectors, and in order to do so, they were compelled to sell, close, or exchange their peripheral businesses. To introduce free market principles in more radical way, legislation was enacted allowing for mergers and acquisitions (M&A) by foreign companies and even hostile M&A transactions were allowed.

Labour also started to lose its power after the crisis. The government tried to launch the Tripartite Commission — consisting of representatives of the government, management, and labour — as the institution to produce social consensus to cope with the crisis. In fact, the launch of the commission was motivated by the desire to bring in a layoff system. At first, the labour unions strongly resisted, but they gave in to public pressure for compromise rather than conflict at a time of crisis and this was soon followed by the launch of the Tripartite Commission (5 January 1998) and the promulgation of a joint agreement (6 February 1998) (Go 2005: 172-173). The core of the joint agreement was that labour accepted the 'layoff system' and the 'labour dispatch

system' on condition that the government allowed the establishment of labour unions for government workers and teachers and gave them the right to engage in political activity.

<sup>64</sup> This commitment by labour, which led to a weakening of their rights, would have been unthinkable in former administrations. The Kim Dae-Jung administration made an effective use of public sentiment and IMF pressure to control the labour force and achieve its goal. Through dealing with this critical situation, the power of both the *chaebol* and labour was weakened, and the Kim Dae-Jung administration was able to maintain relatively strong autonomy without facing critical internal challenges (Weiss 2003b).

However, the autonomy of the Kim Dae-Jung government was not as strong as that which former President Park Chung-Hee exercised during the SOM period. The Kim Dae-Jung government took advantage of the crisis to weaken internal resistance in the immediate post-crisis period, but internal forces were no longer restrained in the latter part of the Kim Dae-Jung government and under the following Roh Moo-Hyun administration. In the crisis, the growth of the *chaebol* halted briefly, but after the turn of the 21st century, the *chaebol* expanded once more, becoming global multinational companies. Labour founded the Democratic Labour Party to represent them on the basis of the tripartite agreement and thus came to participate officially in the political process; since 2000, labour disputes have been on the rise again (see Table E). State autonomy during the MOS period was enhanced just after the crisis, but, overall, it was lower than that seen in the SOM period.

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<sup>64</sup> In July 1998, the National Assembly passed the bills governing the layoff system and the labour dispatch system. The 'layoff system' means that the companies can dismiss the workers in case of urgent management issues. Through the legislation of the layoff system, it became easier for companies to dismiss their workers. The 'labour dispatch system' means a system where human resource supply agencies hire workers to dispatch them to other companies, working under that companies' orders and instructions. The user of the agency came to have the flexibility in employment as they did not have to hire full-time workers and, on the other hand, the workers lost the stability in employment.

In terms of the capacity of bargaining institutions, which is one of the factors of internal constraints, there was a significant change with the enactment of the Foreign Investment Promotion Act (FIPA). As the title suggests, the 1998 FIPA was designed to promote, rather than control or manage FDI and this demonstrated the dramatic shift in the government's attitude toward FDI after 1998. The act called for the establishment of the Korea Investment Service Centre (KISC) within the Korea Trade-Investment Promotion Agency (KOTRA) to serve as the institution charged with responsibility for realising the goals of the FIPA.<sup>65</sup>

As the agency charged with the implementation of FDI policy, KOTRA undertakes a variety of roles and activities related to FDI: conducting investment promotion activities to encourage foreign companies to choose Korea as an investment location; offering administrative support while the investment is in progress; and monitoring the complaints of foreign companies through its after-care service.

However, as a quasi-government organization, KOTRA has its limits lowering the bargaining power of the Korean government in several ways. Firstly, KOTRA is not a government organisation, so it does not have the authority to make decisions on the issues that can arise when foreign companies invest in Korea. Therefore, it has a lower negotiating power with foreign companies. Secondly, KOTRA does not have the authority to coordinate the conflicting interests among the ministries and local governments, so it has very little capacity to settle these issues or to pursue national

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<sup>65</sup> KOTRA is a state-run company established in 1962 by then-President Park in order to support export-driven economic policies. The initial purpose of the agency was to promote exports, but since the late 1980s, as the outward FDI of Korean companies increased, KOTRA founded additional functions to satisfy the demand for related services and information. In 1994 KOTRA changed its name from former 'Korea Trade Promotion Corporation' to the current 'Korea Trade-Investment Promotion Agency' and it began to undertake investment promotion activity as well. In April 1998 KOTRA launched KISC, whose main role was to attract inward FDI, as one of its arms. FIPA of 1998 officially designated the KISC as the Investment Promotion Agency (IPA) of Korea. KISC changed the name in December 2003 to Invest Korea.

goals. As a matter of fact, when foreign companies invest in Korea, many unexpected issues can arise which require prompt cooperation and coordination among ministries; therefore, coordination capacity is vital for the institutions responsible for attracting FDI. However, the head of KOTRA — the president of a state-run company — lacks the authority and capacity to resolve the various conflicts among ministries or local governments.

Thirdly, KOTRA does not have a policymaking function, so it is hard for KOTRA to reflect the policy demands which are created through contact with foreign companies. During the SOM period, the EPB established FDI policy and during the transition period (1980-1997) the Ministry of Finance (MOF) held that responsibility.<sup>66</sup> However, in May 1999, the policymaking function of FDI was transferred to the Ministry of Commerce, Industry and Energy (MOCIE),<sup>67</sup> since when MOCIE has established FDI policies while KOTRA implemented them. However, this sharing of roles has aggravated problems regarding both the policy-making and the implementation capacity of the state: policies are not made on the basis of real, specific problems and they are implemented without proper authority.

Acknowledging KOTRA's as the nation's bargaining institution, the Act also designated the 'Committee on Foreign Investment' (CFI) and the 'Working-level Committee on Foreign Investment' (WCFI) as the higher level decision-making body for FDI. The CFI is chaired by the Finance Minister and its membership comprises minister from related ministries and the governors of the local governments, and

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<sup>66</sup> On 8 November 1981, the function relating to FDI was relocated from the EPB to MOF (Gang 1995: 54)

<sup>67</sup> However, the transfer of the FDI function from the MOF to MOCIE was not completed. Many FDI-related functions are still under the charge of the MOF. For example, the head of CFI is not the minister of MOCIE but the minister of MOF, and the Free Economic Zone, whose major client is foreign companies, is under the responsibility of the MOF. Therefore, the FDI policy making function itself is spread in the MOCIE and MOF.

deliberates and decides on issues relating to established policies and major FDI issues. The WCFI carries out working-level tasks, chaired by the deputy minister of MOCIE, with director-level members from related ministries and the deputy mayors or deputy governors of the local government. However, the CFI, which is assumed to act as the decision-making institution for FDI policy, is not a standing committee; thus, the chair and other members of the committee can hardly be expected to make prudent decisions because FDI is not their own responsibility and concern. Consequently, it cannot be assumed that CFI conducts substantial negotiations with MNCs. The WCFI also suffers from similar defects as its structure is akin to that of the CFI.

As the competition among countries to attract investors becomes increasingly intense, the function of bargaining agencies comes into sharper focus (Wells and Wint 2000). For example, the Singaporean government concentrated all its marketing-related functions in the EDB, the Investment Promotion Agency (IPA) of Singapore, and allowed it to act as the 'marketing arm' of Singapore. The centralization of the state's marketing functions made these activities more systematic and efficient and also strengthened the bargaining power of the host country by preventing firms from engaging in the sub-national level competitions (Encarnation and Wells 1985b: 274, Walter 1998: 291).

In contrast, the Korean government had not created and managed this kind of centralised and efficient promotion activity; the Korean government's FDI promotion activities were carried out by a variety of government organisations and by the provincial governments. Many ministries such as the MOCIE, the Ministry of Finance and Economy (MOFE), and the Ministry and Information and Communication (MIC) were involved in FDI promotion activities and all local governments were competing

with each other to attract foreign companies. In addition, the three authorities of the Free Economic Zones (FEZ) were making efforts to publicise themselves and even the Presidential Committee on the Northeast Asian Cooperation Initiative (PCNACI) was involved in promotion activities. This dispersed and disorderly system caused confusion among potential investors and also resulted in an inefficient use of resources. Furthermore, actions by local governments to attract investors undermined the bargaining power of the central government by providing alternatives to foreign companies. In short, there were many problems relating to the bargaining institution in the MOS phase: the vulnerability of KOTRA, the implementation agency of the FDI policy, as a quasi-government organisation; the limitations of CFI and WCFI as non-standing committees; and the inefficient and dispersed promotion system. These shortcomings regarding the bargaining institutions of the Korean government in the MOS period weakened its bargaining power *vis-à-vis* MNCs.

In conclusion, evaluating the level of internal constraints of the MOS period, the financial crisis led to a weakening of internal resistance, enabling the government to maintain relative autonomy over the internal interest groups for a short while during the crisis situation. However, when the crisis was over, the autonomy of the state significantly abated. On the other hand, after the crisis, KOTRA became the official agency for FDI, but it could not be expected to possess strong bargaining power due to its limited capacity. In summary, the internal constraints level can be described as 'medium' during the MOS period.

## External constraints

During the SOM period, Korea was placed under little external pressure for liberalisation of FDI due to the Cold War advantages described above. However, entering the 1980s, the situation began to change. China renounced its socialist economic policy and adopted an open-door policy. In 1989, the Berlin Wall came down and the Soviet Union collapsed, opening a new chapter in the post Cold-War era. The end of the Cold War also meant the end of competition between the East and the West in their efforts to assist developing countries, and it demolished the solidarity that had existed within each camp. The world, which had been divided by ideologies, was merged again into a capitalist economic model, accelerating globalisation and rushing the world into an intense competition. The US was placing greater emphasis on its own economic interests rather than on acting as a protector in East Asia, which prompted the US government to put pressure on the Korean government to open its market. As globalisation progressed, the Korean government had to react to it, sometimes passively and sometimes proactively. These changes in circumstances acted as external pressures on Korea, making it impossible to maintain the FDI system of the SOM period.

The US, which had been Korea's biggest economic supporter in the past, was no longer tolerant of Korea's protectionist policy because of the reduced strategic value of Korea in the post-Cold-War era. Moreover, the US government took an aggressive position on Korea's market opening in the late 1980s, putting direct pressure on the Korean government. International institutions such as the OECD and the WTO asked Korea to increase the level of liberalisation as a precondition of membership. External pressures on the Korean government intensified in the late 1980s: although the Korean

government increasingly faced external pressures for the liberalisation of the FDI system, the level of pressure was not so strong that it overwhelmed the Korean government. The Korean government was able to absorb the pressures into its gradual institutional reforms.<sup>68</sup>

However, in contrast with its handling of pressures in previous periods, the Korean government was not able to manage the external pressures during the MOS period and, at the beginning of the MOS period, the Korean state was overwhelmed by external pressures. On 3 December 1997, the Korean government signed a Letter of Intent to request a relief loan of USD21 billion from the IMF; the Letter of Intent included a Memorandum of Economic Programme. In return for the IMF's bailout loan, the Korean government had to faithfully carry out the IMF program under constant supervision. However, in August 2001, the Korean government repaid the IMF relief loan, freeing itself from IMF intervention, but the IMF program had significantly changed the appearance of the Korean economic system. The legacy of the developmental state was almost destroyed as it was replaced by a neo-liberal economic system. The Korean government encountered extremely strong external pressure in this period, and the changes stemming from that pressure were immense. Commenting on post-crisis reform in Korea, Shin and Chang (2003: 4) observed

. . . it may be reasonable to say that the scale of the corporate reform implemented in Korea since 1997 is the largest in the world since the forceful break-up of Japanese and German firms by the Allied occupation forces after the Second World War.

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<sup>68</sup> For example, in order to satisfy the qualification of the membership of OECD and WTO, the government set up the long-term plan for the liberalisation of the FDI system, which was called the 'Foreign Direct Investment Opening Five Year Plan'. According to this plan, the government gradually lowered the entry barrier and eased the regulations (Kim *et al* 2002).



Seeing the crisis in the *chaebol* and the financial system and the legacy of the developmental state, IMF undertook far-reaching reforms in these areas, reforms that were directed towards creating a more Anglo-American economic system. The reform program, agreed upon by the IMF and the Korean government, comprised three elements: the retrenchment of the macro-economy, structural reform, and the opening of the domestic market. These programs not only exerted extreme pressure on the government but also led to significant principal changes in the relationship between the government and MNCs (Go 2005, Gang 2005, Shin and Chang 2003, IMF 1997).

The key points of the IMF program and its effects are as follows: firstly, the retrenchment of the macro-economy was designed to stabilize the value of the Korean currency by keeping the current account in surplus and promoting the inflow of foreign capital through a combination of high interest rates and a tight budgetary policy. This retrenchment policy made a vital contribution to stabilizing the value of the *won*, but domestic companies had to face a credit squeeze as domestic financial institutions reduced loans and interest rates surged to more than 30 percent. Problems raising funds were compounded by the collapse of the stock market which made it difficult to obtain funds through direct financing. The macroeconomic retrenchment resulted in many bankruptcies: between January and April 1998, the number of bankruptcies nationwide was 11,920, with an average of 3,000 companies going bankrupt each month. The unemployment rate was only 3.1 percent in December 1997, but it surged to 7.0 percent in June 1998 (Go 2005: 177).

As the financial crisis turned into an economic crisis companies had no choice but to sell their assets to overcome their liquidity constraints. Considering the soaring value of the US dollar, which rose more than twofold after the crisis, and the desperate

situation of Korean companies rushing to sell their assets in order to avoid bankruptcy, it can be easily assumed that the corporate assets would be sold at considerably discounted prices. The macroeconomic retrenchment weakened the bargaining power of Korean businesses, and the drastic surge in FDI activity directly after the financial crisis largely resulted from asset sales by Korean companies (Shin and Chang 2003: 104).

The second feature of the IMF programme was structural reforms which were applied to three sectors: the financial system, the corporate sector and the labour market. In the financial sector, the Financial Supervisory Commission (FSC) was established to supervise financial institutions comprehensively and insolvent financial institutions closed down or became the target for mergers and acquisitions. The government could no longer intervene in the management of banks and decision-making on loans and financial policy, which had been the main vehicle for industrial policy, was virtually prohibited. The opening of the domestic financial sector to foreign investment was agreed upon as a means of accelerating the process. In the corporate sector, the *chaebol* system was the primary target of reform. The *chaebol* had to reduce their debt-equity ratio, which had averaged 400 percent in late 1997 to 200 percent by late 1999 (Shin and Chang 2003: 56). As the government was banned from offering subsidies or tax benefits to save failing companies by the program, many companies had to sell their assets quickly and at a discounted price in order to reduce the debt-to-equity ratio in the short time available. However, there were no domestic buyers for these assets and so the government encouraged firms to sell their assets to foreign companies. In addition to implementing the IMF's measures to enhance the flexibility of the labour market, the Korean government took further action by offering a 'layoff system' which was beyond the demands made by the IMF. The banks, the *chaebol* and labour all had been obstacles

to foreign MNCs seeking to penetrate the Korean market, but the IMF programs effectively removed these impediments to investment.

Finally, the trade and capital markets were liberalised; import licensing and trade-related subsidies were all abolished together with the ‘Import Diversification Program’, which aimed to address Korea’s chronic trade deficit with Japan by restrictions on imports from Japan. In the capital markets, the domestic stock market and the bond market were completely liberalised and the remaining barriers for FDI were eliminated. The IMF program thus removed institutional and legal barriers to investment in Korea and weakened the *chaebol* and labour, which acted as hindrances to MNCs seeking to conduct business in Korea. The US Deputy Treasury Secretary Lawrence Summers acknowledged that “the IMF has done more to promote America’s trade and investment agenda in Korea than 30 years of bilateral trade talks” (Weiss 1999: 31). Needless to say, the external pressure that the Korean government faced during the MOS period was very high.

### **Evaluation of the Government’s Bargaining Power**

So far each factor of the Korean government’s resources, stakes, and constraints *vis-à-vis* MNCs during the MOS period has been discussed. Based on this discussion, we will now move on to assess the level of each dimension, and will identify the Korean government’s bargaining power *vis-à-vis* MNCs during the MOS period by applying the NBM.

Firstly, in terms of resources, Korea was an attractive sales location for market-seeking investors during the MOS period but was not a first-rate production base for

production-seeking investors. With *per capita* GDP standing at more than USD20,000 by purchasing power parity (PPP) Korea was categorized as a high-income country (WEF 2005).<sup>69</sup> With the population of 48 million, Korea was the 12th largest market in the world and, therefore, Korea's resource level was 'high' market-seekers. However, for investors seeking production bases, Korea did not offer attractive resources. Roughly speaking, the production factor seeker can be categorised in two groups: cost-cautious seekers and efficiency-cautious seekers (Nunnenkamp and Spatz 2002). The former seek access to traditional resources to reduce their costs while the latter seek access to non-traditional resources to enhance their production efficiency. Korea could not satisfy either of these needs: labour costs were higher than those of late developing countries, while non-traditional production factors could not match the level found in developed countries. Accordingly, Korea's resource level remained at a 'low' level for production factor seeking investors. In conclusion, Korea's resource level during the MOS period was 'low' in terms of investment motivated by production but 'high' in terms of investment motivated by market access; we can say, therefore, that the resources level was 'medium' overall.

Secondly, as we have seen, the stake level is determined by a combination of the level of commitment and the level of alternatives. In terms of commitment, both President Kim Dae-Jung and President Roh Moo-Hyun showed a high level of commitment to FDI during the MOS period. In particular, Kim Dae-Jung actively used foreign companies as leverage to reform the legacy of the developmental state. The high priority placed attracting FDI gave rise to claims that Korean companies were the subject of discrimination. The Roh Moo-Hyun government also emphasised the

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<sup>69</sup> Korea's GDP per capita in 2004 by PPP is USD 21,305, the 28th biggest in the world. (WEF 2005: 476)

importance of FDI; in particular, the top priority for the Roh government was 'building a Northeast Asia economic hub' for which the core means were foreign companies. Therefore, the Korean government's commitment to FDI during the MOS period can be categorized as 'high'. When it comes to alternatives, there are two categories: the alternatives to the capital provided by FDI and the alternatives to technology that accompanied FDI. After the crisis, alternatives to FDI in terms of sourcing capital were seen as unstable and costly and, as the foreign companies were reluctant to offer their technology to Korea, FDI emerged as important channel for the transfer of advanced knowledge. Therefore, the level of alternatives was 'low.' In summary, the level of commitment was 'high' while the level of alternatives was 'low' in the MOS phase, so it can be said that the Korean government's stake for FDI was at a 'high' level.

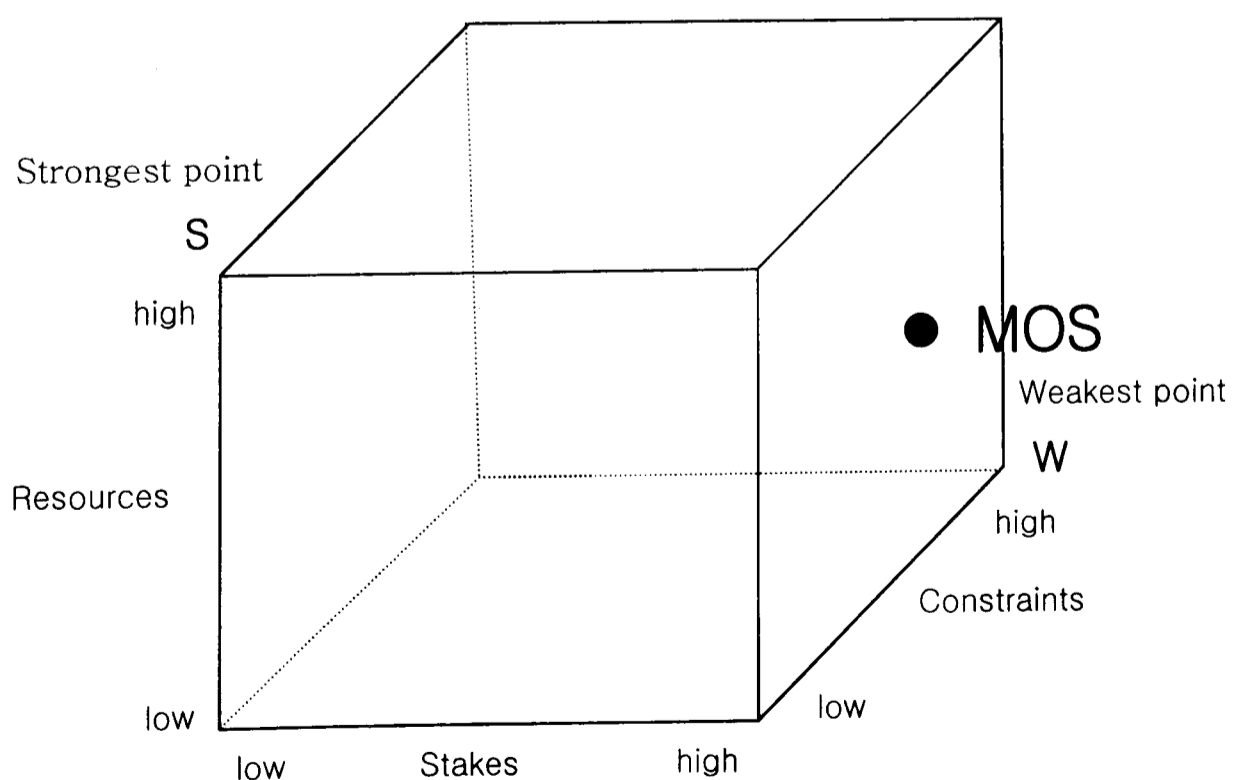
Thirdly, regarding constraints in the MOS phase, the Korean government faced a high level of constraints, both internal and external. First, in terms of internal constraints, since the 1980s, two powerful social groups — *chaebol* and labour — had challenged the state, but the Kim Dae-Jung government was able to weaken this resistance by using negative public sentiment and IMF pressure in the crisis situation. However, state autonomy was not as high as it had been during the SOM period; the increase in autonomy was only a temporary outcome of the crisis and it declined as the crisis passed. With respect to the bargaining institutions in the MOS phase, the official body responsible for FDI was KOTRA which, as a quasi-government agency, did not have the appropriate authority to maintain strong bargaining capacity. KOTRA had neither the power to coordinate the conflicting interests among ministries or local governments nor any means to offer incentives or to impose sanctions on the foreign firms, which would strengthen its bargaining power. In summary, the level of internal

constraints in this period can be described as ‘high’; in terms of external constraints, the Korean government during the MOS period faced a high level of external pressure, especially from the IMF. After the crisis, the government had to carry out IMF programs in return for the relief loan and consequently, the institutional barriers for FDI were mostly eliminated. Therefore, during the MOS period, the level of external constraints can be seen as ‘high’. Table 3.13 summarize the results of the discussion above.

Table 3.13 Korean Government’s Bargaining Power: MOS Phase

Dimensions		Level of Dimensions		Level of Bargaining Power
Resource		Medium		Medium Low
Stakes	Commitment	High	High	
	Alternatives	Low		
Constraints	Internal	High	High	
	External	High		

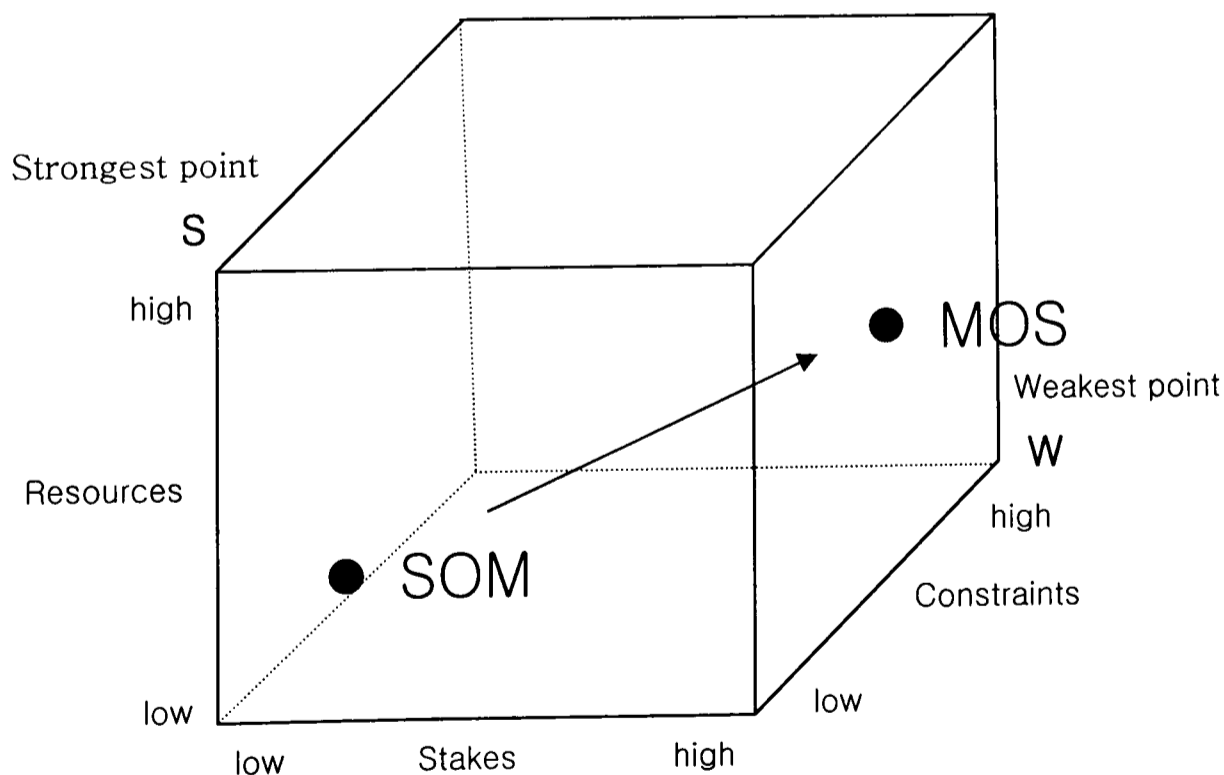
Figure 3.2 The Position of the Korean Government’s Bargaining Power: MOS Phase



The application of the Korean government's bargaining power during the MOS period to the NBM is shown in Figure 3.2. Locating the level of each dimension in the three-dimensional model, Korea's bargaining power is situated at point MOS. Point MOS is close to point W, which represents the lowest level of bargaining power but further away from point S, which represents the highest level of bargaining power. This indicates that the level of bargaining power of the Korean government *vis-à-vis* MNCs during the MOS period was 'low'.

### 3. Conclusion

Figure 3.3 The Transition of the Korean Government's Bargaining Power



The transition of the Korean government's bargaining power is illustrated in Figure 3.3: by applying the NBM to the Korean case, several implications can be drawn. Firstly, the bargaining power of the Korean government has declined almost continuously since 1962. This is evidenced by the fact that point SOM is situated at the closest position to point S, the strongest point, while point MOS lies at the closest location to point W, the weakest point. Secondly, stakes and constraints are the main factors that have reduced the Korean government's bargaining power. As shown in Figure 3.5, despite the fact that resource levels have constantly increased, the bargaining power of the Korean government has declined due to the increased level of stake and constraints. Thirdly, as is self-evident, in order to increase its bargaining power, the Korean government has to endeavour not only to increase its resource level, but also to reduce the level of its stakes and constraints.

During the SOM period, the government could maintain relatively strong bargaining power despite the low level of resources. In contrast, during the MOS period, the bargaining power of the government was weak even though its resources were much higher than those of MOS period. The low level of stakes and constraints during the SOM period led to strong bargaining power for the state, whereas the high level of stakes and constraints resulted in weak bargaining power for the state during the MOS period. Why was the state in the SOM period able to maintain low levels of stakes and constraints whereas the state in the MOS faced high level of stakes and constraints? The reasons can be found both inside and outside the state.

As regards external causes, during the SOM period, the Cold War context and international economy were favourable to the state; as a result of the Cold War situation, foreign governments not only allowed Korean government's protectionist policy but



also provided generous and abundant developmental funds. In addition, the 1970's international economy enabled the country to access foreign capital relatively easily. These external circumstances reduced the level of external constraints and expanded the alternatives to FDI. Unfortunately for the Korean state during the MOS period, the external circumstances favoured MNCs; freed from the restrictions imposed by the Cold War, countries entered into free-market competition and Korea no longer received any lenient treatment. Strong home countries supported their corporations and global actors demanded that obstacle to business be removed. External pressures intensified and the alternatives to FDI slowly disappeared. In many respects, these external circumstances greatly affected the weakening of the Korean government's bargaining power.

However, in addition to these external factors, internal factors also played a critical role in weakening the state's bargaining power. In fact, the decline of the developmental state weakened the government's bargaining power by affecting the level of stakes and constraints. During the SOM period, when the Korean state was a typical developmental state, it had an ultimate vision for development and approached development tasks with long-term strategies, as seen in the Five-year Economic Development Plans. The state mobilised the available resources to achieve its goals and FDI was seen as just one of the resources to be used for attaining those goals rather than as an end in itself. This perception of FDI reduced the state's level of commitment. On the contrary, during the MOS period, when the Korean developmental state significantly was weakened, the state abandoned its long-term approach to development and let market principles, which are dominated by short-termism, rule the economy. The state lost its long-term vision and FDI policy was no longer used for long-term considerations but instead for short-term gains. During the MOS period, attracting foreign companies

became the country's goal. This change in goals, that is, the means becoming the ends, increased the government's commitment to FDI.

Moreover, during the SOM period, the state was able to maintain close relations with domestic capital, control labour's demands, and enhance the capacity of its bargaining institutions by hiring competent bureaucrats and vesting powerful authority in the bargaining agency, all of which lowered internal constraints. In contrast, during the MOS period, the state capacity to cooperate (or control) business and labour weakened; state and business relations became more distant, and insecurity fostered discontent among the labour force. The bargaining institution had little power to actually bargain and the participation of many bargaining actors in the process decreased its bargaining power further.

The globalisation process obviously affected the decrease of the country's bargaining power, and this is generally accepted (Stopford and Strange 1991). However, in this chapter we identified one more factor that weakened the host country's bargaining power *vis-à-vis* MNCs in Korea's case: the decline of the developmental state. Therefore, we have to find a way in the state in order to resurrect the bargaining power.

## **Chapter Four: Bargaining with Multinational Corporations (Empirical Evaluation)**

Chapter Three analysed the transition of the Korean government's bargaining power by applying the Neo Bargaining Model and presented the following findings: (1) the bargaining power of the Korean government had decreased during the SOM and MOS periods and (2) the weakening of the bargaining power was affected by internal factors (the decline of the developmental state) and external factors (the process of globalisation). This chapter will use statistical analysis and case studies to support the arguments made in Chapter Three. The first section of this chapter measures the level of bargaining power in both periods, demonstrating that bargaining power in the SOM period was stronger than in the MOS period. In this section we focus on all foreign manufacturing companies at specific times within the SOM and MOS periods and we thus give a generalised picture of the bargaining power of foreign firms in Korea at specific periods. However, it provides only the results of the bargaining, limiting our view of the process. The shortcomings of the first section will be complemented by the second section. In the second section, the Neo Bargaining Model is applied to specific cases to demonstrate the different ways in which the government dealt with MNCs in the SOM and MOS periods. This section reveals the dynamic process of bargaining by examining specific bargaining cases.

## 1. Measuring Bargaining Power

By applying the Neo Bargaining Model to the case of the Korean government, it was seen that the bargaining power of the Korean government had declined continuously over time. This section will provide statistical evidence to support the argument made in Chapter Three by showing that the government's bargaining power in the SOM period was higher than in the MOS period.

In comparing the level of bargaining power in both periods, we face a critical problem: how to measure intangible, invisible power. The issue of how to measure power has always been controversial in the bargaining power school because, despite the abstract nature of power, measuring it is essential for the bargaining power model. According to the bargaining hypothesis, if the bargaining power of both sides can be measured, the bargaining outcomes can be anticipated and *vice versa*. Therefore, in their efforts to prove the bargaining hypothesis, many scholars have studied the relationships between bargaining power and bargaining outcomes.<sup>70</sup> Although bargaining school scholars share the view that the resources of each party have an impact on the outcomes, they have employed different methods to demonstrate the relationship. Among the methods of measurement, two methods are frequently used: the ownership level measurement and the intervention experience measurement.<sup>71</sup> The former assesses bargaining power by measuring the ownership level of subsidiaries; the latter estimates the strength of bargaining power by relying on the subjective judgment of the MNCs'

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<sup>70</sup> Representative of the studies that examine bargaining relationships between the host country and MNCs by measuring the bargaining power of the both parties are: Fagre & Wells (1982), Lecraw (1984), Kobrin (1987), Gomes-Casseres (1990), Vachani (1995), Poynter (1982), Kim (1988), Grosse (1996) and Minor (1994).

<sup>71</sup> Influential studies in which the ownership measurement is applied include Farge and Wells (1982), Lecraw (1984), Kobrin (1987) and Gomes-Casseres (1990). The intervention experience measurement was used by Poynter (1982, 1985) and Kim (1988).

managers in terms of the level of host government intervention in their business activities. Both methods have strengths and weaknesses. However, the latter method — which requires that the researcher conduct a survey of MNC managers — is not a viable option for this thesis because this method is only available for companies still operating in Korea. As the subjects of this study are all cases of FDI made in the past and since 1962, the study must rely only on statistics. In this case, the ownership level of foreign companies is an effective indicator to measure the relative bargaining power of MNCs and the host government. Thus, this section will evaluate the bargaining power of foreign companies through the analysis of the MNC's ownership level, as this is data that is both available and objective.

The measurement of ownership levels is based on the premise that MNCs pursue a higher level of ownership while developing host governments are reluctant to grant a higher level of ownership for political and economic reasons. That is, the stronger the bargaining power of MNCs (and the weaker bargaining power of host governments), the greater the likelihood that the subsidiary of an MNC will achieve a higher level of ownership. This method has been advocated by many researchers on account of its appropriate premise, objectivity and simplicity of measurement. However, it has two main disadvantages: firstly, there are factors other than the ownership level involved in the negotiation between a host government and MNCs, including employment, technology transfer and incentives. Sometimes such factors are regarded as more important than the ownership level. Secondly, MNCs do not always pursue full ownership; they often want a lower level of ownership in order to share risks with a host government and their counterpart in the country (Grosse 1996, Moon and Lado 2000).

The ownership measurement is, nevertheless, the most frequently used method

of measuring the bargaining power of either MNCs or a host government. There are legitimate grounds for adopting this measure, both theoretically and practically. Firstly, it is based on internalization theory, according to which the motivation of a company for foreign investment is to internalize firm-specific advantages (Buckley and Casson 1976). MNCs try to maximize the profits that they would get from the internalization of their advantages and, in addition, do not want their firm-specific advantages to be transferred to other companies. Hence, companies with more firm-specific advantages tend to pursue full ownership and avoid joint ventures (Lecraw 1984, Kobrin 1987, Gomes-Casseres 1990).

Secondly, the ownership level approach is based on general practice. Host governments in developing countries generally want to have more control over MNCs and thus they are reluctant to allow high ownership levels in foreign companies. Therefore, the stronger the bargaining power of the host governments, the lower the ownership level of MNCs, and *vice versa* (Fagre and Wells 1982, Kobrin 1987). Thirdly, this method is objectively measurable without restrictions of time and space. In contrast, the measurement of bargaining power through a survey investigating managers' perceptions of the level of a host government's intervention is dependent on the subjective judgment of the managers and hence it does not guarantee that the findings are objective (Kobrin 1987, Moon and Lado 2000).

Despite the above-mentioned advantages, there is criticism that in the past developing host governments imposed restrictions on the ownership level, but now most countries do not restrict ownership levels any more; thus, measuring ownership levels is meaningless. However, this research focuses on the period after 1962 when, in most cases, the ownership level was the subject of bargaining in relation to an MNC's entry.

Considering this point, the problem described above can be applied only to the most recent few years. Moreover, the liberalization of FDI implies the weakening of the bargaining power of host governments *vis-à-vis* MNCs. Thus, the increase in the ownership level of foreign subsidiaries following the liberalization of FDI may be the best evidence of the weakening bargaining power of host governments. Therefore, the measurement of ownership levels of foreign subsidiaries is the most appropriate method to apply to this research. This section will measure ownership levels in the SOM and MOS period; the transition period is excluded because our main concern lies with these two periods as mentioned before.

## **Hypothesis**

The purpose of this analysis is to prove statistically that ownership levels in the MOS (1998-2005) period were higher than in the SOM period (1962-1979) by comparing the average levels of ownership level in both periods. The hypothesis as follows:

The ownership levels of foreign manufacturing companies are different in the two periods; that is, ownership levels in the MOS period are higher than in the SOM period.

## **Sampling and data collection**

The population of this research is the foreign-invested companies in manufacturing sector that invested and registered in Korea, as defined under Korean FDI legislation.<sup>72</sup>

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<sup>72</sup> According to the Foreign Investment Promotion Act of 1998, foreign investment, 'foreign investor' and 'foreign-invested company' are defined as follows (Article 2): The term 'foreign investment' refers to

The sample includes companies active in Korea in 1979 and 2005, which were the last years of the SOM period and MOS periods, respectively. Statistics show that there were 708 foreign companies operating in the Korea manufacturing sector in 1979 and 4,424 in 2005. This study took all of the foreign manufacturing companies that existed in 1979 and 2005 into consideration but excluded foreign companies that had already withdrawn their investment from Korea as of 1979 and 2005. Some companies may fall into both periods: that is, foreign companies that invested in Korea in 1979 and were still operating in Korea between 1998 and 2005. Although it would be logical to remove duplicate data in analysing ownership levels at the time of entry, we did not remove duplicate data as we assume that ownership levels continued to change after entry. The samples have been obtained from the database of foreign investors in Korea managed by Invest Korea (2006).

## **Findings and Implications**

The t-test assesses whether the average of two groups are statistically different from each other. The hypothesis is that the ownership levels of foreign companies differ according to the times of entry. The null hypothesis is that the ownership levels of the two groups are the same. The null hypothesis is overruled when the averages for two groups are statistically different from each other. A two-sided test was conducted and

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(a) cases where a foreigner purchases, under the conditions as prescribed by the Presidential Decree, stocks of or stakes in a Korean corporation or a company run by a national of the Republic of Korea, for the purpose of establishing a continuous economic relationship with and participating in the management of the said Korean corporation or company in accordance with this Act; and (b) where a loan with the maturity of not less than five years is extended to a foreign-capital invested company by its overseas holding company or by a company in a relationship with the said holding company of capital investment as prescribed by the Presidential Decree. The term 'foreign investor' refers to a foreigner who is in possession of stocks under the conditions prescribed by this Act. The term 'foreign-invested company' refers to a company financed by a foreign investor.



the significance was 0.05.

Table 4.1 Independent Samples Test for the Ownership Level in SOM and MOS Phase

Group	Number of samples	Average of ownership		t-value
		level	Standard Deviation	
SOM	708	52.72	24.37	6.249***
MOS	4,424	59.28	33.97	

\*\*\*p<0.001

The table above shows the results of the t-test of the ownership levels of 708 companies in 1979 (SOM) and 4,424 companies in 2005 (MOS). The average of ownership levels are 52.72 percent in the SOM period and 59.28 percent in the MOS period. The standard deviation values are 24.37 and 33.97 respectively. According to the t-test results of the independent sample, the null hypothesis is overruled (t-value = 6.249 < 0.05), therefore the ownership levels of the SOM and MOS periods are statistically different from each other. The average of ownership level in the MOS period is higher.

The purpose of this analysis of the ownership levels of foreign companies in manufacturing sector during the SOM and MOS periods is to measure the bargaining power of foreign companies in both periods. The fact that the ownership level in the MOS period is higher than in the SOM period implies that the bargaining power of foreign companies in the MOS period is stronger than in the SOM period. In other words, the bargaining power of the Korean government in the MOS period is lower than in the SOM period. Such results serve as statistical support for the findings in Chapter 3. In following section, three case studies will show how the bargaining power of the government shifted, what factors affected the bargaining power of the government, and how the government approached the bargaining process differently in both periods.

## 2. Case Studies

This section applies the Neo Bargaining Model to three involving three MNCs: Dow Chemical and General Motors (GM). The three negotiations examined are (1) Dow Chemical and Korea Pacific Chemical Corporation (KPCC), (2) GM and Shinjin Motor, and (3) GM and Daewoo Motor. Dow Chemical, which entered the Korean market by establishing KPCC — a joint venture company with the state-run Chungju Fertilizer Corporation (CFC) in 1968 — pulled out of Korea in 1982 after it sold its share of the company. GM left Korea in 1992, having entered in 1972 by setting up GM Korea in partnership with Shinjin Motor. In 2002, GM re-established its presence in Korea by acquiring Daewoo Motor, a successor to Shinjin Motor.

Dow Chemical is a good example of how the Korean government was able to maintain a high level of bargaining power with relatively low resources during the SOM phase. The GM case shows two different attitudes of the Korean government to the same company's market entry in two different phases. Thus, this research identifies two cases from the SOM phase and one case from the MOS phase: Dow Chemical-KPCC and GM-Shinjin Motor for the SOM phase, and GM-Daewoo Motor for the MOS phase. These case studies are effective in displaying the stark difference in the relationship between the host government and MNCs in the two phases. By comparing a typical developmental state in the SOM phase and, in the MOS phase, a state under the strong influence of neo-liberalism, the chosen case studies highlight the difference in the level and components of the government's bargaining power in the two phases.

There are two options when the government exercises its bargaining power with respect to multinational companies: the government can either participate directly in the

negotiation as one of negotiating parties, or control the negotiation indirectly. The second option is more common, wherein the government suggests guidelines and directs negotiating parties to stay within them, and such guidelines are often expressed in the form of laws and regulations reflecting the government's intention. Generally, it is rare for a government to hold direct negotiations with multinational companies; still, we have selected cases where the government acted as one of negotiating parties in order to examine the changing bargaining power and the attitudes of the government toward MNCs. In the case of GM-Shinjin Motor, the government's role was rather indirect but the state still exerted a strong influence over the negotiation by setting the guidelines for negotiation.

The analysis of each case comprised two parts: in the first part, we present the context and background for each case study and in the second part, the Neo Bargaining Model is applied to each case in order to determine the level of the government's bargaining power.

## **Dow Chemical and Korea Pacific Chemical Corporation**

### **Background**

Dow Chemical entered Korea in 1968 by establishing a joint venture called Korea Pacific Chemical Corporation (KPCC) in partnership with Chungju Fertilizer Corporation (CFC). Dow Chemical was successful in the 1970s as it rode on the wave of the rapid economic development of Korea. However, in 1978, due to internal conflicts, Dow Chemical decided to sell its entire stake in KPCC, and it eventually

pulled out of Korea in 1982. This particular case allows us to analyse the components of the Korean government's bargaining power in the 1960s.

In the early 1960s, the Korean government focused on nurturing light industry as part of its economic policy to promote export industries such as shoes, textiles, and plastics. Most of the export goods were labour-intensive products, which were combinations of inexpensive labour, and imported machinery and raw materials. The increase of light industrial exports created a soaring demand for imported raw materials, petrochemical products such as ethylene and propylene. However, this was a period when the petrochemical industry did not even exist in Korea and, therefore, the more this industry sector exported, the more it had to import, and thus the international balance of payments of Korea showed a chronic deficit. This situation led the Korean government to have strong desire to strengthen the petrochemical industry which could reduce the reliance on imported materials (Oh 1995b: 17).<sup>73</sup>

However, the Korean government did not have sufficient capital and technology to establish petrochemical factories in the mid-1960s. The petrochemical industry is a large-scale process industry that requires massive investment in capital and technology and it is typical of economy-of-scale industries in which greater volumes cost less per unit. Due to the peculiar attributes of the petrochemical industry, the government inevitably intervened in its development and provided support from an early stage, especially in the 1960s and 1970s when the mobilisation of private funds was almost impossible due to the absence of affordable domestic capital.

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<sup>73</sup> Oh Won-Chul, who was in charge of nurturing the petrochemical industry as industrial director of Ministry of Commerce, explained the importance of nurturing the petrochemical industry in his book: "The development of the petrochemical industry allows us to localize synthetic resins and textiles using fuels from domestic refineries. In that sense, we will achieve 'the independence of light industry.' The same goes for the steel industry. The development of the steel industry will bring us 'the independence of heavy industry.' Thus, both the petrochemical industry and the steel industry can be designated as two major national industries in that they provide raw materials to other industries" (Oh 1995b: 17).

Although the Korean government decided to join hands with foreign companies in order to develop the project due to the lack of domestic capital and technology, it did not allow foreign companies to invest and operate at will. The government established principles that the foreign companies had to follow if they wanted to participate in the projects: firstly, equal partnership was required (a 50:50 joint venture) and, secondly, foreign investors had to follow the Korean government's policy and accept its plans for the development of the petrochemical industry. The Korean government was in charge of formulating any action plans and selecting joint venture partners. The government also set the principles regarding the creation of petrochemical industrial complexes, such as location and standardisation, which foreign firms had to follow (Oh 1995b: 68-69).

In 1965, the Korean government designated petrochemicals as a core industry in the Second Five-year Economic Development Plan (1967-1971) and the development of the industry began in earnest (Oh 1995b). In 1966, the Petrochemical Industry Development Plan was announced, its main idea being the building of a petrochemical complex in the city of Ulsan. The complex would consist of a naphtha-cracking centre (a fundamental facility of the petrochemical industry) and eight related projects (KDB, 1969: 52).<sup>74</sup> The Korea Oil Corporation (KOC)<sup>75</sup> was in charge of the naphtha-cracking centre, and CFC was responsible for relatively large-scale projects such as the

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<sup>74</sup> The eight related projects include the following: 1) polyethylene and vinyl chloride monomer (VCM), 2) acrylonitrile, 3) caprolactam, 4) alkyl benzene, 5) synthetic rubber (SBR), 6) polypropylene, 7) acetaldehyde, 8) methanol. Naphtha-cracking centres process naphtha, the basic material for the petrochemical industry. The main process of petrochemical industry is the decomposition of carbon compounds; in the decomposition process, naphtha is used as a raw material and numerous chemical materials such as ethylene, propylene, butadiene, benzene, toluene, and xylene are produced. (KPIA 2006)

<sup>75</sup> KOC was a state-run corporation established in October 1962 to ensure a stable supply of oil. It was a joint venture between the Korean government and Gulf Oil with the ownership shares of 75 percent and 25 percent, respectively (Yoo Gong 1983).

production of polyethylene, vinyl chloride monomer (VCM), acrylonitrile, and caprolactam.<sup>76</sup>

Table 4.2 Foreign Candidates for the Petrochemical Industry Projects

Project	Candidates
Naphtha Cracking Centre	Gulf Oil (US)
Polyethylene	Union Carbide (US), Gulf Oil (US), Dow Chemical (US)
VCM	Gulf Oil (US), Dow Chemical (US), Skelly Oil (US)
Acrylonitrile	Skelly Oil (US), Union Oil(US), Litwin(France), TEC (Japan) Nippon Steel (Japan)
Caprolactam	Allied Chemical (US), Union Oil (US)
Alkyl Benzene	Monsanto Chemical (US), Arco (US)
Synthetic Rubber (SBR)	Good Year (US), Good Rich-Gulf Oil (US), Phillips Petroleum (US), Polymer (US)
Acetaldehyde	National Distillers (US), Gulf Oil (US), Celanese (US) Union Carbide (US), AID (US)

Source: KPIA 1977: 48

The Korean government sought joint venture partners for the projects in accordance with the above-mentioned principles. For the naphtha-cracking centre, this was a relatively easy process since Gulf Oil and KOC already had a joint venture relationship. Gulf Oil was chosen to participate in the joint venture by increasing its share in KOC.<sup>77</sup> The remaining task was to find a partner for the projects led by CFC.

<sup>76</sup> The Korean government financed the establishment of CFC in 1964 to supply fertilizers. In addition, the Korean government set up Youngnam Chemical in partnership with an American company, Swift, in 1965 and Jinhae Chemical in partnership with Gulf. CFC changed its name to the Korea General Chemical Corporation in 1973 when it merged with state-run Honam Fertilizer (KPIA 1977).

<sup>77</sup> After taking office in 1961, President Park Chung-Hee tried to build a local refinery using only domestic capital by establishing the state-run Korea Oil Corporation (KOC) in 1962. However, the lack of technology and capital became obstacles to this ambition. Therefore, the Korean government forged a partnership with Gulf Oil in 1962 on the condition that Gulf Oil would buy a 25 percent share of the business. In 1967, the Korean government designated KOC as the main body in charge of building the naphtha-cracking centre but had difficulty in obtaining financing. In 1970, the Korean government asked Gulf Oil to buy an additional 25 percent share in order to finance the building of the naphtha-cracking

The Ministry of Commerce (MOC), which was in charge of the development of the chemical complex and CFC drew up a list of potential partners and contacted them (see Table 4.2). Most were big companies and many of them showed interest in participating in the projects (Oh 1995b: 88).

When the Korean government and CFC negotiated with potential investors, they emphasized the following points in order to increase the attractiveness of their offer. Firstly, on the Korean side, the joint venture partner was essentially the Korean government as CFC was a state-run company that was fully financed by the government. Hence, it was tantamount to forging a partnership with the government, which was expected to reassure foreign candidates in terms of the prospects for the business. Secondly, the Korean government promised to provide raw materials (such as ethylene) and utilities (including electricity) at lower prices to their partners. The petrochemical industry would have to reach a certain size before it could achieve price competitiveness, but, at that time, building a large-scale plant that enabled economies of scale in production was impossible due to the lack of capital mobilization capacity, the limits of the domestic market size, and the country's poor infrastructure. Consequently, Korean petrochemical products would inevitably be more expensive than those of other countries, including Japan and this inability to lower prices acted as a barrier to investment in Korea. The government wanted to remove these disadvantages for prospective investors by guaranteeing an appropriate unit price for their products and guaranteeing lower prices for raw materials. Thus in many cases the Korean government distorted the domestic price structure in the name of industrial policy. In the case of the petrochemical industry, the prices of raw materials and utilities did not

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centre (Yoo Gong 1983).

comply with domestic pricing but were forcibly lowered to below international price levels, thereby allowing petrochemical companies to be competitive. For example, the price of ethylene per pound was 4 cents in the United States, 4.5 cents in Japan, and 5.5 cents in Taiwan, but the Korean government fixed the price at 3.9 cents and supported the providers in various ways so that they could sustain those prices (Oh 1995b: 62). This exemplifies what Amsden (1989) refers to as 'getting the price wrong'.

In November 1968, the Korean government and CFC chose Dow Chemical, a multinational company with headquarters in the US as its joint venture partner in both the polyethylene and VCM businesses and established KPCC on an equal partnership basis (*Chosun Ilbo* 17 November 1968). Dow Chemical was well aware that producing its products in Korea would be less competitive: Korea had a shortage of the natural resources required as raw materials for the chemical industry, and electricity was expensive due to the lack of power-generating facilities. Nevertheless, Dow decided to invest in Korea, believing that its investment would generate profits for the following reasons. Firstly, they observed that the Korean market was growing rapidly. Secondly, they realized that the Korean government was protecting the domestic market by establishing import barriers and, thirdly, the government supported the development of the chemical industry in every possible way, including subsidies, tax incentives, and favourable financial support (*Wall Street Journal* 5 January 1983).

In 1972, KPCC opened a plant in Ulsan with an annual production of 60,000 tons which generated significant profits in the 1970s due to Korea's rapid economic growth and the government's protection of market. The government saw the petrochemical industry as an important source for basic materials, so they protected the chemical industry with various policy measures. Firstly, the government banned the



import of most petrochemical products by designating them as import-restricted products. Secondly, the Korean government made it legal to offer assistance to the petrochemical industry by enacting the 'Petrochemical Industry Promotion Act' in 1970; the law included the subsidisation of R&D activities and gave the Ministry of Commerce the authority to set prices for the utilities which were provided to petrochemical companies. Thirdly, the Korean government granted tax breaks by revising the 'Tax Reduction and Exemption Regulation Act' and the 'Customs Act' in favour of petrochemical companies (Koo 1980).

However, after Dow Chemical opened its wholly-owned subsidiary — Dow Chemical Korea (DCK) which produced the raw materials for KPCC — in 1979, discord began to grow between Dow Chemical and KPCC's Korean executives. In 1979, the world economy was in a turbulent state because of the second oil shock and the Korean economy was experiencing a slowdown, not only because of the global economic downturn but also because of the political turmoil brought about by the assassination of President Park. In fact, in 1980, the Korean economy recorded a negative growth rate for the first time since 1962. Due to the deterioration of the business environment and an excess of production, both KPCC and DCK faced enormous deficits in 1980 and 1981 (*Wall Street Journal* 5 January 1983). While the earnings of the two companies declined significantly, DCK and KPCC started showing discrepancies in the trade between the two companies. DCK had supplied the raw materials for VCM and chlorine to KPCC, but KPCC's Korean executives raised objections to DCK's price for and supply volume of chlorine, quoting the lower international price for chlorine.<sup>78</sup> On the other hand, KPCC's American executives

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<sup>78</sup> Chlorine was a major ingredient for KPCC's production of VCM. At that time, the international price of chlorine was \$145 per ton while the domestic price was more than double that at \$380 (KCC 1987).

insisted that the company bought the entire volume of chlorine from DCK, even at those higher prices, because they believed that KPCC, a joint venture company of Dow Chemical, should use DCK's products as it was a wholly-owned subsidiary of Dow Chemical. For these reasons, a significant conflict was brewing between the Korean and American executives within KPCC (KCC 1987).

The struggle between the two sides became so intense that the case was brought to court, but the court dismissed the case (*Chosun Ilbo* 1 September 1982). In addition to the law suit, Dow Chemical attempted to contact the Korean government on various occasions. Dow Chemical's Chairman, Robert Lundeen, visited then-President Chun Doo-Hwan and other high-ranking government officials attempted to defuse the situation. When Lundeen asked the Korean government for the approval of a merger between DCK and KPCC, the Korean government avoided giving a clear answer (KCC 1987: 148). This was probably because the government favoured domestic competitors over companies with partial or total foreign investment (*Wall Street Journal* 28 October 1982). In fact, Dow Chemical had lost most of its bargaining power after it had transferred capital and technology to Korea.

In August 1982, Dow Chemical finally decided to pull out of Korea and notified the Korean government of its decision. The government took swift action to minimize the effects of Dow Chemical's withdrawal; the Korean government considered several domestic companies as potential candidates for the acquisition of Dow Chemical's share, ultimately choosing Korea Explosive Group (KEG) to be the biggest shareholder of KPCC and DCK.<sup>79</sup> After the acquisition, KEG merged KPCC with DCK and the Korean government offered generous support to the firm, lowering the electricity rate

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<sup>79</sup> KEG was renamed the Hanhwa Group in 1993 (Hanhwa Group, 2002).

for KEG and providing other financial allowances. As a result, KEG gained the momentum to grow into one of the major *chaebol* in Korea (Hanhwa Group, 2002: 185-187).

### Bargaining Power of the Korean Government

As mentioned in previous section, larger MNCs usually require a higher ownership level. As of 1967, Dow Chemical ranked 53rd in *Fortune* magazine's list of the 500 largest US industrial companies and was ranked in third place in the US chemical industry (*Fortune* 15 June 1968). Although the company may have preferred 100 percent ownership in order to seek rents from its firm-specific advantages, as it entered Korea in an equal partnership with the state-owned CFC in 1969, the Korean government's bargaining power was clearly strong enough to convince Dow to accept these terms of partnership. By applying the NBM to this case, this section will explain how the Korean government convinced Dow to enter into the partnership and will thus determine the level of bargaining power of the Korean government in the Dow Chemical case. The discussion will follow the three dimensions of the Neo Bargaining Model: resources, stakes, and constraints.

When it comes to the resources of the Korean government in this case, the government's resources remained at a very low level in the late 1960s when Dow Chemical entered Korea. Consequently, the government's bargaining power could not be based on its resources. As we argued in previous chapter, the country had little to attract foreign companies in late 1960 as it was one of the poorest countries in the world and had not been industrialised (BOK 2004: 16). The manufacturing sector had not yet

developed: manufacturing sector production accounted for only 19.6 percent of GDP and employment in the manufacturing sector was only 8.7 percent of the total workforce in 1968. The natural resources for the chemical industry were insufficient, and infrastructure such as ports, roads, and airports were poor or almost non-existent. Electricity, the main source of power for factories, was expensive due to a lack of power-generating facilities (BOK 2005) and Korea's only abundant resource in the 1960s was low-cost labour. However, due to the capital-intensive nature of the petrochemical industry, the cheap cost of labour was not seen as a key asset by Dow Chemical. The continuing confrontation between South and North Korea combined with unstable and unpredictable domestic politics, was enough to discourage foreign companies from investing in Korea. The only resource that Dow Chemical considered when it entered was the growth potential of the Korean market (*Wall Street Journal* 5 January 1983). In short, the government's resources were so minimal that it could offer few locational advantages to Dow Chemical.

However, in terms of stake, the Korean government could maintain a low level and thus increase its bargaining power. Firstly, the government could lower its level of commitment despite the strong demands for the establishment of the petrochemicals industry. This was possible because the government's approach to FDI focused on a long-term strategy. As the 1966 Petrochemical Industry Development Plan shows, the government first formulated the long-term plan and then established the principles to attain its future goal. The attraction of foreign companies in petrochemical industry was subordinate to the ultimate goal of developing the domestic petrochemicals industry. When the government allowed foreign investment in its petrochemical projects, it applied the principle of joint ventures with equal partnership and the firm's

acquiescence to government policy. The former principle ensured the transfer of technology to the domestic partner while the latter showed the government's firm determination to hold firm to its initiatives on industrial development. These principles clearly showed that the government regarded foreign companies as tools to realise its goal. Thus, by subordinating FDI to the state's long-term goals, the government could lower its level of commitment.

In terms of alternatives, the government tried to increase alternative sources of FDI and its government's approach in selecting joint venture partners illustrated its efforts to find those alternatives. Before the government chose Dow Chemical as a partner for CFC, it had already secured multiple foreign candidates for joint venture partnerships (see Table 4.2). In the case of CFC's polyethylene project, the candidates were Union Carbide, Gulf Oil, and Dow Chemical, all of which were large, well-known companies. In selecting the foreign joint partner, the government carefully considered the technology leaders, who could bring the best technology available at that time to Korea (Bishop 1997: 35). Given Korea's poor resource situation, how could the government make big companies compete to be a part of a joint venture with Korean company? The answer is connected to the capacity of bargaining agency, which is discussed below. By lowering its commitment and increasing its alternatives, the government was able to have a low level of stakes.

When it comes to constraints, the Korean government was able to benefit from a low level of both internal and external constraints. As we have seen in the previous chapter, the Korean government in the 1960s faced few external pressures thanks to the Cold War context. External actors tolerated the Korean government's protectionist policies, such as measures requiring equal joint venture ownership or compliance with

the government's industrial policy. The government did not encounter any serious external efforts to reform its attitudes towards foreign businesses until at least the late 1970s. In addition, with respect to the internal pressures, the government was not confronted by significant challenges from any social groups; the traditional landowner class had been dismantled, and neither the industrial capitalist class nor labour class had yet formed. Hence, as the strongest and the most efficient institution, the state was able to push forward its policies with few obstacles.

The most notable factor in this case was the role of the bargaining agency which on the host country side was the government itself, specifically the Ministry of Commerce (MOC). The Ministry actively participated in the bargaining process and played a critical role in selecting and attracting Dow Chemical as a partner for CFC.<sup>80</sup> In order to attract foreign companies, the MOC enhanced Korea's attractiveness as an investment location by removing obstacles to entry and enhancing the benefits that foreign companies could obtain, as detailed below.

The main obstacle for foreign investors in the chemical industry was the higher cost of production due to the lack of natural resources, poor infrastructure, and the absence of economies of scale — an obstacle that the government had to remove if it was to attract foreign chemical companies. In an ideal world, the government would build a strong infrastructure and create greater demand in domestic and overseas markets, thus realising economies of scale. However, this would require a long time and the Korean government could not afford to wait until such conditions had been realized.

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<sup>80</sup> In the 1960s and 1970s, the Economic Planning Board (EPB) was in charge of formulating policies for and approving cases of foreign investment. However, in the case of Dow Chemical, the Ministry of Commerce played a major role in attracting investment to the chemical complex, acting as the main negotiating party with foreign companies. However, the final decision was made by the Committee of Foreign Investment chaired by the Minister of the EPB.

Instead, the government opted for price controls; the idea was to control the factors contributing to the rising price of products by lowering the price of raw materials and utilities. The government thus guaranteed profitability and competitiveness by providing the raw materials and utilities required by petrochemicals companies at lower than market prices, and gave the Minister of Commerce the authority to control the prices.<sup>81</sup> The government created a more attractive investment environment through price distortion; however, while such measures could remove the disadvantages, they could not create actual advantages for foreign companies to invest in Korea.

Thus, the second method used by the government was the strengthening of advantages. To motivate foreign investors, the Korean government created incentives by protecting the domestic market; the government designated most petrochemical products as import-restricted products, making them impossible to import without permission from the Korea Petrochemical Industry Association (KPIA). By doing so, the government completely shielded domestic players, including foreign companies in Korea, from external competition. Along with this measure, the government gave numerous tax breaks to petrochemical companies.

With the removal of disadvantages and the creation of new advantages, the Korean government had much more bargaining power in their negotiations with foreign companies and Dow Chemical was motivated to invest by the Korean government's market protection measures and its various financial support measures (*Wall Street Journal* 5 January 1983). Clearly, the role of the government was crucial in attracting Dow Chemical, and its capacity to control the nation's scarce resources greatly reduced

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<sup>81</sup> These price controls were shown in the 'Petrochemical Industry Promotion Act', which was enacted in 1970 to protect and nurture the petrochemical industry and abolished in 1986. According to Article 10, the Minister of Commerce was granted the authority to approve prices of electricity and water as well as naphtha.

the internal constraints, which consequently increased the bargaining power of the government.

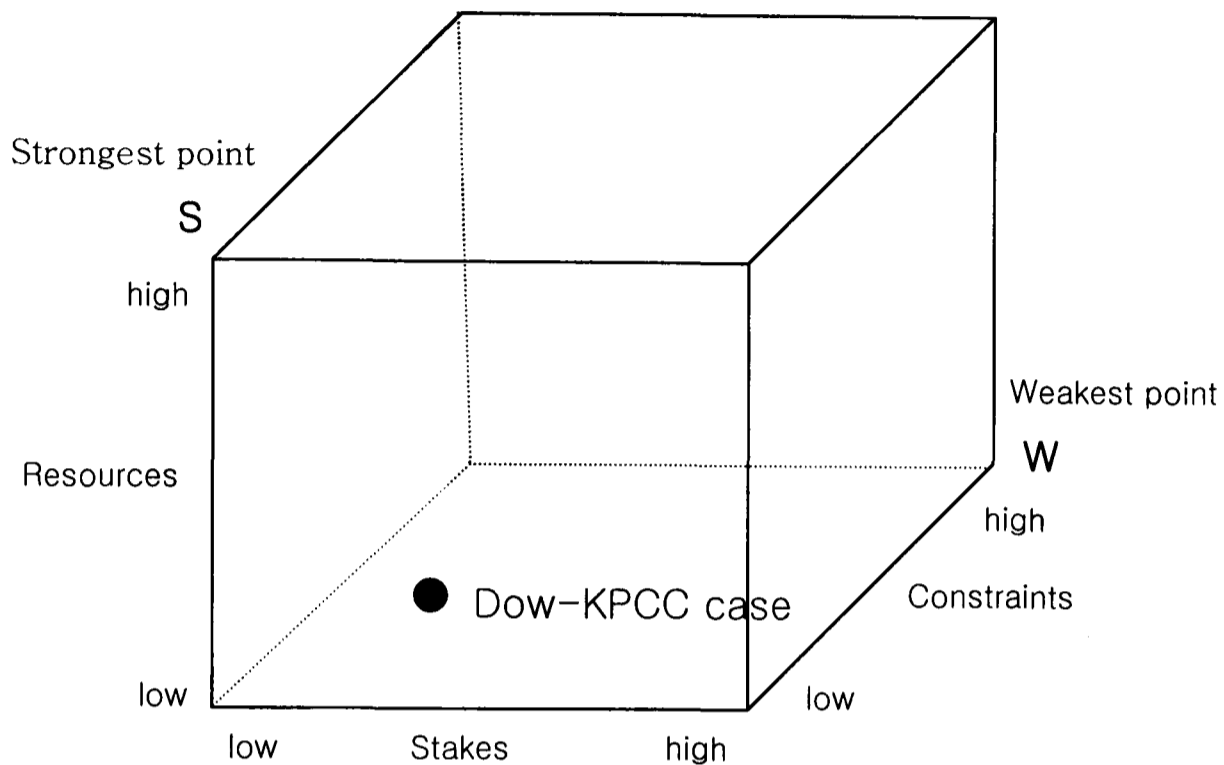
Finally, as these three dimensions are drawn together, we can identify the location of the bargaining power of the Korean government within the framework of the NBM. As is illustrated below, the bargaining power of the government in this case is located at a position that is closer to point S (the strongest point) than point W (the weakest point). That is, the Korean government's bargaining power was relatively strong in the case of Dow Chemical-KPCC, and the strength of the government's bargaining power can be attributed to a relatively low level of stakes and constraints.

Table 4.3 Korean Government's Bargaining Power: Dow Chemical-KPCC case

Dimensions		Level of Dimensions		Level of Bargaining Power
Relative Resources		Low		Medium High
Relative Stake	Commitment	Medium	Medium Low	
	Alternatives	High		
Relative Constraints	External	Low	Low	
	Internal	Low		



Figure 4.1 The Position of the Korean Government's Bargaining Power: Dow Chemical-KPCC case



### General Motors and Shinjin Motor

#### Background

In 1972, General Motors (GM) made inroads into Korea when it established GM Korea (GMK) in equal partnership with Shinjin Motor. Subsequently, GM changed its partnership from Shinjin to Korea Development Bank (KDB) and then to Daewoo Motor. In 1992, the company withdrew from Korea by ending its relationship with Daewoo Motor; in 2002, however, GM returned to the Korean market by acquiring Daewoo Motor, its former partner. This time, GM was in sole management control,

rather than acting as a joint venture partner. Thus, GM was active in Korea for 20 years in Korea following its entry at an early stage of the development of the Korean automobile industry and eventually returned to the market after a ten-year absence. The Korean economy has grown substantially over the past 30 years, thereby changing the Korean government's bargaining power *vis-à-vis* MNCs. The scale of the Korean economy grew substantially during this period: Korea's GDP increased 63 times from just USD8 billion in 1970 to USD511 billion in 2000 and in addition, production capacity increased and the domestic market expanded. However, the bargaining power of the Korean government weakened, contrary to the common expectation that it would have increased in terms of resources. This section will examine the extent of and factors affecting the government's bargaining power by exploring GM's first entry into Korea in 1972 and, in the following section, GM's second entry in 2002.

Shinjin Motor was founded in 1954 and, in its early years, was producing cars manually using second-hand parts sourced from the US garrison in Korea. In 1965, Shinjin Motor acquired Saenara Motor and its manufacturing facilities when Saenara closed its business of importing semi-knocked down (SKD) cars from Nissan Motors in Japan.<sup>82</sup> In 1966, after forming a technical alliance with Toyota, Shinjin Motor produced the Corona model by assembling SKD components imported from Japan (Kim Cheon-Wuk 2002). The Korean government, in constant need of foreign currency for economic development, did not welcome SKD manufacturing because it used valuable foreign currency to import automobile parts and deterred the growth of the domestic parts industry. The government encouraged Shinjin Motor to use domestic parts but to

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<sup>82</sup> 'Semi knocked down (SKD)' refers to a type of import in which products are sold in kit form (semi-finished products) for later reassembly in local markets. 'Completely knocked down (CKD)' is a type of import in which products are completely disassembled.

no avail.<sup>83</sup> At that time, the government had refused to authorize the establishment of another automaker, tacitly approving Shinjin's monopoly. However, Shinjin's reluctance to follow government policy prompted the authorization of the establishment of Hyundai Motor and Asia Motor, bringing competition into the domestic automobile market.

By 1968 the lack of progress in the localisation of automobile manufacturing led then-President Park Chung-Hee to order government officials to take action to accelerate local production of auto parts. The government announced its 'Blueprint for Fostering the Automobile Industry' (also known as the Three-Year Localization Plan) in 1969. The aim was to localise the manufacture of automobiles and the policy included plans for the construction of an engine plant (Kim Cheon-Wuk 2002: 89-90). The lack of capital and technology at this time meant that forging an alliance with foreign automakers to set up this large-scale engine plant was inevitable. Shinjin chose Toyota as its joint venture partner and applied for official permission to establish the alliance. In its application, Shinjin proposed a shareholding ratio of 20:80 with Toyota. Although the government recommended a ratio of 50:50 and instructed Shinjin to modify its proposed ownership plan, Shinjin reapplied with only a nominal change to 30:70 (Oh 1995c: 137). Before the Korean government could make a final decision, however, Toyota revoked the joint venture plan due to events in China: the Prime Minister, Zhou Enlai, announced the 'Four Principles of Zhou' in April 1970 during trade talks between

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<sup>83</sup> Oh Won-Chul, the former presidential economic advisor said of Shinjin Motor: "(Shinjin Motor) did not create any benefits for the Korean automobile industry ... Because their concern was to import parts in kit form and assemble and sell them ... The Ministry of Commerce could not leave this matter unresolved. Thus, the government directed Shinjin to use a minimum of 32 percent of domestic parts yet they used 23.6 percent, making various excuses ... [Shinjin Motor] was not interested in localization at all. They just focused on making money." (Oh 1995c: 109-110).

China and Japan.<sup>84</sup> The main principle was that China would not allow Chinese companies to trade with any company that had business with Korea or Taiwan. Toyota, which was also seeking entry to China, dropped the joint venture attempt because it would have been a serious obstacle to its advancement into China.

Because Japanese automakers were now avoiding Korea, Shinjin Motor had to find a new partner in the US. Given that Ford had already been in negotiation with Hyundai since the 1970s, Shinjin selected GM as its new alliance partner. GM had been actively exploring the possibility of entry to the Korean market since the early 1970s; as Toyota hinted at withdrawing from Korea in 1971 and Ford hesitated over forming an alliance with Hyundai,<sup>85</sup> GM accelerated its joint venture talks with Shinjin Motor. Although the joint venture negotiations between Shinjin and GM went smoothly, the Korean government was disinclined to approve the deal. Oh Won-Chul, then-deputy Minister of Commerce noted in his book that he advised Kim Chang-Won, the president of Shinjin Motor to form a technical alliance with a foreign partner, but not with a big company (Oh 1995c: 156). Ignoring the government's recommendation, Shinjin set up General Motors Korea (GMK) an equal partnership joint venture with GM in 1972. GM invested a total of USD48 million to build and market cars in Korea and, in 1974, GMK opened an engine processing and assembly plant in Korea.

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<sup>84</sup> The Four Principles of Zhou were: firstly, China would not trade with anyone or any corporation that helped Taiwan or Korea. Secondly, China would not trade with anyone or any corporation that invested in Taiwan and Korea. Third, China would not trade with any partner in Vietnam, Laos, and Cambodia that helped or sold weaponry to the United States. Fourthly, China would not trade with the subsidiaries of US companies (Oh 1995c: 138).

<sup>85</sup> The alliance between Hyundai and Ford began in 1968 when Hyundai imported the Cortina on a CKD basis. Joint venture talks began in the 1970s, but negotiations did not proceed smoothly. Hyundai wanted to manufacture small cars under its own brand and export them through Ford's distribution channel but Ford was interested only in boosting sales of its existing range of cars, vetoing Hyundai's plan to use its distribution channels to export to countries where Ford had a presence. Furthermore, Hyundai's ultimate goal was to produce finished products on its own while Ford wanted to produce only diesel engines in Korea under its 'one country one part' principle. These differences made the joint venture fall apart in 1973, and Hyundai adopted a new strategy aimed at developing cars independently (Kim Seong-Hun 1999).

In 1974, the Korean government released its 'Long-term Plan for the Promotion of the Domestic Automobile Industry', seeking to nurture the automobile industry as an export industry, and abandoning its import substitution strategy for automobiles. This policy would depend on developing a local vehicle model.<sup>86</sup> The Korean government asked four major automakers — GMK, Hyundai, Kia and Asia Motor — to design and build a completely new model which did not exist abroad. Although, considering the Korean automakers' capabilities at that time, it was too much to ask the four companies made a commitment to develop a new model according to the government's directive. However, the government pledged to support the development of a new model that would meet the official requirements by designating it a 'national vehicle' and offering preferential support in terms of taxes, finances, and administration (Kim Seong-Hun 1999: 105).

The government promised the following: firstly, the manufacturers of the new model would be entitled to tax cuts, including a 50 percent reduction in commodity tax and a two-thirds cut in the automobile tax. Secondly, the government would allow the firm to secure foreign loans and would provide tax breaks on importing raw materials, and, finally, the government would designate the new model as a 'national vehicle' and thus help to secure a share of more than 80 percent of the domestic passenger car market (Kim Seong-Hun 1999: 131).

Hyundai faithfully followed the government plan. After its unsuccessful joint venture attempt with Ford in 1973, Hyundai had started to develop vehicles on its own.

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<sup>86</sup> The Korean government defined an 'independent local vehicle model' as one that was economical, small (less than 1500cc), had never been developed overseas before, and that not require modification for a long time. The reason for developing a small vehicle was that it could avoid competition with foreign automakers and would also create greater domestic demand than would a big model (Kim Seong-Hun 1999).

George Turnbull, who had been in charge of Austin Morris, part of the British Leyland Motor Corporation (BLMC), was appointed as chief technical officer by Hyundai's chairman, Chung Ju-Yung, with Ital Design of Italy working on the design.<sup>87</sup> Hyundai also brought in key technologies for gasoline engines and transmissions from Mitsubishi of Japan. In 1975, Hyundai finally succeeded in producing the 1200 cc Pony, its first-ever independent model. With the Korean government allowing Hyundai Motor a relatively higher profit margin by protecting the domestic market, Hyundai was able to dominate the domestic market after the launch of the Pony, accounting for 50 percent of the market in 1976, 58 percent in 1977, and 66 percent in 1978.<sup>88</sup> As is shown in Table 4.4, Hyundai's output began to increase rapidly, compared with that of GMK (KCC 1987: 167).

Table 4.4 Production Volumes of GM Korea and Hyundai Motor

Year	GMK	Hyundai Motor
1972	4,471	2,615
1973	6,696	5,426
1974	1,565	6,846
1975	2,559	4,722
1976	3,788	14,826
1977	4,270	27,466
1978	12,162	57,054
1979	18,430	71,774

Source: KAMA 2004

<sup>87</sup> In 1973, then-vice president of BLMC George Turnbull left his company, which had been going through management difficulties due to a strong trade union. In 1974, he was asked to provide technical advice to Hyundai Motor for the development of the Pony model (Hyundai Motors 1992).

<sup>88</sup> The production costs for the Hyundai Pony was USD3,700 in 1979; it sold domestically for USD5,000, and sold abroad for USD2,200 (Wade 1990: 310).

In contrast, GMK's response to the government's request was unenthusiastic, nevertheless, GMK made a proposal for developing a new compact car. As the deadline for the submission of the proposal approached in November 1975, GMK announced another plan to produce the Gemini model, which was manufactured by Isuzu, GM's Japanese joint venture, in Korea; however this plan never came to fruition. With slow progress on the Gemini, GMK introduced the 1500 cc Carmina, a smaller version of the Chivore 1700, without major changes in design and architecture. The reason for the lack of progress in developing an independent model lay in the fact that the parent company GM's strategy was fundamentally incompatible with the Korean government's policy. GM allowed GMK only a limited role in its global specialization structure, but the Korean government wanted GMK to build vehicles independently. MNCs generally allowed their overseas affiliates to build only existing models, and export them under their brand name through their existing sales network. GMK, in partnership with GM, was restricted to developing its own model, contrary to the firm's global specialization structure. GMK eventually went into receivership with the state-run Korea Development Bank (KDB) in November 1976 because of worsening financial difficulties. KDB took a 50 percent share of Shinjin Motor and renamed it Saehan Motor (Kim Seong-Hun 1999).

It can be said that GMK's failure to respond positively to the Korean government's policy resulted in its management crisis and its subsequent acquisition by KDB. Hyundai Motor successfully developed a domestic model and increased its market share with the help of the government. On the other hand, GMK, reluctant to follow the government policy, fell behind in the race, aggravating its financial difficulties, and its collapse can be attributed to its refusal to embrace government

policy and comply with official goals. The main reason for this reluctance lay in the fact that GMK was a joint venture company with GM, which was not enthusiastic about the development of a new model (Cho and Choo 1998: 30).<sup>89</sup> In the next section, we will apply the NBM will be applied to this case.

### Bargaining Power of the Korean Government

In this case, we can assume that the Korean government's bargaining power was strong because the ownership level of GM was only 50 percent. GM, the largest automaker in the world in 1970s, had to settle for 50 percent rather than majority ownership because of the Korean government's restrictions on equity ratio. Although Korea was desperately in need of GM's experience and technology in the 1960s, the government discouraged automakers from forming alliances with foreign companies or limited foreign firms' shareholding ratio to less than 50 percent. The bargaining power of the Korean government in this case cannot be explained solely by elements such as resources; instead, the explanation requires the consideration of dimensions such as stakes and constraints. This section will examine the elements of the bargaining power of the Korean government *vis-à-vis* GM, when GM first entered Korea.

Firstly, we will assess the government's resources when GM entered the market in 1972. The Korean government, which had been keen to foster the domestic automobile industry, announced a series of automobile industry development plans and

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<sup>89</sup> At the time, the Korean government forced automakers who did not comply with its policy to lag behind by not authorizing the import of components while offering compliant companies tax breaks and financial support (Oh 1995c: 205). The government offered incentives or penalties according to the performance of companies. Sometimes, the government relieved companies' financial burdens by freezing the repayment of private loans and forced assembly outfits to close their factories, such as with the closure of Asia Motor in 1974 and the closure of small assembly outfits in 1972 (Cho and Choo 1998: 26-30).



enacted relevant legislation from the 1960s (Cho and Choo 1998).<sup>90</sup> At that time, the government's major concern for the automobile industry was the substitution of local production for imports, but automakers were building vehicles with parts imported on either an SKD or a CKD basis. Strictly speaking, there were assembly companies in Korea but no true automakers.<sup>91</sup> In contrast, GM was the biggest automaker in the world, holding 50 percent of the US market since its establishment in 1916 and ranked as the largest among the *Fortune 500* US industrial corporations in 1971 (*Fortune* May 1972).

GM's entry to Korea was mainly motivated by a desire to access the growing Asian market. Firstly, GM regarded entry to Korea as securing a foothold to move into Japan, which was about to liberalize its automobile market in 1971. Secondly, Korea could serve as a platform for the rest of the Asian market and, thirdly, Korea could be a starting point for an advance into China in the long term (Hyundai Motors 1992: 144). However, production conditions in Korea in 1972 were poor. The automobile parts industry was not sufficiently mature to produce engines, and the country's infrastructure, including roads and ports, was underdeveloped; as of 1970, only 9.6 percent of roads were paved. The Korean government wished to export Korean-made vehicles, but, in the view of GM executives, that was unlikely to happen.<sup>92</sup> Korea simply could not produce enough vehicles for export because the industry was still at an assembly phase.

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<sup>90</sup> Major policies included the 1962 'Five-year Plan for the Automobile industry,' the 1964 'Master Plan for the Automobile Industry,' and the 1969 'Framework for Developing the Automobile Industry (Three-year Plan for Localization).'

<sup>91</sup> In the 1960s, the domestic automobile industry and the components industry were not sufficiently developed enough to build vehicles independently, so all of the vehicles manufactured were assembled with imported parts. In 1962, Saenara Motor assembled the Nissan Blue Bird on an SKD basis but subsequently stopped production due to a shortage of foreign exchange. In 1965, Shinjin assembled the Toyota Corona after acquiring Saenara Motor and Hyundai Motor, which was established in 1968, assembled the Ford Cortina on a CKD basis.

<sup>92</sup> On hearing of Hyundai's plan to develop an independent model, the Chief Vice President of GMK said in 1974 "it is absolutely impossible for Hyundai to develop and export its own model." His remarks highlighted the low capabilities of the Korean automobile industry in the 1960s (Oh 1995c: 170).

All four automakers in Korea were manufacturing vehicles by assembling parts imported on a KD basis. Although the Korean government had tried to localize vehicles by promoting the automobile parts industry since the 1960s, the ratio of localization for components in 1971 stood at only 40 percent, with manufacturers relying on imports for major components including engines (Oh 1995c: 128). In 1972, Korea's GDP was USD10 billion, and its *per capita* income was only USD320. Annual production of vehicles was 15,000 units, which were mostly assembled and manufactured on a KD basis, and domestic sales volume was no more than 15,000 units a year. Not only was the market small, but also production capacity was weak. Korea was not attractive to multinational companies in either terms of production or consumption (Kim Cheon-Wuk 2002: 86). Therefore, the Korean government's resources were relatively low.

Secondly, the commitment of the Korean government, and the alternatives available to it, must be determined to assess the level of its stakes. In terms of commitment, the GM case is similar to that of Dow Chemical. FDI was considered in the context of the long-term plan for the development of the industry. The government established various plans for the development of the auto industry such as the 'Blueprint for Fostering the Automobile Industry' in 1969 and the 'Long-term Plan for the Promotion of the Domestic Automobile Industry' in 1974. This long-term approach to the development of the industry made the government consider FDI as one of the possible resources for realising its long-term aim; that is, FDI policy was subsumed under industrial policy. As, in the 1960s, the Korean automobile industry lacked the necessary technology and capital to develop further the government's reliance on MNCs seemed to be inevitable. Yet the government was not eager to enter into a partnership with MNCs to promote the industry; instead, it urged domestic automakers to develop

their own model. The government knew that the development of a local vehicle model was essential to encourage the domestic automobile industry to become an export industry. Their own brand model could not be achieved through partnership with MNCs because MNCs would not be willing to help potential competitors develop. For these reasons, government officials at that time were wary of foreign capital dominating the domestic market.<sup>93</sup> As Kim Jae-Kwan, Assistant Deputy Minister of Commerce and Industry in the 1970s, explained, it was vital for an underdeveloped country seeking to become independent to develop its own vehicle model, in order not to be subordinated to multinational carmakers (Kim Jae-Kwan 1995: 270).<sup>94</sup> Oh Won-Chul, who was an advisor to President Park in the 1970s on the heavy and defence industries, noted that he advised Chung Se-Young, the President of Hyundai Motors,

... not to collaborate with foreign automakers. Mass-production is a key attribute in the automobile industry, inevitably creating oversupply. So, automakers must strive to get rid of the excess supply. If you are a partner in an alliance, you easily end up being an outlet for clearing the excess stock. The same goes for every company. Who would be willing to help nurture the automobile industry of underdeveloped countries? Development with the help of multinational companies would be the same as raising a tiger cub with the permission of its mother, which is absolutely impossible. The Japanese industry can be as prosperous as it is today because they pursued their own way (Oh 1995c: 140-141).

The Korean government ultimately wanted to achieve its own production capability

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<sup>93</sup> Until the 1960s, Japan had implemented a protective policy to nurture the industrial capital of its automobile industry. The Japanese government prohibited foreign capital from entering the country and instead encouraged technical alliances. As Korea modelled its industrial policy on that of Japan, both nations had a similar industrial structure (Cho and Choo 1998: 65).

<sup>94</sup> Kim Jae-Kwan drafted the 'Long-term Plan for the Promotion of the Domestic Automobile Industry,' which was most important plan for the Korean government's automobile policy.

using foreign capital and technology and refused to be subordinated to multinational companies. Thus, the Korean government's industrial policies reduced its level of commitment toward foreign capital.

In terms of alternatives, although the Korean government had tried to build its own production capability, reliance on multinational companies was inevitable due to the absence of capital and technology. However, as the case of Hyundai shows, the government was able to create alternatives to relying on MNCs by working with a loyal domestic corporation that would comply with its industrial policy. In the first place, the government provided seed money through various tax breaks and financial benefits to companies that complied with its policy and, if necessary, the government forced to transfer the wealth of specific groups to industrial capital. The '8.3' Action is an example of special favours offered by the government to promote specific industries (see Chapter Three footnote 18). Hyundai, which had overstretched itself to build a capital-intensive automobile production arm in the early 1970s, was borrowing money from private money lenders at annual interest rates as high as 45 percent because institutional financial sources could not meet the company's demand for money. A natural consequence of this was that Hyundai went into serious financial difficulties and under those circumstances, it was impossible for Hyundai to develop an original vehicle model without obtaining direct investment from foreign capital. However, the government saved Hyundai from such troubles through the '8.3 Action'. Although the '8.3 Action' was not designed specifically for Hyundai Motors, it turned out to be the biggest beneficiary of the action (Hyundai Motors 1992: 141). In addition, the Korean government assisted Hyundai in securing foreign loans to compensate for the lack of domestic capital. In all, the development of the Pony cost Hyundai Motors USD78

million, of which domestic capital contributed only USD17 million. Hyundai borrowed the remaining 78 percent from overseas, with Barclays of England, Suez of France, and Mitsubishi of Japan being among the biggest lenders (Hyundai Motors 1997: 200). With interest rates abroad significantly lower than those at home, it was highly beneficial to borrow money from overseas<sup>95</sup> and the Korean government supported Hyundai's efforts to raise capital by co-signing the loans.

The matter of technology could be solved through technology licence agreements. Hyundai signed agreements with Perkins of UK for diesel engine technology, Mitsubishi of Japan for gasoline engines and transmissions, and Ital Design of Italy for design. These agreements made it possible for Hyundai to access technology and design without the formation of a joint venture. Although the global automobile industry was controlled by a small number of multinational companies, many other automakers were competing on the basis of their own technology. Their technologies could be obtained as long as they were standard or matured; thus when Ford refused to transfer technology, Hyundai could rely on Mitsubishi (Baek 1990: 411). In short, the stake was not high as a result of industrial policy, which lowered the level of commitment and created available alternatives.

Lastly, in terms of the Korean government's constraints, the Korean government in the 1960s and 1970s faced a low level of constraints. As we all know, Korea in the 1960s and 1970s was one of the poorest countries in the world and was regarded as a country in need of help from the rest of the world; this enabled her to avoid external pressures in terms of opening the domestic market in terms of both trade and investment. In this case, the government's efforts to develop its automobile industry did not face any

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<sup>95</sup> The difference between domestic and foreign borrowing rates ranged from 4.4 percent to 18 percent between 1965 and 1970 (Amsden 1989: 94).

external obstacles even though they were undertaken in an extremely protectionist way. Internally, as we have seen, the Korean state in the SOM phase maintained a significant level of autonomy over society. In fact, the government wielded power by nurturing or weeding out industrial capital, based on its relatively strong autonomy. According to Amsden (1989: 15), the Korean government could discipline the businesses by using a system of penalties and rewards; the Asia Motor case was a representative example of the government's control use of penalties for poor performers to control industries. Asia Motor was the product of the government's strategic choices. In 1965, the government decided to authorize another automaker, Asia Motor, to foster competition with Shinjin, which had not been enthusiastic about developing a new domestic car model.<sup>96</sup> However, Asia Motor was not passionate about developing a domestic model either and so the government eventually forced Asia Motor to merge with Kia Motor in 1976 (Hyundai Motors 1992: 151). In other words, the government forced out companies that refused to follow its policy and, at that time, the government's power was strong enough to dictate market entry and withdrawal. In contrast, the government could help to make businesses successful in a short period of time through various rewards. It carefully selected companies that had potential and enthusiasm about following its goals, and then concentrated every possible resource on them to help them grow. The government encouraged competition among four major carmakers to develop a local vehicle model, and when Hyundai won the competition, the government fully supported Hyundai not only by offering numerous tax cut and subsidies, but also by designating its model as a 'national vehicle'. This was the start of Hyundai Motors, which became the world's 6th

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<sup>96</sup> Until the mid-1960s, the Korean government did not authorize the establishment of any more automakers and supported only one company in order to achieve economies of scale.

largest automaker in 2006.<sup>97</sup> The government could use its power to control domestic companies and thus weaken internal constraints. In short, the government faced few constraints internally or externally and this low of constraints helped to strengthen its bargaining power.

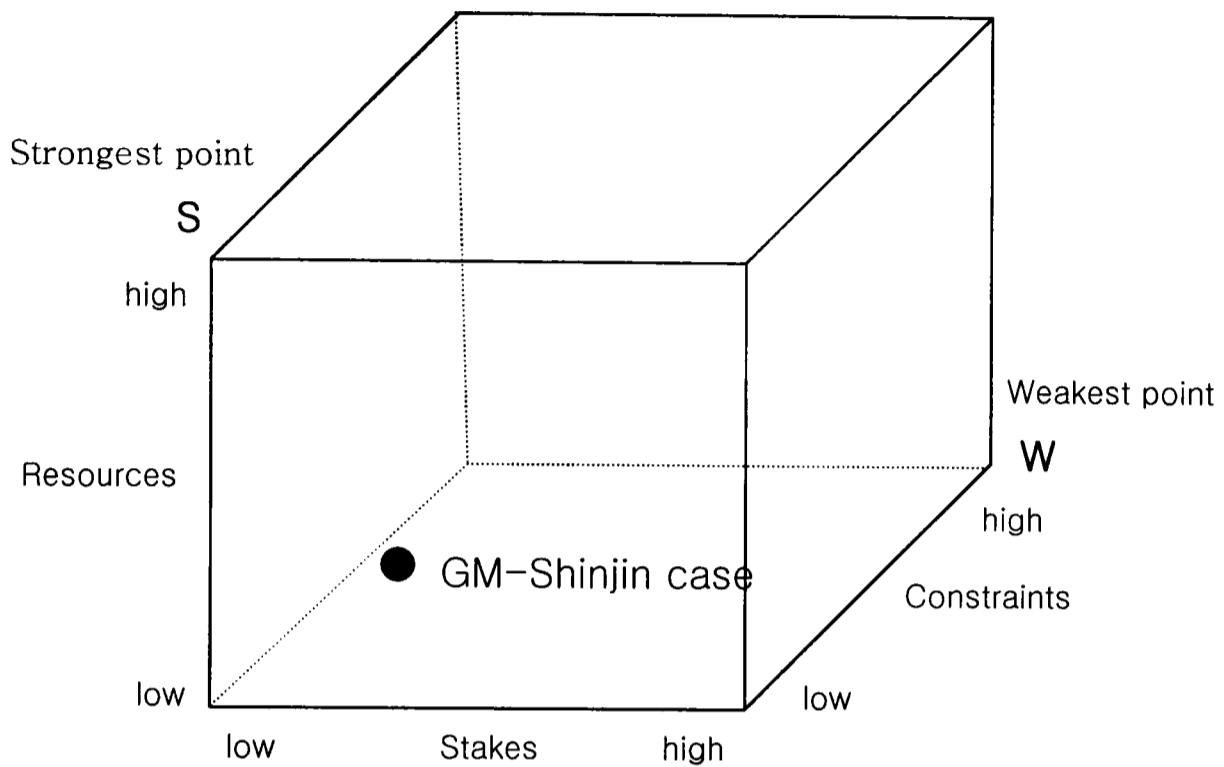
Applying the Neo Bargaining Model to the GM-Shinjin case, the Korean government's bargaining power can be illustrated as seen in the table and figure below. As in the Dow Chemical case, the position of the bargaining power of the government in this case is near point S (the strongest point), which indicates the relatively strong bargaining power of the Korean government. This strength is attributed to the low level of stakes and constraints.

Table 4.5 Korean Government's Bargaining Power: GM-Shinjin case

Dimensions		Level of Each Dimensions		Level of Bargaining Power
Relative Resources		Low		Medium High
Relative Stake	Commitment	Medium	Medium Low	
	Alternatives	High		
Relative Constraints	External	Low	Low	
	Internal	Low		

<sup>97</sup> The ranking of global automakers in terms of 2005 global sales is as follows: 1st General Motors (8.4 million units), 2nd Toyota Motor Corp. (8.1 million), 3rd Ford Motor Co. (6.2 million), 4th Volkswagen AG (5.2 million), 5th DaimlerChrysler AG (4.9 million), 6th Hyundai Automotive Group (3.7 million), 7th Nissan Motor Co. (3.6 million), 8th PSA/Peugeot-Citroen SA (3.4 million), 9th Honda Motor Co. (3.4 million), 10th Renault SA (2.5 million) (<http://www.automobile.com> 10 June 2006)

Figure 4.2 The Position of Korean Government's Bargaining Power: GM-Shinjin case



## General Motors and Daewoo Motors

### Background

As was mentioned in the previous section, GMK suffered from a deterioration in its market share and experienced financial difficulties from 1974 because of its lack of response to government policy and the parent company's lukewarm attitude toward the Korean market. Eventually GMK went into the receivership of the KDB in 1976. KDB bought 50 percent of Shinjin's stake and renamed it Saehan Motor, thus changing GM's partner from Shinjin to KDB. The relationship between KDB, which was a state-run bank without any experience in the automobile industry, and GM, which lacked an



understanding of the Korean market, was never smooth. Hence, the government started looking for a buyer who would take over KDB's shareholding in Saehan Motor. The government asked the Daewoo Group to acquire Saehan Motor, appreciating its performance to normalize Hankook Machinery, an insolvent state-owned company.<sup>98</sup> Daewoo was also interested in the offer since its affiliate, Daewoo Heavy Industries, was already producing diesel engines. Daewoo began participating in the management of Saehan Motor from 1978 and in 1982, when Saehan was still performing poorly under the management of GM, Daewoo took over management control through negotiations with GM and changed the name to Daewoo Motor.<sup>99</sup>

In the 1980s, in order to compete with rapidly-growing Japanese competitors, GM made a plan to introduce an affordable compact car to the Korean market. In 1986, the Le Mans, which was developed by Opel, GM's affiliate, was introduced to Korea on an OEM basis.<sup>100</sup> Although, from that time, GM used Korea as a production platform for export, the quality of the Le Mans produced by Daewoo failed to meet GM's expectations, and GM was unenthusiastic about the sales. In addition, GM did not undertake the export quota that it had promised to Daewoo.<sup>101</sup> Eventually the partnership began to fall apart. GM had been increasingly dissatisfied with Daewoo's

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<sup>98</sup> Daewoo started as a trading company and advanced into the heavy and chemical industries in the 1970s by acquiring insolvent companies. Its diversification included acquisitions of Hankook Machinery (Daewoo Heavy Industries) in 1976, Saehan Motor (Daewoo Motor) in 1978, Okpo Shipbuilding (Daewoo Shipbuilding) in 1978, and the home appliances sector of Daehan Wires (Daewoo Electronics) in 1983. Since then, Daewoo grew rapidly to become the second-largest conglomerate in Korea. However, in 1999, it was dissolved as a result of its highly-leveraged expansion.

<sup>99</sup> The joint venture between GM and Shinjin Motor started in 1972 with equal partnership on the condition that management control belonged to GM. In 1982, Daewoo gained management control, but had to transfer it back to GM in 1984 (Kim Seong-Hun 1998: 164).

<sup>100</sup> In the 1984 investment agreement, GM and Daewoo struck a deal to build a derivative of Opel's Kadett that was customized for the Korean market, investing USD100 million each and raising USD450 million from outside (Kim Seong-Hun 1998: 168).

<sup>101</sup> GM promised to produce no fewer than 100,000 vehicles a year in 1986 when Daewoo started producing the Le Mans model. However, in the seven years until 1992, total exports of the Le Mans to the US were as few as 240,000 units. As a result, the operating of the Le Mans production line remained at less than 40 percent (Cho 2001a: 160).

declining price competitiveness as a result of labour disputes, frequent strikes, and low quality. For Daewoo, GM's restriction on access to export markets was the biggest source of dissatisfaction. Furthermore, Daewoo could no longer tolerate GM's indifference to the sluggish sales of the Le Mans model in the US market and its refusal to invest in the development of a new model (Ryu 1993: 185-186). This growing dissent between the companies was perhaps inevitable as Daewoo grew in size and strength;<sup>102</sup> in 1992, GM sold its share to Daewoo for USD170 million and left Korea, 20 years after its entry.

Now under independent management, in 1993 Daewoo Motor embarked on a bold overseas investment programme under the slogan of 'global management (*Segyeo Gyeongyeong*)' and backed by the government's liberalisation policy and the globalisation trends. Daewoo bought the Worthing Technical Center in the UK and began operations in India, China, Romania, Poland and Uzbekistan. The company continued to expand in Korea, building a complex in Gunsan and as a result of aggressive management including the concurrent introduction of three models (the Lanos, Nubira and Leganza). Daewoo Motor emerged as the 20th largest automaker in the world in 1996 (Lee Young-Myeon 2002: 44).<sup>103</sup> When Korea was hit by the 1997 financial crisis, Daewoo's excessive expansion increased the burden of its financial

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<sup>102</sup> According to Kim, the limitations in their partnership on Daewoo's side were as follows: Firstly, Daewoo's sales in overseas markets were restricted by GM. Daewoo's advance into Europe — traditionally the territory of GM's affiliate, Opel — caused friction with GM. Secondly, Daewoo's production costs increased as it manufactured only GM models; Daewoo had to depend entirely on GM or GM's affiliates for key components and GM did not allow Daewoo to cut prices or to diversify its sources of technology transfer. Therefore, Daewoo had to bear the increased costs of imported parts when the yen and German mark strengthened. Thirdly, due to the delay of important decisions, Daewoo could not properly respond to changes in government policies and the management environment. Finally, Daewoo was obliged to pay management and technology consulting fees to GM even though they were joint venture partners (Kim Seong-Hun 1998: 169-170).

<sup>103</sup> As of 1995, it ranked as the 52nd largest multinational company as well as the biggest multinational company in developing nations in terms of assets. As of 1997, Daewoo was the third largest *chaebol* in Korea, with 290 affiliates. It owned 343 subsidiaries in 62 countries and 153 overseas branches. Daewoo group was dissolved after its bankruptcy in 1999 (Park 1999).

costs. Finally, Daewoo Motor was placed in a workout programme (a corporate restructuring programme established by the Korean government) and then was put in the hands of its creditors in August 1999.<sup>104</sup> Subsequently, Daewoo Motor was treated as a public company since its main creditor, KDB, was a state-owned bank. The Korean government took an active role in dealing with Daewoo Motor, taking into consideration the impact of its difficulties on the industry and the economy.

In August 1999, when it was under the workout programme, Daewoo began talks on a strategic alliance with GM with the aim of surviving on its own. However, the talks fell apart in November of the same year due to disagreements on the proposed acquisition price and debt write-off. This time, the government's intervention was indirect, as officials urged for an early agreement while Daewoo's management exercised autonomy to a significant extent. After the failure of the negotiations, the government's intervention became more substantial and the government and creditors nationalized Daewoo Motor through a debt-for-equity swap.

In December 1999, GM notified the Korean government of its intention to buy Daewoo Motor for USD5.5 billion and Ford also announced its willingness to acquire the company. Therefore, the Korean government and creditors decided to open it to international bidding and set the deadline at the end of June 2000. GM, Ford, and Hyundai-DaimlerChrysler participated in the international bidding; Ford offered the highest price of USD7 billion while GM offered USD4 billion (Ahn 2003: 606). Although the government designated Ford as the preferred bidder, in September 2000,

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<sup>104</sup> The workout program refers to a corporate restructuring program by the Korean government since 2002 to select promising companies among troubled companies and assist in normalizing their business as well as restructuring. In exchange for benefits such as extension of maturity, interest cuts, and additional loans, the companies have to undergo harsh restructuring under the leadership of creditors. The importance of this program is in normalising the company and allowing creditors to collect debts, benefiting the entire national economy.

Ford suddenly withdrew its bid because of internal problems.<sup>105</sup> Although Hyundai Motor indicated its willingness to acquire Daewoo Motor, the government's response was negative because it had decided to sell Daewoo Motor to a foreign company. In October 2000, GM submitted their letter of intention (LOI) with a bid of USD1.2 billion, less than a third of the previously proposed price and one month later, Daewoo was bankrupt and was placed under court receivership.<sup>106</sup> After Daewoo's bankruptcy, GM suspended negotiations and refused to make its intentions clear, contrary to the government's wish for an early settlement and a quick decision from GM. In March 2000, during his visit to the US, then President Kim Dae-Jung asked GM's chairman, John Smith, to acquire Daewoo and MOCIE announced that Daewoo Motor would look for another way to survive if GM did not confirm its willingness to buy the company by April. In May 2001, the board of GM made a decision to acquire Daewoo Motor and in September, the creditors of Daewoo and GM signed a memorandum of understanding (MOU) and a contract for the sale of Daewoo. The amount invested by GM to acquire a controlling share of the company was just USD400 million, against assets estimated at more than USD10 billion (Shin and Chang 2003: 105).

### Bargaining Power of the Korean Government

As we have seen, the bargaining power of the Korean government had continuously decreased throughout the negotiation process with GM. Finally, the negotiations ended

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<sup>105</sup> In 2000, Ford had to recall substantial numbers of its pickup trucks and SUVs because of defects in the tyres, which were made by Firestone. Ford was also about to recall other vehicles which had defective ignitions (Lee Young-Myeon 2002: 49).

<sup>106</sup> Court receivership is a legal process to normalize a company by coordinating the interests of creditors and shareholders under court supervision after freezing debt repayments. It is most effective when it is difficult to coordinate interests among parties. The disadvantage is that it damages the credibility of the company in question and prevents it from doing business normally for a considerable period of time.

under disadvantageous conditions from the government's perspective, with the outcome falling far short of original expectations. In terms of assets and technology, Daewoo Motor was sufficiently competitive for five domestic and foreign automakers for the takeover when the Korean government opened up the international bidding. Nevertheless, Daewoo Motor was sold to GM for a disappointing amount; the reason for the decline in the Korean government's bargaining power was its high level of stakes and constraints. We will now examine the Korean government's bargaining power by applying Neo Bargaining Model to the case.

Firstly, in terms of resources, Korean government had a relatively high level of resources in the negotiations with GM. In 1972, the time of GM's first entry into the Korean market, Korean GDP was USD10 billion and the Korean economy was ranked 33rd in the world. As the annual production and sales of vehicles was only 15,000 units, which were mostly assembled and manufactured on a KD basis, Korea was not attractive to carmakers as a production location or as a market (Kim Cheon-Wuk 2002: 86). By 2000, however, Korea's economy had grown to be the 12th largest in the world with GDP of USD511 billion. Korea was the fifth-largest automaker with annual production of 3 million units, the second-biggest car consumer in Asia and the 8th-largest consumer in the world (Lee Young-Myeon 2002: 65). Moreover, Korea now had appropriate infrastructure and related industries for automakers. The value chain was strong throughout the production processes, including design, manufacturing, sales, and distribution. Furthermore, all related industries had developed to an advanced level, including machinery, chemistry, textile, electricity, and electronics. Obviously, Korea had advantages as a production base for multinational companies in terms of industrial infrastructure (Lee and Jung 2001: 37). In the 2000s, Korea was not only an attractive

production base but also a big market for MNCs.

GM had been interested in the Korean market even after the end of its relationship with Daewoo in 1992, as evidenced by GM's unsuccessful attempt to acquire Ssangyong in 1997.<sup>107</sup> Firstly, GM's interest in the Korean market can be attributed to the size of the Korean market and, secondly, Korea could serve as a production platform for GM's advance into Asian markets which were growing rapidly. GM's target was to gain a 10 percent share of the Asian market, although it held only 3.8 percent share at the end of 1990s. Even though GM had six regional offices in six countries in the Asia-Pacific region — including China, Taiwan, and Thailand — there were only two nations with production capacity of more than 100,000 units and, in 2000, Daewoo's production capacity was more than one million units. Therefore, investment in the Korean market satisfied GM's motivations of both production and consumption. Korea was rich with resources in the automobile industry (Lee Young-Myeon 2002: 64) and, therefore, the level of relative resources of the Korean government can be said to have been high during the second round of bargaining with GM.

Secondly, in terms of stake, the commitment level of the Korean government was high due to the lack of alternatives. The government's insistence on selling Daewoo Motor to a foreign multinational company increased its level of commitment to those companies. Since he took office, President Kim Dae-Jung had tried to attract foreign investment; wanting to settle the situation with Daewoo Motor by attracting MNC investment, on two occasions he asked GM's chairman to acquire Daewoo Motor. in June 1998 and March 2000. His efforts at sales diplomacy aimed to salvage the Korean economy after the financial crisis; hence, it was no exaggeration to say that the success

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<sup>107</sup> Ssangyong Motor was merged with Daewoo in 1998.

of President Kim's diplomacy depended on the sale of Daewoo Motor to GM. It was almost impossible for those within the government to propose another option for Daewoo Motor because of the President's determination to sell Daewoo Motor to a foreign company (Cho 2001b: 151). Although there were some groups — including MOCIE and the Korea Institute for Industrial Economics and Trade (KIET) — that advocated an interventionist industrial policy and criticized the sale of Daewoo to a foreign company, the government did not accept their suggestions.<sup>108</sup> Rather, the Minister of MOCIE, Kim Young-Ho, and the head of KIET, Lee Sun — both of whom had advocated nationalizing Daewoo — had to step down from their positions.

In the meantime, the Financial Supervisory Service (FSS), the Ministry of Finance and Economy (MOFE), and the Korea Development Bank (KDB), all of whom opposed the industrial policy approach, took the initiative in dealing with Daewoo Motor. Their argument was based on the prediction that only the five major automakers would survive in the world car market, creating an oligopoly system, and so it was only a matter before Daewoo was sold to a foreign automaker, as Daewoo could not survive on its own. Therefore, they argued that trying to save Daewoo through nationalization was meaningless and that selling Daewoo to one of the MNCs was the best solution for the Korean automobile industry (Cho 2001b: 131-132). Industrial policy groups were alienated as the sale of Daewoo Motor to a foreign MNC. This development was the opposite to the situation seen with the above-mentioned cases of KPCC and Shinjin Motor. During the SOM period, the high level of commitment to the capital and technology of MNCs was offset by the government's industrial policies. However,

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<sup>108</sup> Traditionally, the Ministry of Finance and Economy (MOFE) and Korea Development Institute (KDI) took a liberal stand, opposing industrial policy while MOCIE and KIET were proponents of industrial policy, advocating mercantilism.

during the MOS period, the level of commitment to MNCs was higher because of the abandonment of industrial policy, even though the level of dependence on MNCs' capital and technology was low.

The government decreased its bargaining power by exhausting these alternatives. The industrial policy group within the government recommended temporarily nationalizing Daewoo Motor for the sake of the long-term interests of the domestic automobile industry. MOCIE and KIET also maintained that Daewoo could be normalized through the settlement of bad debts by giving KDB, the main creditor, the large stake in the company through a debt-for-equity swap, a practice that was not uncommon when the government liquidated debt-ridden companies. In 1976, when GMK (the predecessor of Daewoo Motor) was in financial trouble, the government sold it off after taking over GMK's management control for a while by transferring Shinjin Motors' share in GMK to KDB. This time, however, this option did not gain support within the government. The other option was to sell Daewoo Motor to one of the domestic automakers; although Hyundai Motor had a strong interest in acquiring Daewoo at the time, the government did not approve the sale. The government's rationale was that Hyundai's monopoly in the domestic automobile market would be reinforced because it had already acquired Kia Motors, one of the major carmakers in Korea.<sup>109</sup> Although the government itself had eliminated some of the available alternatives, it still had various options, such as GM, Ford, and Hyundai-DaimlerChrysler, when it opened the international bidding for Daewoo Motor.<sup>110</sup> The government appointed Ford as the sole preferred bidder, but Ford withdrew from the

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<sup>109</sup> The monopoly logic ran counter to the previous governments' monopolisation policy for the automobile industry, which was intended to limit competition and realize economies of scale.

<sup>110</sup> Hyundai Motor formed a consortium with DaimlerChrysler when the government opposed its sole bid.



bidding. Even after Ford withdrew, the government continued to oppose Hyundai's acquisition, citing a possible monopoly in the domestic market as the major reason. Thus, GM became the only option left because the government had already set the principle that Daewoo Motor should be sold to a multinational company.<sup>111</sup> In this way, neither nationalization nor domestic automakers were viable options for the government, and only foreign MNCs were considered possible. When Ford withdrew, the government's bargaining power shrank drastically, leaving GM as the sole option.

Thirdly, in terms of constraints, the level of both internal and external constraints of the Korean government was high. In terms of external constraints, after the 1997 crisis the Korean economy had faced tremendous external pressure under the IMF restructuring programmes. Furthermore, there had been increasing pressure from the US government regarding the trade imbalance in the automobile industry. The US government had complained that Korea imported far fewer cars than it exported<sup>112</sup> and urged the Korean government to provide favourable conditions for the import of American vehicles. The United States Trade Representative (USTR) invoked trade restrictions in October 1997, citing Korea's import barriers to American vehicles (Cho 2001b: 146). The conflict was mitigated in October 1998 when Korea and the United States reached agreement in the Korea-US Automotive Talks.<sup>113</sup> Even after that, the

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<sup>111</sup> The government's determination to sell Daewoo to a foreign firm is confirmed by the fact that it designated Ford as the sole preferred bidder. Generally speaking, it is more common to designate multiple preferred bidders in order to secure favourable conditions and to prepare for a possible withdrawal by one of the parties. Nevertheless, the government designated Ford as a single preferred bidder, which was enough to raise the suspicion that the government would not give an opportunity to Hyundai-DaimlerChrysler, who offered better conditions than GM (Cho 2003: 85).

<sup>112</sup> In the US auto market, sales of Korean automobiles continued to increase from 1.43 percent in 1995 to 1.58 percent in 1996, and to 1.8 percent in 1997. On the other hand, US automakers held only a 0.2-0.3 percent share of the Korean market (Ahn 2003: 512-513).

<sup>113</sup> In the Korea-US Automotive Talks in October 1998, the two nations agreed to reduce the automobile tax which was graded according to engine displacements in Korea, to maintain the current level of customs duties at 8 percent, and to cut the excise tax by 30 percent. As a result, the price gap between domestic and imported vehicles with an engine displacement of 2000cc narrowed from 12.5 percent to

USTR and American Chamber of Commerce (AMCHAM) continued to put pressure on Korea, with AMCHAM insisting that the tariff on imported cars should be lowered from the current 8 percent to 2.5 percent and asking the Korean government to help alleviate the public's antipathy toward imported cars. The US pressure on automobile trade acted as an indirect pressure on the settlement of Daewoo Motor, which the Korean government saw as a way of escaping from US pressure (Cho 2001b: 148).

Internally, there were too many negotiating parties, changing too many times, regardless of each of their capabilities. Although KDB was the main party in the negotiations, representing the entire group of creditors, other parties such as the Presidential Office, MOFE, FSS, and the negotiation task force of Daewoo Motor also participated, because of the possible effects on the national economy and because public funds that had been channelled into Daewoo. To make matters worse, there was no single coordinator on Korea's side who was responsible for the negotiations; the Korean coordinator in the negotiations changed six times: Lee Hyun-Jae, head of the FSS; Lee Keun-Young, president of KDB; Oh Ho-Keun, president of the Daewoo Restructuring Association; Eom Nak-Yong, president of KDB; Jeong Keun-Yong, president of KDB; and Lee Jong-Dae, chairman of Daewoo Motor. A consistent policy could not be expected to emerge under these circumstances. In contrast, Allen Periton, head of GM Asia-Pacific, had represented GM throughout the whole negotiation process; Periton, who had been sent to Korea as a missionary in 1965 and was an expatriate executive in Saehan Motor (the predecessor of Daewoo Motor), knew Korea and the Koreans very well (Ahn 2003).

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11.7 percent. The Korean government applied higher taxes on large size vehicles, which was an obstacle to US carmakers which had a competitive edge in large size models (Cho 2001b: 146).

Another factor contributing to the deterioration of the Korean government's bargaining power was internal resistance, the strongest of which was Daewoo's labour union. From the beginning, Daewoo's union opposed the sale of their company to a foreign company and, even after the deal was struck, the union continued to strike, opposing restructuring schemes that included layoffs. The union's resistance to the sale and restructuring weakened the bargaining power of the government and GM's desire for acquisition. Moreover, local sentiment in the Incheon area, where Daewoo's main factory was located, was against the sale of Daewoo to GM because of the fear of mass layoffs and negative effects on the regional economy after the acquisition. Protesters set up various organizations and local lawmakers joined forces with them, intervening in the negotiation process in various ways. There was little consensus even within the government on the settlement of Daewoo. MOFE and the FSS considered that the best solution was to sell Daewoo Motor to a foreign company as quickly as possible. On the contrary, MOCIE was negative about the sale of Daewoo overseas, insisting on the possibility of reviving Daewoo without selling it (Ahn 2003: 612-613). The main bargaining body had to cope with two separate negotiations, bargaining with GM while seeking to persuade the opposing camps at home. Thus, it was natural that the Korean government's bargaining power decreased during the course of negotiation.

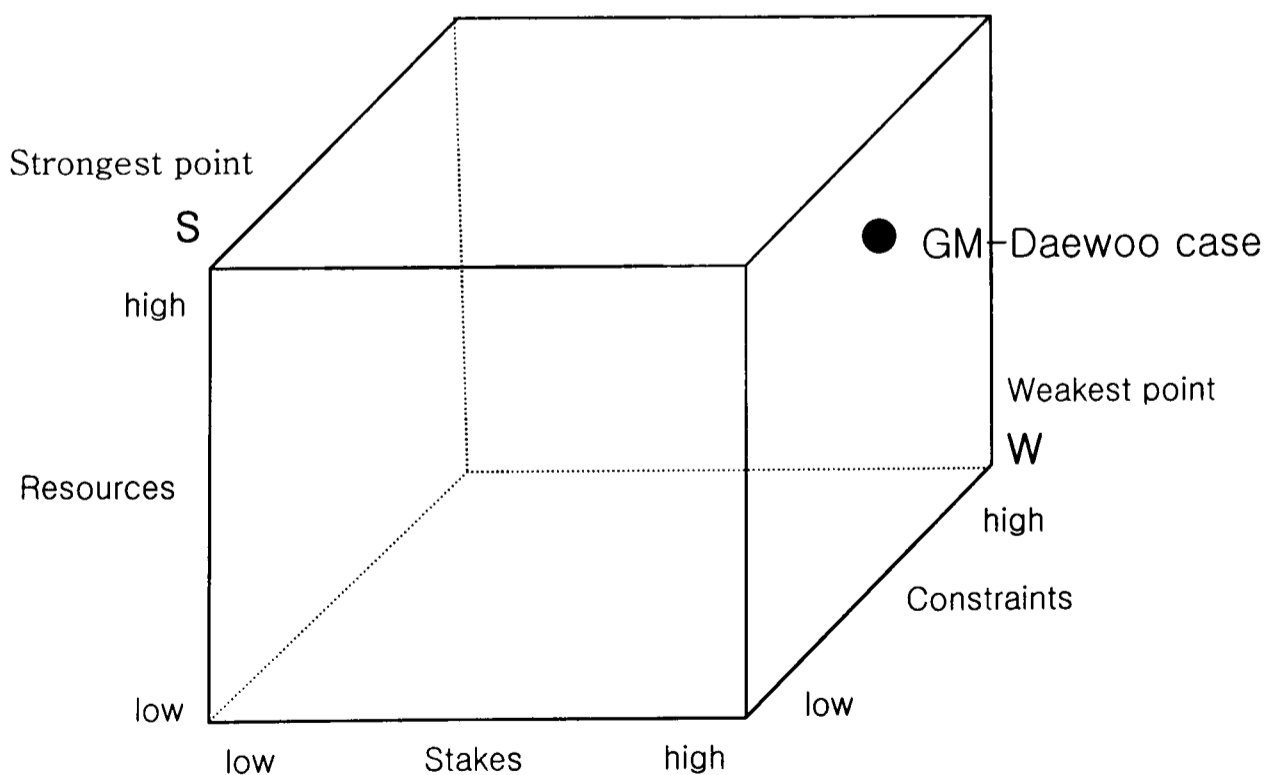
Applying the Neo Bargaining Model to the GM-Daewoo Motor case, the Korean government's bargaining power can be illustrated by the table and figure below. Despite plentiful resources, the Korean government failed to secure favourable conditions for the negotiations and completed the bargaining process with outcomes that were far from satisfactory. This can be attributed to the high level of stakes and constraints on the Korean government. Putting these three dimensions together, we now place the position

of the bargaining power of the Korean government in the cube of the Neo Bargaining Model. As the figure indicates, the bargaining power of the government in this case is located closer to point W (weakest point) than point S (strongest point). Therefore, it can be concluded that the Korean government's bargaining power was relatively weak in the case of GM-Daewoo.

Table 4.6 Korean Government's Bargaining Power: GM-Daewoo case

Dimensions		Level of Each Dimensions		Level of Bargaining Power
Relative Resources		High		High
Relative Stake	Commitment	High	High	
	Alternatives	Low		
Relative Constraints	External	High	High	
	Internal	High		

Figure 4.3 The Position of Korean government's Bargaining Power: GM-Daewoo case



### 3. Conclusion

This chapter comprised a statistical analysis of foreign-invested firms in Korea and three case studies on the bargaining power of the government, both of which strengthen the arguments made in Chapter Three. The statistical analysis demonstrated the decline of the government's bargaining power and the case studies showed how the three elements of the Neo Bargaining Model — resources, stakes, and constraints — influenced the changes in the bargaining power of the Korean government. The arguments made in the previous chapter were generalised by the statistical analysis and specified by the case studies.

In particular, this chapter clearly showed how the differences in the approach adopted by the government had in dealing with multinationals in the SOM (developmental state) period and the MOS (neo-liberal dominated state) period. This different attitude toward foreign investment had contrasting consequences in terms of the stakes and constraints dimensions of the NBM. In the SOM period, the state had firm industrial policies, to which FDI policy was subordinated. KPCC's joint venture with Dow Chemical was a project arising from the 1966 'Petrochemicals Industry Development Plan', and Shinjin's partnership with GM was made under the 1969 'Blueprint for Fostering the Automobile Industry'. When foreign companies entered Korea, they were required to follow the government's industrial policy, which was applied to foreign capital as well as domestic capital. The government's commitment to FDI was lower in this period because the government gave a higher priority to industrial policy considerations than FDI policy. These industrial policies also created alternatives to reliance on foreign companies by building competitive domestic companies, which

eventually could check the domination of foreign companies, as the case of Hyundai Motors showed. Therefore, the government's stake could be reduced by the industrial policies of the developmental state.

In contrast, in the MOS period, the government was only concerned about coping with the crisis situation, disregarding the previous long-term strategies for domestic industry. This abandonment of industrial policy prompted the government to increase its level of stakes. In the MOS period, the industrial policy argument lost favour while neo-liberal beliefs were dominant in the government; in fact, the term 'industrial policy' was almost forgotten and FDI policy received a new emphasis in the government. The attempt to transfer the management of Daewoo Motor to domestic capital was discouraged because foreign companies were perceived as the cure for an ailing industry while the *chaebol* had fallen from grace. The pursuit of foreign capital heightened the commitment of the government and diminished domestic alternative options, resulting in high stakes in FDI during the MOS period.

In terms of the constraints aspect, government capacity in the SOM period — both in terms of controlling social pressure groups and managing a competent bargaining agency — enhanced its bargaining power, which, in turn, reduced internal constraints. Many cases in the automobile industry showed the impact of strong government initiatives in promoting the industry's development; the government set targets (such as the development of a local vehicle model) and, in order to motivate companies to achieve these targets, the government penalised poor performers (as in the case of Asia Motors) and rewarded good ones (as in the case of Hyundai Motors) (Amsden 1989: 15). The government's powerful grip on the domestic industry enabled the state have strong bargaining power. In the petrochemicals industry, the government

led not only the planning process but also negotiations with foreign firms, during which the government generated artificial competitiveness through the removal of disadvantages and the creation of advantages, as the Dow Chemical-KPCC case showed.

However, in the MOS period, the government faced not only strong external pressures but also a high level of internal restraints. The government could not effectively control groups that opposed or resisted its policies: the labour union at Daewoo Motors persisted in its strike action even during the process of bargaining. Within the government and National Assembly, officials were split into different factions, making it difficult to form consistent and firm government bargaining policy. Moreover, the bargaining agencies also drifted toward weaker powers in the cases of GM-Daewoo.

The difference in the bargaining power between the two periods produced contrasting consequences. In the SOM period cases — Dow Chemical-KPCC and GM-Shinjin — both companies left the country and the assets they left behind were transferred to the emerging *chaebol*. The shares that had belonged to Dow Chemical and GM were taken over by the Korea Explosive Group in 1982 and Daewoo Motors in 1992, respectively. In contrast, Daewoo Motors — which had grown under the protection of the state and which were sustained by substantial amounts of public funding after their collapse — transferred their ownership to foreign concerns. Strong bargaining power led to increased domestic capital, but weak bargaining power allowed domestic capital to flow out of the country.

## **Chapter Five: Bargaining Outcomes**

Chapter Three examined how the Korean government's bargaining power has changed and what factors have affected that power shift and in Chapter Four, the arguments in Chapter Three were illustrated by case studies and statistical analysis. This chapter will analyse the consequences of this change in bargaining relations. The strengths and weaknesses of bargaining power, of course, affect bargaining outcomes; when the bargaining power of the host government is strong, bargaining outcomes are likely to be favourable to the host country. However, when its bargaining power is weak, bargaining outcomes tend to be more beneficial to foreign firms. This chapter will identify the legal consequences of the changes in host country bargaining power in Korea.

Bargaining power relations impact on the host country FDI legal structures, which regulate the activities of foreign companies. The legal system, in turn, affects the inflow of FDI, which eventually produces an economic effect in the host country. In this chapter, we first examine how bargaining power has affected Korean FDI legal structures.

### **1. FDI Laws and the Bargaining Outcomes**

Bargaining outcomes are the result of bargaining between the host government and MNCs; in this thesis, FDI laws are considered to be the one of the bargaining outcomes. The host government, in attracting foreign firms, wants to obtain MNC assets such as capital and technology, while MNCs aim to realize their profits by expanding their markets and exploiting factor endowments in host countries. Such conflicting goals



between two parties are coordinated through the bargaining process, from which the bargaining outcomes will emerge.

FDI laws, which regulate the entry and operations of foreign companies, are regarded as bargaining outcomes because such laws result from the bargaining between a host government, and MNCs and the forces behind them such as home countries and supranational institutions. This study has assumed that the government negotiated with MNCs when they entered or operated in the host country, an assumption that is abstract rather than practical. In practice, the government rarely negotiates with potential investors at the table except in certain special cases. The reality is that the government sets rules regulating foreign companies' inward investments and applies them unilaterally. However, the relative power of the state and MNCs is reflected in the process of establishing FDI rules. The power of MNCs or home countries and the strength of the host economy affect the formulation and implementation of a host country's FDI laws directly or indirectly, as does the relative strength in bargaining power of the host country and MNC. In this respect, FDI laws are regarded as part of the creation of the host country's 'circumstances', which is a passive interpretation of FDI laws.

On the other hand, the laws also have proactive aspects. That is, the laws embody the government's intentions and desire to attempt to introduce changes into an existing situation. Therefore, FDI laws include both proactive and passive aspects. The proactive aspects represent what the government wants from MNCs and how it tries to achieve its goals, while the passive aspects reveal the circumstances of the state in relation to MNCs. Accordingly, FDI laws can be seen as the reflection of both internal goals and capacities and external conditions and environments. In other words, the FDI

laws are the outcome of the interaction between a host government and external forces. In this section, we will first briefly review how Korean FDI laws changed from 1960 to 2005 and demonstrate how the FDI laws are formed by the interactions between the host government and external forces. The second section will compare FDI law in both the SOM and MOS periods to calculate the consequences of bargaining power strengths and weakness in those periods. By this analysis, we will demonstrate how bargaining outcomes are affected by the bargaining power of the state: strong bargaining power tends to produce favourable outcomes to the host country whereas weak bargaining power is likely to result in detrimental effects on the economy.

## **2. Overview of FDI Laws in Korea**

Korea's principal FDI laws have developed from the Foreign Capital Inducement Promotion Act (FCIPA) in 1960; to the Foreign Capital Inducement Law (FCIL) in 1966; to the Foreign Investment and Foreign Capital Inducement Act (FIFCIA) in 1997; and to the Foreign Investment Promotion Act (FIPA) in 1998. This section will review how these laws have shifted and what factors have caused these changes.

The first FDI legislation was the Foreign Capital Inducement Promotion Act (FCIPA), which was enacted on January 1, 1960. This law was later replaced by the Foreign Capital Inducement Law (FCIL) on August 3, 1966, which remained in force for 31 years from 1966 to 1997, with two major revisions in 1973 and 1983. The FCIL was replaced by the Foreign Investment and Foreign Capital Inducement Act (FIFCA) in 1997 and the FIFCA was in turn abolished in September, 1998, less than two years after its implementation. The Foreign Investment Promotion Act (FIPA) was passed on

September 16, 1998; although the FIPA had undergone three partial revisions by 2005, none of these revisions had any real effect on the main framework of the 1998 law.

Table 5.1 Changes in the Laws on FDI

<p>Foreign Capital Inducement Promotion Act (FCIPA)</p> <ul style="list-style-type: none"><li>● Enactment: 1 January 1960</li><li>● Partial revisions (3): 7 August 1961, 1 December 1961, 16 December 1963</li><li>● Abolition: 3 August 1966</li></ul>
<p>Foreign Capital Inducement Law (FCIL)</p> <ul style="list-style-type: none"><li>● Enactment: 3 August 1966</li><li>● Complete revisions (2): 12 March 1973, 31 December 1983</li><li>● Partial revisions (4): 14 January 1991, 8 December 1992, 10 December 1993, 22 December 1994</li><li>● Abolition: 13 December 1997</li></ul>
<p>Foreign Investment and Foreign Capital Inducement Act (FIFCIA)</p> <ul style="list-style-type: none"><li>● Enactment: 13 December 1997</li><li>● Partial revisions (2): 24 February 1998, 25 May 1998</li><li>● Abolition: 16 September 1998</li></ul>
<p>Foreign Investment Promotion Act (FIPA)</p> <ul style="list-style-type: none"><li>● Enactment: 16 September 1998</li><li>● Partial revisions (3): 29 December 2000, 31 December 2003, 31 December 2004</li></ul>

Source: Yoon *et al.* 2005

Laws regulating FDI have changed incrementally through many revisions since the legislation of the FCIPA in 1960. Significant changes in Korean FDI laws are as

follows: the enactment of the FCIPA in 1960; the enactment of the FCIL in 1966; complete revisions of the FCIL in 1973 and 1983; partial revisions of the FCIL in 1991 and 1992; the enactment of the FIFCIA in 1997; and the enactment of the FIPA in 1998. These changes were coupled with important changes in government FDI policy and bargaining power.

The dire need for foreign capital in the early stages of economic development and industrialisation necessitated the establishment of the FCIPA in 1960 and the FCIL in 1966. The complete revision of the FCIL in 1973 was triggered by changes in international relations in north-east Asia and their impact on domestic. While the revision in 1983 was the result of liberal reform within the government after the economic crisis at the end of the 1970s, the revisions in 1991 and 1992 were prompted by trade pressure from the US government. The enactment of the FIFCIA in 1997 was a product of Korea's joining the OECD and the enactment of the FIPA in 1998 was the result of pressure from the IMF after the 1997 financial crisis, coupled with the neo-liberal stance of the Kim Dae-Jung administration. According to the periodisation of this thesis, these changes can be grouped as follows:

#### State over Market phase

- The enactment of the FCIPA in 1960
- The enactment of the FCIL in 1966
- The complete revision of the FCIL in 1973

#### Transition phase

- The complete revision of the FCIL in 1983

- The partial revisions of the FCIL in 1991 and 1992
- The enactment of the FIFCIA in 1997

#### Market over State phase

- The enactment of the FIPA in 1998

#### **State over Market Phase (1962-1979)**

As we have discussed above, in the SOM period, the Korean government was able to maintain relatively strong bargaining power *vis-à-vis* MNCs. The strong bargaining power in this period was manifested in the restrictive FDI laws of the 1960s and 1970s. The SOM phase can be divided into two periods: from 1962 to 1971 and from 1972 to 1979; in the first period, government FDI policy was relatively open and friendly towards foreign companies. The two laws, the 1960 FCIPA and the 1966 FCIL, show the investment-friendly atmosphere of the 1960s. However, from the early 1970s, the government began to show a more restrictive attitude, which was reflected in the total revision of the FCIL in 1973. Despite this difference between the laws of the 1960s and of the 1970s, throughout the period, the government screened every foreign company entry through a complicated approval process and subjected them to demanding criteria. Following the review of changes to FDI legislation presented in the first part of this chapter, we will examine more thoroughly the FDI laws in the SOM and MOS periods, comparing the rights and duties of foreign companies in the those periods.

### Enactment of the Foreign Capital Inducement Promotion Act in 1960

The first legislation relating to inward FDI was the FCIPA, enacted on January 1, 1960. From Korea's liberation from Japanese occupation in 1945 to the late 1950s, foreign aid was virtually the sole source of foreign capital. However, as foreign aid began to decline in the late 1950s, the government had to secure other sources of foreign capital to sustain the economy. This urgent need prompted the government to enact the FCIPA (Gang 1995: 41); the main purpose of the new legislation was to attract foreign capital, regardless of its form. Therefore, the law did not only target FDI but all sources of foreign capital, including foreign borrowing, as suggested by the name of the law – the Foreign Capital Inducement Promotion Act. FDI was treated as just one among several sources of foreign capital.

As the aim of the law was to attract foreign capital, the law's articles were favourable to foreign companies and included the national treatment of foreign investors, the guaranteed repatriation of profits, and the granting of tax relief.<sup>114</sup> However, despite its apparent purpose of attracting foreign capital, the law also stipulated a number of unfavourable regulations for foreign investors, such as the imposition of certain restrictions on profit repatriation, the forced requisition and confiscation of foreign companies, and the mandatory hiring of nationals. Moreover, the law specified its application only to 'citizens of nations that (had) signed a treaty of commerce and navigation with Korea as of 1960'. Since the US was the only nation that had signed such a treaty with Korea at that time, the law, in fact, was aimed at investment from the US (Yoon *et al.* 2005: 33).

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<sup>114</sup> Article 1 (the aims of the law) of the 1960 law specified the attraction, promotion and protection of new foreign capital for the development of manufacturing, mining, agriculture, forestry and fishing industries in order to stabilize the economy and improve the living standards of the nation.

### Enactment of the Foreign Capital Inducement Law in 1966

The FCIPA, which was abolished on August 3, 1966, was succeeded by the FCIL. Although the 1966 law removed the word 'promotion' from the title of the law, it basically aimed to promote the attraction of foreign capital (principally foreign loans), which was the major source of funding for the export-oriented industrialization of the 1960s. The 1966 law also had another purpose: to attract investment from Japan following the normalisation of diplomatic relations with Japan in 1965 (Bishop 1997: 75). Moreover, the law made the foreign capital inducement system more effective by incorporating two special laws of the previous FCIPA: the 'Law for Payment Guarantee of Foreign Borrowing' and the 'Special Law for Facilitating Capital Equipment Imports on a Long-term Deferred Payment Basis'.<sup>115</sup> However, the law was also formulated in such a way as to prevent the domination of foreign capital; in Article 1, which stipulated the purpose of the law, 'economic independence' was accentuated as the first word of the first sentence, demonstrating both the Korean government's determination to attract foreign capital and its resolve to accept foreign money only to the extent that economic independence was not compromised.<sup>116</sup> This provision provided the basis for restricting the activities of foreign companies in order to preserve Korea's economic independence.

Compared with the FCIPA, the FCIL of 1966 was more lenient towards FDI; it not only provided for the protection of foreign investment by specifying investment

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<sup>115</sup> The 'Law for Payment Guarantee of Foreign Borrowing' was established to provide government guarantees for firms' loans from international financial institutions in 1962. The 'Special Law for Facilitating Capital Equipment Imports on a Long-term Deferred Payment Basis' was enacted to assist Korean manufacturers by allowing them to import capital equipment under favourable conditions in 1963 (Sakong 1993: 102-103).

<sup>116</sup> Article 1 (the aims of the law) of the 1966 law made it clear that the law aimed to attract, protect, utilize and manage foreign capital in order to achieve economic independence, economic development and a favourable international balance of payments situation.

guarantees, tax relief, equal treatment with nationals and repatriation of gains, but also lessened the risks associated with foreign investment in Korea by removing stipulations in the 1960 law such as the mandatory employment of nationals, war-time conscription, forced confiscation of assets and limited repatriation of profits. Yet the 1966 FCIL still demanded a strict screening process by the Economic Planning Board (EPB) for entry to Korea. The EPB, in consultation with private enterprises, screened every project and granted approval only on the basis of whether the projects were essential for national industrialization and the boosting of exports (Bishop 1997: 33).

#### Complete Revision of the Foreign Capital Inducement Law in 1973

Controls on foreign capital were tightened by the overhaul of the FCIL in 1973; on March 2, the Korean government established the ‘General Guidelines on Foreign Investment (GGFI)’ and, later that month, undertook a complete revision of the FCIL in order to reinforce the regulations relating to foreign investment. The state’s strong determination to control foreign capital in the SOM period was expressed in the revision of the FCIL and GGFI in 1973. Two major reasons underpinned this change in the government’s attitude to FDI: the rapid changes in the Northeast Asian international situation and the sudden increase in Japanese investment in the early 1970s.<sup>117</sup>

The 1973 and the 1966 laws are quite similar except for the creation of punitive provisions relating to foreign investment companies in the 1973 law. While the 1966 law did not stipulate any strong penalties for foreign companies, the 1973 law added punitive provisions that allowed the government to revoke licenses when foreign investment companies failed to meet the requirements attached to their license.

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<sup>117</sup> For a more detailed discussion of the background of the shift in government FDI policy in the early 1970s, see Chapter Three.



Although the changes made in the 1973 law were not seemingly major, significant changes were made with the creation of a subordinate regulation of the law — the GGFI. Although the GGFI was originally intended as merely an internal guideline for the EPB, since the EPB was not only in charge of the screening of foreign entries in the SOM period but also responsible for the entire economy as a pilot agency, in practice the GGFI served as an essential guideline for FDI (Lee 1995: 188).

From 1973, the GGFI tightened the criteria governing approvals for foreign investment and in fact, after 1973, the GGFI had more impact on foreign investment policy than the FCIL. The GGFI provided detailed guidelines on the EPB's approval of FDI, specifying the businesses open to FDI, the acceptable size of investment, and the foreign ownership ratio. Under the guidelines, the Korean government did not allow any investment in Korea that might cause competition with local companies, either in the Korean or in international markets. Even in areas that were open to foreign investment, various strict performance requirements were applied, along with limitations on foreign ownership. Following the revision of the legislation in 1973, the Korean government accelerated its control and management of FDI, and this control peaked between 1973 and 1979 (Stoeber 2002: 56). The characteristics of the 1973 law and the GGFI will be discussed in detail in the latter part of this section.

In summary, the basic laws on FDI in the SOM period — the FCIPL in 1960, the FCIL in 1966 and the FCIL in 1973 — all focused on the control and management of foreign investment. These laws treated FDI in the same way as foreign loans, regarding FDI as one source of foreign capital. That is, the government took an interest only in the capital transfer effect of FDI. In the 1960s and 1970s, when domestic savings were in seriously short supply, overseas savings or foreign capital were indispensable as a

source of funding to boost domestic investment. This desperate need for foreign capital provoked the government to focus its attention on the capital transfer effect of FDI. As the government was concerned about the erosion of its economic autonomy and the possible domination of the domestic economy by foreign companies, it was interested only in capital transfer and it was reasonable that it would prefer foreign loans to FDI. The Korean government was in desperate need of foreign capital, but felt less of a need to attract FDI.

### **Transition Phase (1980-1997)**

The 18 years from 1980 to 1997 were a transitional period from the SOM period, when the state dominated the market in the 1960s and 1970s, to the MOS period when the market dominated the state after 1998. Therefore, FDI laws in this period also took on a transitional pattern. During this time, the government did not control FDI as strongly as in the SOM period, yet FDI was not fully liberalized, either. FDI laws in this time were characterised as being somewhere between strong regulation and complete openness. In the transition period, the principal motivations for change in the Korean FDI system came from external pressures. The important changes in FDI laws in this period — the revisions in 1983, the revisions in 1991 and 1992, and the enactment of the FIFCIA in 1997 — show how the Korean FDI regimes had shifted to accommodate changes in external circumstances.

### **Complete Revision of the Foreign Capital Inducement Law in 1983**

The 1973 FCIL was radically changed in 1983 and three major factors were responsible

for the overhaul of this legislation. First, as a direct cause, the World Bank exerted pressure on the Korean government to change its foreign investment regulations. Since the end of the 1970s, Korea had suffered from a huge balance of payments deficit and had received structural adjustment loans from the World Bank twice in December 1981 and again in November 1983. The bank, in return for its loan, demanded that the Korean government restructure its economy, and one result was a revision of foreign investment policy (Gang 1995: 53-54). The second factor was Korea's high levels of debt; in the 1980s, Korea was burdened with heavy debt, ranking as the fourth largest debtor in the world in the first half of 1980s (MOF 1991b:15). This problem, a consequence of a high reliance on foreign loans for the promotion of heavy and chemical industries in the 1970s, was regarded as more serious in light of the debt crisis in Latin America at that time. The Korean government became more cautious about raising foreign loans and began to consider FDI as an alternative source of foreign capital. Thirdly, bureaucrats who supported neo-liberal prescriptions for the Korean economy began to emerge in the early 1980s. Valuing stabilisation over growth and preferring market principles to intervention measures (Amsden 1994), they wanted to apply their belief to the FDI laws. The revision of the law in 1983 was the consequence of these external and internal pressures.

The complete revision of the FCIL on December 31, 1983, was a turning point for foreign investment policy in Korea. First, the 1983 law removed the reference to the goal of 'economic independence' from Article 1 (the aims of the law), which had been prescribed since the 1966 FCIL and which had served as a basic provision for regulating the entry and operations of foreign businesses. The previous laws (enacted in 1966 and 1973) specified the aim of seeking the promotion of foreign investment only to the

extent it did not hurt economic independence. This goal, which had served as a restraint on inward FDI since 1966, was removed under the 1983 law.

Table 5.2 FDI Liberalization Ratio 1981-1987 (Unit: %)

	Jul 1981	Oct 1982	Jul 1984	Sep 1985	Apr 1987
Total	49.9	60.9	66.1	76.3	78.9
Manufacturing	80.0	80.0	86.0	92.5	97.5
Service	21.6	-	47.2	60.8	60.8
Primary	12.5	-	12.5	20.0	20.0

Note: FDI liberalization ratio denotes the number of the businesses open to FDI divided by the number of total businesses.

Source: MOF 1991a: 13

Secondly, the 1983 law dramatically expanded the number of businesses open to FDI. The previous laws had adopted a ‘positive system’ under which businesses open to foreign investment were listed and all other businesses were prohibited. However, the 1983 FCIL adopted a ‘negative system’ whereby prohibited businesses were listed and the rest were open for foreign investment, significantly broadening the gateway to foreign investment. The 1983 law expanded the extent of business open to foreign investment by permitting all FDI activity except for in some businesses prohibited under the FCIL and its subordinate laws.<sup>118</sup> As a result, the ratio of openness to FDI rose from 49.9 percent in 1981 to 66.1 percent in 1984 and again to 79.4 percent in 1991 (see Table 5.2). Moreover, the government simplified the approval processes for

<sup>118</sup> Areas in which foreign investment was prohibited under Article 9 of the 1983 law were: (1) public businesses run by public corporations (water supply and sewage, postal, telegram and telephone services, railroads and transportation, tobacco and red ginseng production); (2) businesses harming national health or the environment (such as industries that cause pollution); (3) businesses harmful to public morals (including casinos); and (4) other businesses designated by presidential ordinances (newspaper publication, radio and broadcasting, crops and grains production and so forth).

some businesses<sup>119</sup> and the remaining restrictions on repatriation of profits were eliminated.<sup>120</sup>

### Revisions of the Foreign Capital Inducement Law in 1991 and 1992

The Korean economy was booming in the late 1980s; between 1986 and 1988, the annual economic growth rate stood at 11 percent, and the country recorded a substantial current account surplus (see Tables A and B). Of particular note was the huge surplus that Korea enjoyed in its trade with the US in 1987. During the 1960s and 1970s, the US government had maintained a supportive attitude toward Korea out of political considerations, granting generous assistance and tolerating the protectionist policy of the Korean government. Yet, from the late 1980s, with the end of the Cold War and the rapid economic growth of Korea, and as the US suffered large trade deficits, the US government began to put pressure on Korea to open its capital markets and service sector as a means of rectifying the trade imbalance (Gang 2002: 141). Korea and the US started talks to solve these trade conflicts in early 1989 and came to an agreement in May 20 1989.<sup>121</sup>

Although the Korea-US trade talks in 1989 dealt with a wide range of issues

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<sup>119</sup> As in the previous law, the 1983 law required Ministry of Finance (MOF) approval for all foreign investments (The MOF was responsible for inward FDI from 1981 to 1997). Yet, for small businesses that had low levels of foreign ownership and that were not eligible for incentives, the approval process was minimized to give automatic approval.

<sup>120</sup> The 1966 law and 1973 laws stipulated that foreign investors were allowed to remit funds invested at least two years after the initial investment and the authorities could restrict the remission depending on the foreign currency circumstances of the country. The 1983 law ensured free remission of funds by foreign investors by eliminating these restrictive provisions.

<sup>121</sup> The US, suffering from the accumulated trade deficit in the 1980s, passed the Omnibus Trade and Comprehensive Act of 1988 in August of that year. The act of 1988 instituted the Super 301 provision by which the US government could designate a priority foreign country which was suspected of causing a trade imbalance by unfair trade practices. It also granted the right to impose trade retaliation such as retaliatory customs when negotiations to ease the imbalance failed. It was a temporary clause used from 1989 to 1991 and abolished in the Bush Administration. In 1988, Korea along with Japan, Taiwan, India and Brazil were among the candidates, but avoided the designation as a result of successful trade talks in May of 1988 (Kim 1989: 6)

concerning the Korean government's trade policy, the greatest focus was on the Korean government's FDI policy, and this led to significant changes in FDI policy (Kim 1989: 6-7). The major agreements on this issue were as follows: firstly, from 1991, the Korean government would gradually adopt a notification system for the entry of FDI, and after 1993, the notification system would be generally applied.<sup>122</sup> Secondly, the government would not impose performance requirements when it approved the entry of foreign companies and it would also eliminate the existing performance requirements for foreign-invested companies. Thirdly, the government would open sectors including wholesale cosmetics, wholesale pharmaceuticals and manufacturing, advertisement agencies and travel agencies to foreign investment. Finally, foreign-invested companies would be given the same treatment as nationals in terms of the acquisition or development of land (MOF 1991a: 14).

The agreements of the Korea-US trade talks were implemented one by one. First, the FCIL was revised to adopt the notification system in 1991 and 1992. The revisions of the law in 1991 and 1992 enabled foreign companies to invest in Korea by merely notifying the Korean government of their investment. Thus MNCs no longer needed to request the approval of the authorities to invest in Korea. Conversely, with the adoption of the notification system, the government lost its power to screen FDI. Second, the Korean government removed all performance requirements on foreign-invested companies such as export quotas, technology transfers, local sourcing and access to export markets from January 1, 1990 (Kim *et al.* 2002: 102). Third, the Korean government gradually liberalised the service sector investment in the domestic market opening up wholesale medication (July, 1989), wholesale cosmetics (July, 1990), travel

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<sup>122</sup> The notification system for the entry of FDI means a system whereby foreign companies can invest in Korea by merely notifying the authorities instead of requesting government approval.

agencies (January, 1991) and advertisement agencies (January, 1991) (MOF 1991a: 19). Lastly, foreigners were allowed to acquire land in Korea for business purposes when the 'Law on Foreigners' Acquisition and Management of Land' was enacted in January 7, 1994. In short, the critical changes in the FDI system in the early 1990s came mainly as a result of external pressures and engendered a weakening of the power of the Korean government.

#### Enactment of the Foreign Investment and Foreign Capital Inducement Act in 1997

On December 12, 1996, Korea became the 29th member of the OECD. The Korean government officially delivered its intention to join the OECD in April 1994, and the OECD then began to examine Korea's eligibility and level of liberalization. Consequently, the OECD demanded that, as a condition of membership, the Korean government implement several measures to liberalise the nation's FDI laws (MOFE 1997: 547-548). In the eyes of the OECD, the major problem relating to Korean FDI regulations was the Korean government's definition of 'direct investment'. The OECD and the Korean government had different understandings of direct investment; while the OECD regarded long-term commercial foreign loans (LCFL) from a parent company to its subsidiary and Merger and Acquisition (M&A) transactions as direct investment, their view was not shared by Korea's FCIL (Wang 1997: 83). The Korean government had to modify the related regulations on FDI in accordance with the OECD's liberalization rules and this demand was reflected in the Foreign Investment and Foreign Capital Inducement Act (FIFCIA) in 1997.

The 1997 law had a few important modifications compared with its predecessor. Firstly, the most notable change was to its name; the law was changed from the Foreign

Capital Inducement Law (FCIL) to the Foreign Investment and Foreign Capital Inducement Act (FIFCIA). While the FCIL did not deal exclusively with inward FDI, regarding it merely as one of many sources of foreign capital, the FIFCIA started to emphasize the distinction between foreign investment and foreign capital. This change symbolised the shift in domestic and global economic circumstances; the economic role of FDI was gaining importance while that of foreign loans began to diminish from the late 1980s. Secondly the revision acknowledged long-term foreign loans with maturities of more than five years offered by a parent company to its overseas subsidiary as FDI, in order to meet the OECD standards of direct investment. The acknowledgement of such loans as foreign investment was one of the liberalization measures relating to capital flows which had been controlled in the past.<sup>123</sup> Thirdly, the 1997 law permitted direct investment through M&A by treating the acquisition of existing stocks as direct investment, whereas the previous laws had regarded only the start-up investment in a business as direct investment. Most members of the OECD allowed free cross-border M&A and acknowledged the acquisition of controlling stocks as direct investment. When considering Korea's eligibility for membership in 1996, the issue of the liberalization of M&A activity was of the greatest concern to the OECD (Wang 1997: 85). The Korean government took this issue into account and permitted M&A transactions as one form of FDI under the revised 1997 law.

From 1980 onwards, the FCIL and FIFCIA were revised in favour of MNCs.

The shift of the bargaining power of the Korean government was reflected in the series

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<sup>123</sup> According to the Article 19 of the 1997 law, the Korean government controlled the inflows of commercial foreign loans by requiring the approval of the Minister of Finance and Economy. Thus, as long as long-term loans with a maturity of more than five years provided by a parent company to its subsidiary were not acknowledged as FDI, the firms had to seek the approval of the Minister of Finance and Economy. Under the revision, such loans are regarded as FDI, so that they do not need to obtain approval from the Minister, and they also became eligible for a series of incentives including tax breaks.



of revisions to the country's FDI laws. After the 1980s, the capital of MNCs continued to grow and their influence also increased and in the 1980s and 1990s, the Korean government faced pressures from MNCs' home countries (especially the US) and international institutions (for example, the World Bank, OECD and WTO). Yet, the level of pressure was not so strong that it overwhelmed Korea's policy; it changed the extent to which the Korean government could manage and control the market. In fact, the Korean government opened the market gradually, so the changes would not have too sudden an impact on the economy. However, after the 1997 financial crisis, the Korean government was no longer able to control external pressures and was forced to submit to them.

### **Market over State Phase (1998-2005)**

Throughout the 1980s and 1990s, the Korean government's bargaining power had gradually diminished, but after the 1997 financial crisis, that bargaining power was dramatically weakened. This event prompted the enactment of the Foreign Investment Promotion Act in 1998. The background to the legislation and the major changes contained in the FIPA are briefly reviewed in this section, after which the complete contents of the FIPA will be discussed.

#### Enactment of the Foreign Investment Promotion Act in 1998

Faced with the financial crisis in 1997, the Korean government requested bailout funding from the IMF and received a relief loan, in return for which the government pledged to implement the economic reform programs proposed by the IMF. As

mentioned in Chapter Three, the IMF program was very comprehensive, including the macro-economy, the structural reform of the *chaebol*, banks and labour and the opening up of the domestic market. Under the IMF program, the items related to the 1998 FIPA were as follows: firstly, the simplification of investment procedures; secondly, the opening of other financial sectors to foreigners, and permission for foreigners to own local banks; thirdly, the abolition of limitations on foreigners' ownership of stocks and real estate (IMF 1997, Shin and Chang 2003: 55). Those requirements related to areas that had previously remained closed despite continuous pressure from the US government in the early 1990s. Along with the pressure from the IMF, another factor playing a role in the establishment of the FIPA in 1998 was the support for neo-liberal ideals within the Kim Dae-Jung administration. As we have seen in Chapter Three, the Kim administration believed that the financial crisis resulted from moral hazard and the inefficiency of local banks and *chaebol*, thus financial and corporate sectors became the target of reforms. The government was looking for forces in the foreign companies to reform these sectors. Therefore, FDI was regarded as an instrument for accelerating reforms and investors were offered generous benefits. Therefore, the 1998 FIPA was the outcome of both external pressures and internal drive.

The differences between the FIPA and previous laws are as follows. Firstly, the 1998 FIPA dealt solely with FDI, while previous laws treated FDI as one element of foreign capital. The 1998 law demonstrated the growing importance of FDI in the Korean economy as perceived by the government. Secondly, the 1998 law stated explicitly in Article 1 that its purpose was to 'attract and promote foreign investment through support and facilitation'. While the purpose of previous laws had been to control foreign capital, the aim of the 1998 law was to attract and promote it as FDI

policies focused on promotion rather than regulation. Thirdly, the IMF program was reflected in the law; as the IMF had requested, the registration process for FDI was streamlined so that investment procedures were simplified. The restrictions on foreigners' ownership of stocks and real estate were abolished and the limitations on foreign ownership of Korean banks and financial firms were also eliminated (Crotty and Lee 2001: 37). In addition, under the pressure from the IMF, the liberalisation of M&A was expanded to include hostile takeovers in all sectors except for the defence industries (Weiss, 1999: 33). The hindrances to foreign investment that remained despite the gradual liberalisation in the 1980s and 1990s were eliminated all at once, reflecting the shrunken bargaining power of the government after the financial crisis. Throughout the MOS phase, the FIPA law changed several times, but all changes were minor adjustments to the 1998 FIPA.<sup>124</sup>

This section has examined the changes in basic laws on FDI from 1960 to 2005 and has shown that FDI laws were the result of the interaction of external factors and internal motivations. The next section will look into the differences in the rights and duties of foreign companies in the SOM and MOS periods by comparing the FCIL in the SOM period and the FIPA in the MOS period.

### **3. Comparison of FDI Laws in the SOM and MOS Phase**

This section will compare the bargaining outcomes in the SOM and MOS phases by

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<sup>124</sup> In the revision of December, 2000, real estate and stocks were included in the means to invest for the foreign investment. In the next revision of December 2003, cash grants and rewards were included as incentives for foreigners and for people who contributed to attracting foreign investment, respectively. In the December 2004 revision, cash grant was expanded to include local governments as well as the central government.

comparing the laws of the two periods. The third and fourth chapters showed that the state's bargaining power in the SOM period was greater than that of MNCs, whereas MNCs' bargaining power in the MOS period surpassed that of the state. Now, the outcomes of these differences in bargaining power will be examined. This section will examine the regulations and incentives for foreign firms, which are prescribed under the laws of both the SOM and MOS periods. When the bargaining power of the MNCs is weaker than that of the host government, the MNCs will face more regulations and enjoy fewer incentives. Conversely, when the bargaining power of the MNCs is stronger than that of the host government, the situation will be reversed. Therefore, it is assumed that the regulations relating to foreign companies in the SOM period were stricter than those in the MOS period, while the incentives to foreign firms in the SOM period were fewer than those in the MOS period. This assumption is tested and proved through an analysis of the FDI regimes in both periods.

The laws on FDI in the SOM period had changed as the 1960 FCIL was replaced by the 1966 FCIL and, finally, the 1973 FCIL. The first two laws, instituted in the early stages of the SOM period, demonstrated an ambiguous position towards FDI and the fact that the system was not well-established. However, the 1973 FCIL showed a firm government orientation with a coherent and systematic approach to FDI. Therefore, it is the 1973 law that perhaps best represents the characteristics of the Korean developmental state in the SOM period; thus the examination of FDI legislation in the SOM period will focus on the 1973 law. Other than the 1973 FCIL, the 'General Guidelines on Foreign Investment (GGFI)' played a decisive role in FDI inflow in the SOM period, providing the criteria for FDI approval from the EPB; for this reason the GGFI is also analysed in this section. As regards laws in the MOS period, the discussion

centres on the 1998 Foreign Investment Promotion Act (FIPA) which has established the basic systems for managing FDI since 1998. Even though the FIPA had undergone several revisions, its basic structures and foundations have not changed since its promulgation in 1998. The discussion of the MOS period principally focuses on the 1998 FIPA, but the major revisions of the FIPA are also included. This section first discusses the regulations imposed on foreign companies and then examines the incentives that the government offered to foreign firms.

### **Regulations relating to Foreign-Invested Companies**

#### State over Market phase

If we categorise the type of government regulation according to the various stages of investment, FDI regulations imposed by the host government can be divided into three types: (1) restrictions on entry, (2) regulations on operation, and (3) limits on repatriation. In the SOM period, the Korean government had a rigid regulatory policy regarding FDI, controlling foreign companies at every stage of the investment process: when a company entered the market, during its operations, and when it withdrew from the market.

Firstly, considering restrictions on entry, foreign companies were tightly controlled at the entry stage during the SOM period. There were two types of entry restrictions: the closure of certain types of business to foreign investment and complicated entry procedures. In terms of the extent of market opening, according to the EPB (1981: 70), the Korean government allowed investment in only 427 businesses (49.9 percent) out of a total of 855 in the SOM period, with the remaining 428

businesses being closed to foreign investment.<sup>125</sup> The manufacturing sector showed a higher rate of openness (80 percent) while the service sector was less accessible to foreigners (with only 21.6 percent of businesses being open to FDI). In terms of entry procedures, a foreign investor was required to receive approval from the Minister of the EPB even if the target business belonged to a sector open to FDI. The criteria for the approval of foreign investment were specified in the 'General Guidelines on Foreign Investment (GGFI)'. The GGFI classified foreign investment projects into 'appropriate' and 'inappropriate', and allowed foreign investment only in those businesses in the 'appropriate' category.

The general rules regarding the appropriateness or inappropriateness of businesses included the following guidelines (MOF 1991a: 245-246). 'Appropriate businesses' included businesses requiring a massive scale of capital in which domestic companies could not yet compete due to their lack of capital and technology; export businesses in which domestic companies were facing difficulties in securing overseas markets; and business activities involving the exploitation and utilization of domestic resources. 'Inappropriate businesses' included businesses that might cause a blockage to the domestic supply and demand of raw materials and intermediate goods; businesses that might compete with local exporters in overseas markets; businesses aiming to supply funds to domestic firms; businesses making profits from land exploitation; and businesses forbidden or restricted under other laws. These approval criteria allowed the entry of those industries regarded as beneficial to the host economy but precluded projects that were perceived as harmful to domestic businesses. Furthermore, the GGFI regulated the size of investment, allowing only investments on a large scale but

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<sup>125</sup> The categorization of business was made in accordance with the Korean system of industry categorization, which is called the Standard Classification of Korean Industries.

forbidding small investments; this decision was based on the belief that big companies with more ownership advantages would transfer more resources to a host country than small companies, thereby enhancing the quality of the investments. According to the general guidelines, the minimum amount of a foreign investment was USD 200,000, with lower minimum requirements of USD 100,000 for electronics and machinery industries and of USD 50,000 for businesses engaged exclusively in export activity using local resources. Lastly, M&A was not permitted in this period. All foreign investments were greenfield investment, introducing new capital to the Korean economy to build factories and new businesses.

Secondly, two restrictions regulated the operation of foreign companies: ownership requirements and performance requirements. After 1973, the Korean government permitted FDI on the condition that it took the form of a 50:50 joint venture with a domestic company. The government believed that a joint venture was more likely to result in the transfer the foreign company's firm-specific advantages to its Korean partners, thus enhancing the capabilities of Korean industry. However, MNCs with more firm-specific advantages tended to seek full ownership, enabling them to maintain management control of the company in order to exploit their firm-specific advantages and to in order to prevent local firms gaining access to their advantages (Gomes-Casseres 1990). Therefore, in dealing with these types of MNCs, the Korean government needed to be more flexible or offer some attractive inducements to potential investors. In fact, the Korean government did not always adhere to the 50:50 principle but, in applying the policy, the government varied the ownership level of foreign firms according to their bargaining power. When it came to industries where the investors' bargaining power was weak, such as labour-intensive industries or industries targeting

the local market, foreign ownership was restricted to less than 50 percent. Foreign ownership levels of between 50 and 100 percent were permitted for export industries or import-substitution projects where the investors' bargaining power was stronger. Only MNCs with high technology and whose bargaining power was dominant were allowed 100 percent ownership (MOF 1991a: 247-248).

In addition to the restrictions on the level of foreign ownership, the government pursued the maximization of FDI benefits through various performance requirements for investment projects. According to Article 6 of the 1973 law, the Minister of the EPB had the authority to attach additional conditions when approving foreign investment in Korea. Thus, the Korean government imposed various performance requirements on foreign companies when they entered the Korean market, with the magnitude of the requirements being determined by the company's bargaining power. These requirements included mandatory export requirements, local sourcing requirements, technology transfer requirements, a requirement to assist Korean companies to access export markets, and requirements regarding conditions of divestiture such that the foreign investor's stake would be transferred to its Korean partner at a specified point in the future (EPB 1981: 28-31; Mardon 1990: 127).

Lastly, there were restrictions on withdrawal and repatriation. The 1973 law did not specifically regulate the repatriation of dividends, but it did contain certain restrictions on the withdrawal of investments. According to Article 12 of the 1973 law, when foreign investors wanted to sell their stake in a business or their stocks, both the buyer and seller were required to notify the Minister of the EPB, and the money from the transaction could not be repatriated overseas until two years after the new domestic business had begun operations. This aimed was to prevent short-term speculative



foreign investment and instead attract long-term strategic investment. Regarding the repatriation, the Minister of the EPB had the authority to order foreign investors remit funds in stages (rather than all at once) in order to minimize the impact of sudden outflows of foreign currency from the national economy. Thus, in the SOM period, the Korean state controlled every stage of a foreign business's life including entry, operation, and withdrawal in order to maximise the benefits accruing from the introduction of foreign capital.

#### Market over State phase

In contrast to the situation in the SOM phase, controls on foreign investment were eliminated in all areas of business activities in the MOS period. Firstly, in terms of regulations on foreign entry, the previous restrictions on the entry of certain types of businesses almost disappeared. Article 4 in the 1998 FIPA clearly stated that in principle foreigners could undertake any business, with only a few exceptions. These exceptions included cases that threatened national security and public order; cases that might have a negative impact on public sanitation and environmental conservation; and cases that violated national laws and ordinances. Thus, except for these few restrictions, all investors could enter and conduct business freely in Korea. While the laws in the SOM period did not allow foreign company entry into Korea except for when they were investing in specific businesses selected by the government, the law in the MOS period opened the entire Korean market to foreign investors (in principle). As of August 2004, the ratio of market openness in Korea stood at 99.8 percent, with almost all industries open to foreign investors except for a few businesses such as television and radio broadcasting. Thus, to all intents and purposes, restrictions on the entry of foreign

businesses can be said to have been removed (Yoon *et al.* 2005: 76).

Secondly, regarding the entry process, the 1998 law simplified procedures for investing in Korea by requesting that foreign companies and institutions simply notify the authorities of their investments. In contrast, the 1973 law had required government approval for foreign investors to invest in Korea, with the authorities screening and negotiating all investment projects. The notification system was originally introduced in response to a demand from the US government in the 1989 trade talks; following the agreements reached at these talks, the Korean government replaced the approval system with the notification system when the FCIL was revised in 1991 and 1992. Nevertheless, before the establishment of the 1998 FIPA, there was still some room for government intervention, as officials were given the authority to either approve on or demand further conditions of the foreign investors (Yoon *et al.* 2005: 176). After the financial crisis in 1997, the IMF demanded more streamlined investment processes, and the Korean government reflected those demands in the 1998 law. In the earlier notification system, the government reviewed the underlying substance of the applications for investments; however, after 1998, the government examined applications only to determine whether or not they satisfied formal requirements. Under the 1998 law, officials had to accept all applications for foreign investment regardless of their substance as long as there were no formal problems in the applications.

The law in the SOM period also imposed restrictions on the entry of foreign businesses according to the scale of investment, with a general minimum level of USD 200,000; in contrast, the law in the MOS period lowered this minimum to KRW 50 million (approximately USD 50,000 in 2005 exchange rate). Moreover, the law in the MOS period allowed M&A transactions except in the case of defence industries, while

the 1973 law permitted only greenfield investments and forbade mergers with or takeovers of existing companies by foreign investors. M&A investment was liberalised for the first time under the 1997 FIFCIA. The 1997 law still required foreign acquirers to obtain agreement from the board of directors of the company being merged with or acquired, in effect legalizing only friendly M&A transactions. However, after the financial crisis in 1997, the Kim administration allowed even hostile takeovers by foreign investors by removing the conditional provisions. The 1998 law opened FDI to almost all businesses, streamlined the FDI entry process, and allowed foreign investment through M&A transactions. Thus it is fair to say that the 1998 law eliminated most entry barriers to FDI.

Thirdly, in terms of regulations on operation, the 1998 law did not stipulate any performance requirements or restrictions on ownership level. In fact, those two regulations had been removed during the transition period; the 1983 revision of the FCIL removed regulations relating to foreign ownership levels and eliminated the obligatory joint venture provisions of the FDI system that had operated in the SOM period, allowing ownership levels to be decided by agreement among the parties involved (Gang 1995: 55). As mentioned above, the performance requirements were abolished in response to US demands in the 1989 trade talks; following the agreements reached at those negotiations, the Korean government revoked all the performance requirements attached to investment approvals in January 1990, and deleted the provisions of conditional approval for foreign investment in the 1991 revision of the FCIL (Kim *et al* 2002: 102).

Lastly, the provisions on withdrawal and remittance in the 1973 law were eliminated in the 1983 revision and thus are not found in the 1998 law. Instead, Article 3

of the 1998 law established a provision on the protection of foreign investment to guarantee foreign investors' overseas remittances. The provision reduced risks for foreign-invested companies by allowing remittances even in the event of natural disasters or war and proscribed any discrimination against foreigners in terms of business operation and taxation. MNCs in the MOS period were virtually free of governmental regulation after the removal of restrictions on entry, operation, and withdrawal. In summary, the strong bargaining power of the state in the SOM period and of MNCs in the MOS period resulted in strong governmental regulations in the SOM period and higher levels of freedom in the MOS period respectively. We have seen the comparison of duties of the foreign companies between the two periods and now we turn our attention to the rights of the foreign companies.

### **Incentives for Foreign-Invested Companies**

#### State over Market phase

Currently, many host governments offer various types of incentives to attract foreign companies, such as tax breaks, subsidies, location grants, and various types of assistance in the establishment and operation of their businesses. However, in the SOM period, the Korean government officially only offered tax breaks to investors. Foreign-invested companies in the SOM period were exempt from income tax, corporate tax, and property tax in proportion to their investment ratio for five years after embarking on their business, and they were eligible for a 50 percent tax credit for the following three years. All companies approved for foreign investment were eligible for such tax credits; in addition, foreign investors were exempt from tariffs on the import of capital goods.

For investors in export-oriented industries, the government provided the same benefits as those given to local export companies including export financing, capital assistance for equipment investment, and tax exemption for importing raw materials and machinery (EPB 1981: 28). Although tax exemptions were granted to all foreign-invested companies in the SOM period, this did not mean that tax incentives were generally applied regardless of business type; the companies had already been screened and selected, so only the eligible ones would receive tax benefits through the approval process.

Apart from the tax benefits, the government in the SOM period sometimes offered unconventional incentives to foreign companies when it considered them indispensable to the economy. These were not stipulated in law but instead decided by negotiation on a case-by-case basis. In the SOM period, Korea was a poor and unstable country, making it an unattractive location to foreign investors. Despite this unfavourable situation, the Korean government succeeded in attracting some MNCs that it regarded as indispensable for its industrialisation, keeping their ownership levels low and attaching various performance requirements (see the case of Dow Chemicals in Chapter Four). This was possible because the government had enough capacity to make attractive offers; it guaranteed a minimum profitability and reduced the risks involved in projects by providing access to the domestic market, protection of their local markets and price controls on their raw materials and products (Mardon 1990: 128). Although the FCIL in the SOM period only prescribed tax benefits as incentives for foreign-invested companies, the government had the flexibility and extensive capacity to grant powerful inducements to foreign bargaining partners during negotiations. This flexibility and capacity was the source of the state's strong bargaining power in the

SOM period.

### Market over State phase

In the MOS period, the regulations on foreign companies were lifted and the incentives for foreign firms became more diversified. Besides the existing tax benefits, cash grant systems and location support for foreign businesses were added in the MOS period. Moreover, the 1998 law expanded tax breaks for foreign firms to seven years on corporate tax, income tax, property tax, and tariffs, compared with five years under the 1973 law.<sup>126</sup> The cash grant system was added in 2003, providing assistance in cash for certain uses for foreign investors who satisfied specific requirements. The location support system was designed to provide land to foreign companies at an affordable price, allowing foreign companies to receive a 50-100 percent reduction in their rent according to their size and type of business. Furthermore, the FIPA specified the establishment of both Invest Korea and the Ombudsman's Office to assist foreign businesses in Korea. Moreover, many special zones including economic free zones (EFZ), foreign-invested zones (FIZ), and free trade zones (FTZ) were created and managed to attract foreign investment, providing favourable business circumstances to foreign companies. In the MOS period, the types and scale of support systems for foreign-invested companies became larger and more diversified than in the SOM period. However, most of the support systems mentioned above were established only for foreign investors, and were not made available to domestic companies.

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<sup>126</sup> Tax exemptions were not given to all foreign companies but were offered on a selective basis to businesses in possession of high technology. Since the 1973 law had granted tax credits to all companies approved for foreign investment, the selective tax exemptions under the 1998 law could be regarded as a diminution of investment incentives. However, in view of the fact that the 1973 law required the government to approve entry into the Korean market on a selective basis while the 1998 law opened the market to all types of FDI without a screening process, it is fair to say that both systems offered incentives on a selective basis.

In fact, in the MOS period, many thought that the provision of benefits to foreign companies was excessive, arousing concerns of reverse discrimination against domestic companies. Indeed, examples of reverse discrimination can be found in the FIPA and many other laws during the MOS period (SERI 2005). Firstly, the 'Banking Act' forbade any individual to own more than a 10 percent stake in a bank in order to prevent it from being used as a private vault. Any person wishing to possess a stake of more than 10 percent was required to obtain the approval of the Financial Supervisory Committee (Article 15, Banking Act). This provision prevented the concentration of management control of financial institutions within a small group. In addition, businesses not operating in the financial sector were prohibited from acquiring a stake of more than four percent in a bank, virtually preventing domestic industrial capital from owning any bank in Korea (Section 2, Article 16, Banking Act). After the financial crisis, however, the principle was bent to be lenient to foreign capital; as a result, private equity funds, which were not qualified to be major stakeholders under the Banking Act, were allowed to become majority shareholders of domestic banks (Chun *et al.*, 2005: 20-22).<sup>127</sup> Secondly, according to the 'Act on the Promotion of Cooperation among Conglomerates and Small-and-Medium-sized Enterprise (APCCSME),' domestic conglomerates were banned from entering business areas that were specifically designated for SMEs in order to protect small- and medium-sized businesses (Article 30, APCCSME). However, the provisions of the act allowed exceptions when it came to foreign-invested companies in foreign investment zones and free economic zones. That

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<sup>127</sup> Under Article 5 of the enforcement ordinance of the Banking Act, a foreigner must be a financial institution in banking, securities, or insurance in order to be a majority shareholder with over 10 percent of a local financial institution. Carlyle and Lone Star, which acquired Koram Bank and Korea Exchange Bank, respectively, were private equity funds that were not eligible to be major shareholders of local banks. Therefore, there was a suspicion that the Korean government had disregarded the law in order to allow their acquisitions (Chun *et al.* 2005: 20).

is, foreign conglomerates were allowed to invest in SME-specific areas to which domestic conglomerates were denied entry.

Thirdly, the ‘Act on the Designation and Management of Free Economic Zones (ADMFEZ)’ stipulated that foreign-invested companies in economic free zones were exempt from many rules and laws such as the ‘Labour Standard Act’ and the ‘Planning Law on Metropolitan Area Improvement.’ For example, unlike local companies, foreign-invested companies in FEZs were exempt from the obligation to hire disabled workers or citizens of merit.<sup>128</sup> The preferential treatment to foreign companies in the MOS period was overly generous, resulting in reverse discrimination against domestic companies. In summary, the strong bargaining power of the state in the SOM period resulted in the low level of incentives offered to foreign investors, while the strong bargaining power of MNCs in the MOS period produced a higher level of incentives to foreign companies, and even resulted in reverse discrimination against domestic companies.

#### **4. Conclusion**

This section examined the results of bargaining relations between a host government and MNCs by analysing FDI laws in Korea. The first part showed that FDI laws were the outcome of interactions among the Korean government, its bargaining partners (MNCs), MNCs’ home countries, and other international institutions by examining the changes in FDI laws and causes of the changes. The second part looked into how the

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<sup>128</sup> Under Korean law, businesses are obliged to hire a certain number of the disabled or citizens of merit.



bargaining power of the host government in the SOM and MOS periods was reflected in FDI laws in Korea. Regulations were maximized and incentives were minimized in the SOM period when the bargaining power of the state was strong, while regulations were minimized and incentives were maximized in the MOS period when the state's bargaining power was weak.

In this chapter, an analysis of FDI laws showed how differences in bargaining power produced different outcomes. The chapter examined the changes in the FDI regulation system since the 1960s and compared the rights and duties of foreign companies in the SOM and MOS periods. It was found that the strong bargaining power in the SOM period allowed the government to impose its will on foreign companies, while weak bargaining power in the MOS period made the government bow to foreign forces.

In the SOM period, when its bargaining power was strong, the state selectively allowed FDI to serve national goals but in the MOS period, when its bargaining power was weak, the government had to open industrial sectors under pressure from MNCs, thereby losing its capacity to select FDI. During the latter period, therefore, the quantitative increase in FDI did not guarantee the qualitative growth of FDI.

We have argued that investment by an MNC can create either benefits or costs to the host economy. An MNC locates in another country not for the sake of the country but for its own business purposes, which means that the entry of a foreign company can not always guarantee beneficial results to a host economy. It is obvious that the benefits to a host country do not arise just from the entry of foreign companies, but include the effects resulting from that entry. Therefore, a host country's main promotional efforts should concentrate not just on attracting foreign companies but on achieving beneficial

effects from their investment and it is the government's bargaining power that can influence the effects of the foreign companies. In this chapter we have seen that a host country's bargaining power can have a profound effect on whether the host country gains or loses from foreign investment. This is the reason that bargaining power has to be emphasised.

## **Conclusion: Toward the State and Market Era**

At the beginning of this thesis, we posed two general questions: (1) as globalisation deepens, will states necessarily be dominated by expanding foreign capital? (2) Are there any ways to enhance the bargaining power of states vis-à-vis MNCs? In order to seek the answers to these questions, we selected Korea as our subject and examined the state-MNC relationship in Korea between 1962 and 2005. We explored the Korean case with three sub-questions in mind, which were: (1) how has the Korean state bargaining power vis-à-vis MNCs changed? (2) What factors have weakened or strengthened its bargaining power? (3) What are the consequences of the fluctuations in the state's bargaining power? The answers for these sub-questions will determine the ultimate answer to the general questions posed above.

The study started with the realistic assumptions that MNCs have variable effects on host economies and that MNCs are fundamentally national firms doing business internationally. This assessment of MNCs reflects the need for government efforts to increase their bargaining power in order to maximise the positive effects of FDI while minimising its negative effects. Based on this view, we developed our theoretical framework, the Neo Bargaining Model (NBM) and applied it to the Korean developmental state in the State over Market (SOM) period and the Korean neo-liberal state in the Market over State (MOS) period, using the contrast to draw implications about the relationship between the nature of the state and its bargaining power. Through the application of the NBM to the case of Korea, we reach the answers to the three sub-questions: (1) the bargaining power of the Korean state diminished constantly over time (Chapters Three and Four). (2) The Korean state's bargaining power has been affected

by internal factors (the decline of the developmental state) and external factors (the progress of globalisation) (Chapters Three and Four). (3) The bargaining power of the state affects its bargaining outcomes (Chapter Five).

Now, based on these findings, we further progress the discussion to suggest future implications. According to finding (3), the strong bargaining power in the SOM period produced advantageous results while the weak bargaining power in the MOS period brought about the more detrimental effects of the MNCs on the economy. In the SOM period, the strong bargaining power of the state made the foreign companies serve the goal of the state, whereas in the MOS period the weak bargaining power of the state forced it to serve foreign firms' interests. This finding generates the proposition (1) that *'the state must have strong bargaining power in order to enhance the national economy and minimise the negative effects imparted by MNCs'*.

Next, the subsequent problem is how to ensure the state has strong bargaining power. The solution to this problem is drawn from finding (2). In the SOM period, the strong bargaining power of the state stemmed from its developmentalism and the absence of globalisation pressures; in the MOS period, the weak bargaining power of the state was conversely caused by the loss of developmentalism and the increasing intrusion of globalisation pressures, as we have seen in Chapters Three and Four. Therefore, two common factors of the causes of the fluctuation in bargaining power of the state are drawn from finding (2): developmental state and globalisation. This finding generates the second proposition, that *'stronger developmentalism and weaker global pressures tend to create stronger bargaining power of states vis-à-vis MNCs'*. However, as globalisation has deepened and impacted negatively on states, so the restoration of the developmental state remains a possible means for the state to enhance its bargaining

power vis-à-vis MNCs.

However, the old developmental state of the SOM period is not a future option for the current Korean state because it is no longer viable. The circumstance under which the old developmental state was created had changed according to the shifts of international and domestic political economy: the growth of domestic and foreign capital, the disappearance of the Cold War competition, and the establishment of international institutions, much of which can be represented as globalisation. In this era of globalisation, a new form of developmental state is required that is fit for globalisation.

The idea of a new form of developmental state in the globalisation era might provoke serious criticism from the proponents of globalisation, many of whom anticipate the extinction of the nation-state (hyperglobalists) or the erosion of the power of the state (transformationalists).<sup>129</sup> They argue that global integration has seriously undermined the state's power to manage the economy and rendered every effort by governments to create national wealth unviable (Ohmae 1995, Strange 1996). However, we agree with the idea that globalisation not only constrains the power of states but also enables the active role of states (Weiss 2003). As factors of production such as human and material capital become more mobile, the immobile factor of land — namely, location — becomes more crucial for production. In other words, as the openness of the global economy increases, the capacity of governments to manage their economies becomes even more important than before (Shin and Chang 2003: 125). The growth of so-called 'footloose' business not only risks the hollowing out of domestic industries, but it also offers opportunities that enable economies to become prosperous by

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<sup>129</sup> For a general explanation of the globalisation debate, see Held et al (1999: introduction), Weiss (2003: chapter one) and Hobson and Ramesh (2002: 5-8).

capturing mobile resources. This critical situation prompts governments to take action to reduce the risks, uncertainties and vulnerabilities, which Weiss (2005) called the state-augmenting effects of globalisation. Therefore, we argue that as globalisation progresses, the role of states becomes more important, and a new form of developmental state needs to emerge in order successfully to cope with the challenges of globalisation.

The new developmental state will have many differences from its older counterpart. The old developmental state had six main components: (1) determined developmental elites, (2) relative state autonomy, (3) powerful, competent, and insulated state bureaucracy, (4) weak and subordinated civil society, (5) dominating economic interests, and (6) suppression of civil rights (Leftwich, 1995). Among these essential factors of the old developmental state, components (1), (2) and (3) can be retained in the new developmental state; the other elements (4), (5) and (6) have to be discarded because those elements are no longer applicable in the new global era. Above all, the most important difference is the point that the new developmental state is the creature of the globalisation era while the old developmental state was motivated by industrialisation. Therefore, globalisation defines the form of the new developmental state and the new developmental state is in turn characterised by the nature of globalisation. It is generally agreed that the most distinctive attribute of globalisation is the growth of MNCs and the internationalisation of production and finance. MNCs are major carriers of economic globalisation and central to the globalisation process (Strange 1991, Gilpin 2001: 22, Held *et al* 1999: 236). Accordingly, in the globalisation era, dealing with global capital becomes the essential task for the new developmental state whereas controlling domestic capital was the key issue of the old developmental state.

In the industrialisation era, the SOM period in Korea, the old developmental state could dominate domestic capital because domestic capital was relatively weak: it was dependent on the resource distribution of the state (such as subsidiaries), and was locked in domestic locations. The state, for its part, had been active in promoting, persuading, pushing and bullying in the direction of industrialisation (Leftwich 1995: 417). The state operated in a position of superiority, enabling it to deploy the tactic of ‘*carrot and stick*’. In addition, the state could maintain a strong position in relation to foreign capital because its goal of industrialisation could be achieved by using domestic capital, thus lowering its level of stakes in the age with few globalisation pressures.

However, in the globalisation era, the state faced strong pressures of globalisation and the powerful force of foreign capital. In the MOS period, the nature of foreign capital is completely different from that of domestic capital in the SOM period. Foreign capital is generally big (sometimes bigger than a nation state), it is less interested in states’ resource distribution activities, and it has high mobility. These factors offer greater power to MNCs, which consequently brought about the Market over State (MOS) era in Korea. In the MOS period, we saw the increasing power of MNCs and the shrinking power of the state. Not only was the state unable to control MNCs, but MNCs forced the state to ‘race to the bottom’, maximising incentives to MNCs and minimising the regulation on them, as we have seen in Chapter Five. The state lost its ‘*stick*’ and only had a rather unappealing ‘*carrot*’.

The era that we believe might unfold in the future might be characterised as one of ‘State *and* Market’ (SAM): both actors, state and foreign capital, are strong and cooperate with one other while maintaining their autonomy, essentially a ‘flexible state’ stage (Weiss and Hobson 1995; cf. Evans 1995). In this era, the nature of the

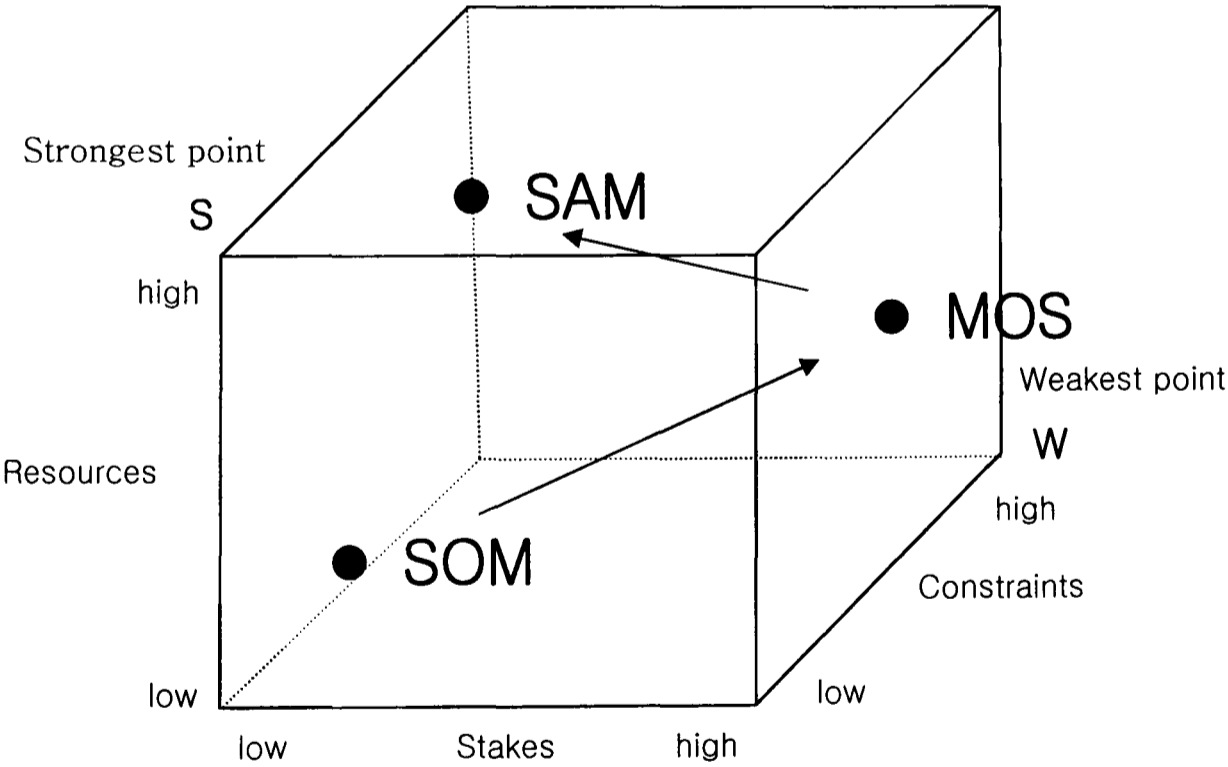
relationship between states and MNCs changes to become more collaborative because of the balance of power between the two actors. In this stage, the power of both actors are sufficiently equal not to allow one party's unilateral dominance of the other party and both parties have enough resources to generate mutual demand leading to interdependence. This interdependence will direct them to a collective sum game rather than the zero-sum game of previous ages. The wealth of states can be enhanced through the linkages with MNCs, and also the interest of MNCs can be satisfied by the benefits of certain locations. In the SAM era, although the state does not have a '*stick*', it does have a very tempting '*carrot*', which every MNC wants to have.

This does not mean that the state plunges into the 'race to the bottom' by increasing incentives (such as cutting corporate taxes or offering grants). In fact, incentives are not regarded as significant determinants of MNCs' location decisions at the national level (Stopford 1994: 66-67, Loewendhal 2001: 57-58). Instead, fundamental location-specific advantages — such as the creation of knowledge based assets, good physical infrastructures and agglomeration economies — are more important to making the country attractive in the globalisation era (UNCTAD 1998, Dunning 2000, 2002, Nunnenkamp and Spatz 2002). Therefore, in this context the '*carrot*' represents the fundamental attractiveness of a country. These efforts to enhance attractiveness have two effects; on the one hand, they contribute to increasing the host countries' bargaining power; the more MNCs want to enter, the more bargaining power the state has. On the other hand, they enrich the business environment, which MNCs can benefit from. Therefore, the bargaining power of the state in SAM has a cooperative perspective and aims for a collective-sum game. This is, paradoxically, one aspect of the way to increase the bargaining power of the state by enhancing the level of resources. In



addition, the state is able to increase its bargaining power vis-à-vis MNCs by using the leverage of the stakes and constraints dimensions. The following suggests how the Korean state’s power can be enhanced – specifically by managing the three dimensions of the Neo Bargaining Model. In order to reach the SAM period, the bargaining power of the state, which had diminished in the MOS era, has to be increased. The NBM had been used as a tool for analysing past state-MNC relations. Here we shall use it to provide insights regarding what efforts the state should make to increase its bargaining power in the future.

Figure 7.1 Korean Government’s Policy for State and Market Era



Applying the NBM to the Korean case, the policy aim of the Korean government in

terms of its bargaining power can be illustrated (see Figure 7.1). As we argued in Chapter Three, the bargaining power of the Korean government has continuously declined since the SOM period (point SOM, located close to point S, the strongest point) and it is now represented at point MOS (located close to point W, the weakest point). The low level of bargaining power in the MOS phase derives from the medium level of resources, the high level of stakes and constraints that the government faced in the MOS period. In order to increase its bargaining power, the Korean government has to make efforts not only to increase its resource level but also to reduce the level of stakes and constraints. If such efforts were successful, the government's bargaining position would change from point MOS to point SAM, which is close to point S, the strongest point, in Figure 7.1.

In order to identify the necessary measures for the enhancement of resources and the reduction of both stakes and constraints, some preliminary processes are required. First, the three factors are deconstructed into their constituent elements because each element requires different measures: bargaining resources are broken down into location-specific advantages; bargaining stakes into commitments and alternatives; and constraints into both internal constraints (from internal interest groups and the capacities of bargaining institutions) and external constraints (from other states and supranational institutions). Next, these elements are re-grouped into three categories, ranked by the degree to which they can be attained by the government: (1) elements where the government can anticipate results in the short term; (2) elements for which the government has to take a long-term approach; and (3) elements that are not under the Korean government's control.

## **Short-Term Elements**

There are two elements for which the government can take measures immediately and can anticipate results in the short term: bargaining institutions and alternatives. In the case of the capability of bargaining agencies, the government's bargaining power would increase if the government made efforts to enhance the capacity of its bargaining agencies. Compared with other issues, the measures relating to bargaining institutions are relatively straightforward and can be implemented immediately. As we have seen, a government agency's bargaining power increases if the agency holds a dominant position in the task (Encarnation and Wells 1985a: 52). However, the power of Korean bargaining institutions has continuously declined from the strength wielded by the EPB to the weaker powers of the MOF and, most recently, KOTRA (see Chapter Three). As the commitment of the Korean government to FDI increases, the capacity of the bargaining body must be enhanced in line with the increased commitment; in Korea, however, the opposite has occurred. Improving the capacity of the bargaining agency is essential if the Korean government is to strengthen its bargaining power.

Secondly, the government could increase its bargaining power by augmenting its alternatives, which can be divided into two groups: those that can be regulated within a relatively short period of time and those that require more long-term action. Clearly, only the former is applicable as an immediate or short-term measure. Alternatives can be enhanced in the short term by expanding the number of potential investors; if a host country can ensure that potential investors are competing for entry, the bargaining power of that government improves. In the long-term view, a host country must develop its fundamental investment environment to make it more attractive for businesses,

thereby increasing the number of potential investors. In the short term, potential investors can be attracted by strengthening marketing activities. The investment promotion agency (IPA) plays a crucial role in this respect. Positive and effective IPA activity with regard to image building and the marketing of a country enables a government to nurture a growing number of potential investors, which in turn augments the alternatives available to a country. However, as we have seen in Chapter Three, KOTRA, the official investment promotion agency in Korea, faces many limitations in terms of playing a strong and effective promotion role in the current situation in Korea. Moreover, promotion functions are not centralised, even though KOTRA is designated as the official agency, and are dispersed both within and outside the government, which decreases the effectiveness of these activities even further. Clearly, the government's bargaining power would increase if these marketing activities were centralised and coordinated, thereby succeeding in the creation of a positive and constructive image of Korea as an investment location.

### **Long-Term Elements**

The second category consists of elements which require a long-term approach but whose improvement is within the capacity of the government. This category includes location-specific advantages (LSA), long-term alternatives, and internal constraints. Firstly, the government's bargaining power will be stronger if it has more LSAs. Generally, the overall performance of the economy strongly affects market seekers and, given this, economic growth is the most important factor in an investor's decision. Therefore, for market seekers, deliberate, strategic and systematic efforts on the part of

the government to enhance the nation's LSA's are relatively unimportant when the economy is performing well. In contrast, production-location seekers are more sensitive to these efforts because they are directly affected by the quality of the factors of production and infrastructure.

Currently, Korea attracts mainly market seekers and is relatively unattractive for production location seekers (see Chapters Three and Five). As we argued above, Korea no longer has a late developer's advantages, nor does it provide the creative productivity advantages of developed countries. It therefore has little attractiveness both to cost-cautious investors and efficiency-cautious investors. This situation is prompting domestic manufacturers to relocate their production bases to Southeast Asia or China in search of low-cost labour, or to the United States or the European Union to establish efficient manufacturing bases and access the knowledge assets of these countries (Cherry 2001). Given the circumstances underlying the exodus of Korean manufacturers from Korea, it is unreasonable to expect foreign companies to establish their production bases in Korea. In order to keep Korean companies at home while attracting more foreign companies to Korea, it is necessary to offer the quality factors of production that companies demand. Due to the loss of the advantages of a late developer, Korea's production resources have to be transformed into more knowledge- and efficiency-based resources by cultivating human capital, fostering knowledge assets, and designing production clusters. Such reforms could cause resistance from interest groups or local governments because the changes may conflict with existing interests; therefore, a strong state is necessary to carry out such goals in the face of resistance from individual and short-term interests.

Secondly, governments can enhance their bargaining power by developing long-

term alternatives, specifically, domestic capabilities that may lessen the need for FDI, such as domestic capital and technologies. As we argued in Chapter Three, one of the reasons for the high stakes in the MOS period was the low level of technology. After the crisis was over, the government's demand for foreign capital was relatively low while the demand for technology was still high. The Korean economy currently still has a relatively high-cost production structure and technological progress is increasingly important. The development of domestic technological capabilities is not only an alternative to FDI that increases government bargaining power; it is also a crucial factor for sustaining long-term growth (Chang 2003: 256). Therefore, the government should focus its efforts to strengthening the educational system and R&D activities. If technological and scientific progress can produce innovative ideas and products, domestic businesses will be further encouraged to invest in these initiatives. This will lead not only to increased alternatives for the government but also to higher levels of FDI activity in the economy.

Thirdly, if the government can reduce the pressures from internal interest groups, it can increase its bargaining power *vis-à-vis* MNCs. One of the most serious problems that foreign investors faced in Korea was that of labour disputes (Park 2003). Increasing pressure from organised labour is one of the major factors that can weaken the government's bargaining power; conversely, its capacity to coordinate conflicts and maintain industrial peace is essential to increasing its bargaining power. Furthermore, the government must maintain a close relationship not only with labour but also with business in order to create cooperative networks. Strong links with labour and business endow the government with strong bargaining power by reducing internal constraints. The authoritarian regime during the SOM period advanced the position of capital but

oppressed labour; in the transition period, business freed itself from state control while labour aggressively challenged the government, thus weakening state bargaining power. In the MOS period, the government launched the Tripartite Agreement among labour, capital and government, as an institution to coordinate their conflicting interests. It remains in question whether the institution will continue, but undoubtedly, the successful management of social forces will surely increase the host country's bargaining power.

### **Uncontrollable Elements**

The final category includes those elements that operate outside the government's control. For the Korean government, international economic variables are beyond its control; thus, the external pressures from the home countries of potential investors or supranational organizations are regarded as independent variables that affect the government but are beyond its control. The capacity of the government in managing external pressures can vary, but the external pressures themselves are not manageable by the Korean state.

Most of the above measures to augment the government's bargaining power demand a strong state – a new form of developmental state in the SAM era. A weak state without autonomy and capacity could hardly be expected to achieve such aims as creating stronger bargaining agencies, improving marketing capacity, reforming economic structures, developing domestic industrial capacities, and coordinating internal conflicts. Most tasks demand an active role of a competent government that can set long-term

policy goals, orchestrate its resources, and overcome challenges. Some of the tasks may be achieved by neo-liberal means, as the cases of successful Anglo-American economies show. However, Korea's circumstances are different from these forerunners and, as we pointed out in Chapter One, the same strategies cannot be applied to latecomers. Korea is still in the process of catching up and needs the critical role of the state to overcome its disadvantages.

However, it is hard to expect the current Korean government, which seems to lack the capacities to cope with the above matters, to play an active role in the market. Many neo-liberal proponents argue that the Korean state is no longer a developmental state (Pirie 2005; Jayasuriya 2005; Maswood 2002), and even the advocates of the developmental state concede that the Korean system has been transformed into an Anglo-American economic system (Shin and Chang 2003). Clearly, the role of the government has been seriously reduced since the crisis. The present government appears to be unwilling to call itself a developmental state and the remains of the developmental state are ostensibly fading away. However, as long as the key features of the developmental state are regarded as part of what defines the state's vision of economic development, so the Korean state can regain its developmental characteristics (Weiss 2003a, Thurbon and Weiss 2006, Woo-Cumings 2001).

MOCIE (2003, 2006) has still made regular formal announcements on industrial policy, and industrial policy is still popular among government officials. In contrast with Anglo-American regulatory systems, in which the legislature is more influential than the executive in economic decisions, the Korean administration still exerts actual power in economic affairs. Many official government documents use phrases such as 'the promotion of growth engine industries for the next generation', which clearly illustrates



the state's perceptions of its role in the market. The Korean government still regards itself as an entrepreneur who dares to attempt risky investments for the future. The mentality of the developmental state is still alive almost everywhere in the government. Therefore, it is a latent developmental state rather than a dismantling developmental state. Although this study can not anticipate whether this latent nature will be reactivated or not and can not provide the way to arouse the latent nature of current Korean state to action, the findings of the study suggest future directions for the state, urging it to revive its past developmentalism of the industrialisation era in a new form in the era of globalisation, that is, SAM.

In this thesis, we have initially sought to answer the two questions by examining the relationship between state and market in Korea. Now we can finally reach the answers by synthesising all the discussions in this thesis.

(1) As globalisation deepens, will states necessarily be dominated by expanding foreign capital? No, states will not necessarily be dominated by global capital. Following proposition (2), that '*stronger developmentalism and weaker globalisation pressure tend to create stronger bargaining power of states vis-à-vis MNCs*', developmentalism and globalisation are the causes of the change in bargaining power of the state. Therefore, if a state can build new form of developmental state while facing globalisation pressures, the state can maintain its bargaining power and can avoid being dominated by global capital. Whether states are dominated by MNCs and whether globalisation becomes an opportunity or a threat to states is contingent on the capacity of states and this critical task in the global era provokes the need for the emergence of a new form of developmental state. In addition, if a state can build a new form of

developmental state, which has strong bargaining power vis-à-vis MNCs, the state can take advantage of globalisation according to proposition (1) that *'the state must have strong bargaining power in order to attain more beneficial effects and less harmful consequences from the MNCs'*.

(2) Are there any ways to enhance the bargaining power of states vis-à-vis MNCs? Yes, there are and the Neo-Bargaining Model can illustrate them. The above policy prescription for the State and Market era in Korea shows one example of a direction wherein the state makes positive efforts to increase its bargaining power. This study's Neo Bargaining Model produces a fresh framework for analysing state-MNC relations. Using the NBM, policy makers can identify their bargaining setting and evaluate their strengths and weaknesses *vis-à-vis* MNCs. Furthermore, this model provides useful insights regarding what efforts the state should make to increase its bargaining power. Whether states facing the challenges of globalisation become victors or victims is dependent on the states' capacity, and this thesis shows one way for the state to become a victor in the global era.

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## Appendices

(Table A) National Accounts 1962-2005

	GDP	Per Capita GNI	GDP Growth Rate	Gross Domestic Investment Ratio	Gross Saving Ratio	Saving Investment Ratio	GDP Deflator Increase Rate	Growth Rate of Gross Fixed Capital Formation
Unit	USD billion	USD	%	%	%	%	%	%
1962	2.3	87	2.1	11.8	11.0	25.5	18.4	28.7
1963	2.7	100	9.1	17.0	14.4	48.0	29.3	27.3
1964	2.9	103	9.7	13.2	14.0	62.2	30.0	-9.3
1965	3.0	105	5.7	14.1	13.2	49.1	6.2	27.1
1966	3.6	125	12.2	20.4	16.6	54.8	14.5	59.5
1967	4.2	142	5.9	20.9	15.4	51.9	15.6	22.6
1968	5.2	169	11.3	24.9	18.2	58.3	16.1	37.4
1969	6.5	210	13.8	27.9	21.4	65.3	14.8	24.8
1970	7.8	254	8.8	24.8	17.8	64.7	15.6	1.0
1971	9.5	290	8.2	25.2	15.7	71.7	14.5	4.6
1972	10.7	320	4.5	21.4	17.0	62.3	17.9	1.7
1973	13.7	401	12.0	25.4	22.8	79.1	15.4	26.2
1974	19.2	554	7.2	31.8	21.9	89.6	33.2	14.1
1975	21.5	602	5.9	28.8	19.5	69.0	26.0	8.9
1976	29.6	818	10.6	26.6	25.3	67.6	24.5	20.7
1977	37.9	1.034	10.0	28.6	28.7	95.2	16.7	30.2
1978	53.1	1.431	9.3	32.7	31.0	100.5	23.4	34.4
1979	63.3	1.676	6.8	36.0	30.2	94.8	20.1	10.0
1980	63.8	1.645	-1.5	31.9	24.7	84.0	24.0	-10.7
1981	71.4	1.800	6.2	29.9	24.6	77.3	18.2	-3.1
1982	76.2	1.893	7.3	28.9	25.7	82.3	6.7	11.1
1983	84.5	2.076	10.8	29.2	29.0	88.8	6.2	17.4
1984	93.2	2.257	8.1	30.6	31.0	99.5	6.0	10.9
1985	96.6	2.309	6.8	30.4	31.2	101.4	4.8	5.3
1986	111.3	2.643	10.6	29.4	34.9	102.7	5.5	11.5
1987	140.0	3.321	11.1	30.3	38.4	118.8	5.6	18.1
1988	187.7	4.435	10.6	31.2	40.4	126.7	7.6	13.6
1989	230.5	5.418	6.7	33.8	37.6	129.3	5.7	16.0
1990	263.7	6.147	9.2	37.4	37.5	111.0	10.5	25.4
1991	308.1	7.105	9.4	39.7	37.6	100.4	10.7	14.4
1992	329.8	7.527	5.9	37.2	36.8	94.8	7.6	0.6
1993	362.1	8.177	6.1	35.7	36.7	98.8	6.4	7.7
1994	423.3	9.459	8.5	36.9	36.3	102.9	7.8	12.5
1995	517.3	11.432	9.2	37.8	36.3	98.3	7.4	13.1
1996	557.4	12.197	7.0	39.0	35.5	96.0	5.1	8.4
1997	516.4	11.176	4.7	36.1	35.5	90.8	4.6	-2.3
1998	346.1	7.355	-6.9	25.2	37.5	98.4	5.8	-22.9
1999	445.2	9.438	9.5	29.3	35.3	148.9	-0.1	8.3
2000	511.8	10.841	8.5	31.1	33.7	120.3	0.7	12.2
2001	482.0	10.160	3.8	29.4	31.7	108.4	3.5	-0.2
2002	546.9	11.499	7.0	29.1	31.3	107.9	2.8	6.6
2003	608.0	12.720	3.1	30.1	32.8	107.3	2.7	4.0
2004	680.9	14.193	4.7	30.4	34.9	109.0	2.7	2.1
2005	787.5	16.291	4.0	30.2	33.0	114.7	-0.4	2.3

(Note) The definition of 'saving-investment ratio (SIR)' is the ratio of gross savings (GS) to gross capital formation (GCF). However, prior to 1970 the SIR was the ratio of gross national saving (GNS) to GCF. The GNS differs from GS in that GNS does not include "net current transfers from the rest of the world" whereas GS include this figure.

Source: BOK 2006

(Table B) Balance of Payments 1962-2005

	Export	Export Increase Rate	Import	Import Increase Rate	Balance of Goods	Current Account	Capital Account
Unit	USD million	%	USD million	%	USD million	USD million	USD million
1962	55	34.1	422	33.4	-367	-56	19
1963	87	58.4	560	32.8	-473	-143	107
1964	119	37.2	404	-27.8	-285	-26	27
1965	175	47.1	463	14.6	-288	9	7
1966	250	43.0	716	54.6	-466	-103	197
1967	320	27.9	996	39.1	-676	-192	280
1968	455	42.2	1,463	46.8	-1,007	-440	501
1969	623	36.7	1,824	24.7	-1,201	-549	718
1970	835	34.2	1,984	8.8	-1,149	-623	662
1971	1,068	27.8	2,394	20.7	-1,327	-848	815
1972	1,624	52.1	2,522	5.3	-898	-371	500
1973	3,225	98.6	4,240	68.1	-1,015	-309	630
1974	4,460	38.3	6,852	61.6	-2,391	-2,023	2,010
1975	5,081	13.9	7,274	6.2	-2,193	-1,887	2,501
1976	7,715	51.8	8,774	20.6	-1,058	-314	1,973
1977	10,046	30.2	10,811	23.2	-764	12	1,365
1978	12,711	26.5	14,972	38.5	-2,261	-1,085	767
1979	15,055	18.4	20,339	35.8	-5,283	-4,151	5,251
1980	17,505	16.3	22,292	9.6	-4,787	-5,312	6,522
1981	21,254	21.4	26,131	17.2	-4,878	-4,607	5,313
1982	21,853	2.8	24,251	-7.2	-2,397	-2,551	3,935
1983	24,445	11.9	26,192	8.0	-1,747	-1,524	2,391
1984	29,245	19.6	30,631	16.9	-1,387	-1,293	3,059
1985	30,283	3.6	31,136	1.6	-853	-795	1,633
1986	34,714	14.6	31,584	1.4	3,131	4,709	-4,217
1987	47,281	36.2	41,020	29.9	6,261	10,058	-10,369
1988	60,696	28.4	51,811	26.3	8,886	14,505	-5,068
1989	62,377	2.8	61,465	18.6	912	5,344	-2,886
1990	65,016	4.2	69,844	13.6	-4,828	-2,014	2,564
1991	71,870	10.5	81,525	16.7	-9,655	-8,417	6,412
1992	76,632	6.6	81,775	0.3	-5,144	-4,095	6,587
1993	82,236	7.3	83,800	2.5	-1,564	821	2,741
1994	96,013	16.8	102,348	22.1	-6,335	-4,024	10,295
1995	125,058	30.3	135,119	32.0	-10,061	-8,665	16,786
1996	129,715	3.7	150,339	11.3	-20,624	-23,120	23,327
1997	136,164	5.0	144,616	-3.8	-8,452	-8,287	1,314
1998	132,313	-2.8	93,282	-35.5	39,031	40,371	-3,197
1999	143,685	8.6	119,752	28.4	23,933	24,522	2,040
2000	172,268	19.9	160,481	34.0	11,786	12,251	12,110
2001	150,439	-12.7	141,098	-12.1	9,341	8,033	-3,391
2002	162,471	8.0	152,126	7.8	10,344	5,394	6,252
2003	193,817	19.3	178,827	17.6	14,991	11,950	13,909
2004	253,845	31.0	224,463	25.5	29,382	28,174	8,319
2005	284,419	12.0	261,238	16.4	23,180	16,559	4,689

Source: KITA 2006, BOK 2006



**(Table C) Inflows and Outflows of Capital 1962-2005**

	Public Loan	Commercial Loan	Bank Loan	Inward FDI (Arrival Basis)	Inward FDI (Notification Basis)	Outward FDI (Actual Basis)	Outward FDI (Notification Basis)
Unit	USD million	USD million	USD million	USD million	USD million	USD million	USD million
1962	3	0	0	23	4	-	-
1963	43	24	0	0	6	-	-
1964	12	12	0	0	1	-	-
1965	5	35	0	0	22	-	-
1966	73	110	0	0	16	-	-
1967	106	124	0	98	28	-	-
1968	70	268	40	5	26	3	3
1969	139	410	30	3	49	2	4
1970	115	367	25	9	76	5	8
1971	303	345	90	1	40	4	1
1972	324	326	20	518	122	2	2
1973	403	461	49	5	318	5	14
1974	385	603	218	2	153	12	36
1975	477	801	200	6	207	14	12
1976	713	839	131	5	79	7	18
1977	636	1,241	300	143	84	21	18
1978	817	1,913	328	181	149	34	38
1979	1,089	1,578	1,522	195	191	21	98
1980	1,518	1,402	440	131	143	17	21
1981	1,705	1,247	2,196	152	153	28	294
1982	1,877	914	1,619	129	189	101	818
1983	1,494	973	2,121	123	269	109	83
1984	1,424	858	3,121	193	422	50	195
1985	1,024	964	3,880	236	532	113	219
1986	880	1,620	1,180	477	355	183	364
1987	1,124	1,558	777	626	1,063	410	367
1988	891	988	9	894	1,284	216	1,636
1989	475	860	208	812	1,090	571	974
1990	418	30	1,344	895	803	963	2,274
1991	430	0	4,077	1,178	1,396	1,111	1,800
1992	486	150	2,114	807	895	1,217	2,027
1993	417	0	2,662	731	1,044	1,264	1,997
1994	734	0	3,565	997	1,317	2,304	3,631
1995	462	38	6,906	1,361	1,948	3,102	5,223
1996	535	108	8,940	2,321	3,203	4,458	7,019
1997	5,396	1,302	19,419	3,091	6,971	3,677	6,105
1998	5,170	1,914	15,779	5,308	8,853	4,794	5,837
1999	3,814	12,161	5,133	10,851	15,531	3,329	5,111
2000	769	-	7,196	10,237	15,221	5,073	6,091
2001	225	-	2,168	5,046	11,286	5,171	6,390
2002	153	-	7,218	3,804	9,093	3,708	6,348
2003	80	-	8,234	5,125	6,469	4,059	5,925
2004	0	-	10,806	9,260	12,786	6,003	8,063
2005	-	-	-	9,615	11,563	6,500	9,166

Source: Lee 2005, Invest Korea 2006, KEIB 2006

(Table D) Foreign Debts and Foreign Exchange 1962-2005

	Total Foreign Debt	External Assets	Net Foreign Debt	Total Foreign Debt to GDP	Net Foreign Debt to GDP	Foreign Exchange Reserves	Exchange Rate
Year	USD million	USD million	USD million	%	%	USD million	KRW/USD
1962	89	-	-	3.9	-	169	130
1963	157	-	-	5.8	-	131	130
1964	177	-	-	6.1	-	136	256
1965	206	-	-	6.9	-	146	272
1966	392	-	-	10.9	-	245	271
1967	645	-	-	15.4	-	357	275
1968	1,199	-	-	23.1	-	391	282
1969	1,800	-	-	27.7	-	553	304
1970	2,245	675	1,570	27.7	19.4	610	317
1971	2,922	-	-	30.8	-	568	373
1972	3,587	-	-	33.5	-	740	399
1973	4,257	1,497	2,760	31.1	20.1	1,094	398
1974	5,933	-	-	30.9	-	1,056	484
1975	8,443	1,693	6,750	39.3	31.4	1,550	484
1976	10,520	-	-	35.5	-	2,961	484
1977	12,649	5,049	7,600	33.4	20.1	4,306	484
1978	14,823	5,286	9,537	37.9	18.0	4,937	484
1979	20,287	6,294	13,993	32.0	22.1	5,708	484
1980	27,170	7,539	19,631	42.6	30.8	6,571	660
1981	32,433	7,963	24,470	45.4	34.3	6,891	701
1982	37,083	8,778	28,305	48.7	37.1	6,984	749
1983	40,378	9,504	30,874	47.8	36.5	6,910	796
1984	43,053	10,108	32,945	46.2	35.3	7,650	827
1985	46,762	11,222	35,540	48.4	36.8	7,749	890
1986	44,510	12,008	32,502	40.0	29.2	7,955	861
1987	35,568	13,156	22,412	25.4	16.0	9,193	792
1988	31,150	23,874	7,276	16.6	3.9	12,378	684
1989	29,368	26,356	3,012	12.7	1.3	15,245	680
1990	31,700	26,847	4,853	12.0	1.8	14,822	716
1991	39,135	27,186	11,949	12.7	3.9	13,733	761
1992	42,819	31,724	11,095	13.0	3.4	17,154	788
1993	43,870	35,996	7,874	12.1	2.2	20,262	808
1994	89,831	71,560	18,271	21.2	4.3	25,673	789
1995	119,800	94,380	25,420	23.2	4.9	32,712	775
1996	157,363	111,120	46,243	28.2	8.3	33,237	844
1997	174,230	106,148	68,082	33.7	13.2	20,405	1,415
1998	163,807	129,275	34,532	17.3	10.0	52,041	1,208
1999	152,937	146,095	6,842	34.4	1.5	74,055	1,145
2000	148,119	166,954	-18,835	28.9	3.7	96,198	1,260
2001	128,687	163,415	-34,728	26.7	-7.2	102,821	1,326
2002	141,470	183,488	-42,018	25.9	-7.7	121,413	1,200
2003	157,552	229,250	-71,698	25.9	-11.8	155,352	1,198
2004	172,260	284,196	-111,936	25.3	-16.5	199,066	1,044
2005	-	-	-	-	-	210,391	1,013

Source: Lee 2005, BOK 2006

(Table E) Human Resources 1962-2005

	Population	Economically Active Population	Unemployment Rate	Real Wage Increase Rate	Labour Dispute	Secondary Enrolment	Tertiary Enrolment
Unit	Thousand	Thousand	%	%	number	%	%
1962	26.513	-	-	-1.2	-	-	-
1963	27.262	8.230	8.1	-7.9	-	-	-
1964	27.984	8.341	7.7	-6.5	-	-	-
1965	28.705	8.754	7.3	0.8	-	69.1	32.3
1966	29.436	8.957	7.1	10.9	117	67.8	28.3
1967	30.131	9.180	6.1	10.9	130	70.2	30.8
1968	30.838	9.541	5.0	14.1	135	68.6	29.5
1969	31.544	9.747	4.7	19.3	94	70.2	26.2
1970	32.241	10.062	4.4	9.3	90	70.1	26.9
1971	32.883	10.407	4.4	2.4	109	69.4	28.3
1972	33.505	10.865	4.5	2.1	-	67.2	29.0
1973	34.103	11.389	3.9	14.3	-	77.6	28.1
1974	34.692	11.900	4.0	8.8	-	67.6	26.5
1975	35.281	12.193	4.1	1.5	133	74.7	25.8
1976	35.849	12.911	3.9	16.8	110	75.5	23.8
1977	36.412	13.316	3.8	19.9	96	76.8	21.4
1978	36.969	13.849	3.2	18.0	102	79.3	22.0
1979	37.534	14.142	3.8	8.5	105	81.0	25.9
1980	38.124	14.431	5.2	4.1	407	84.5	27.2
1981	38.723	14.983	4.5	0.5	186	86.5	35.3
1982	39.326	15.032	4.4	7.9	88	86.9	37.7
1983	39.910	15.118	4.1	7.4	98	89.4	38.3
1984	40.406	14.997	3.8	6.3	113	89.7	37.8
1985	40.806	15.592	4.0	6.6	265	90.7	36.4
1986	41.214	16.116	3.8	5.8	276	91.2	36.4
1987	41.622	16.873	3.1	6.9	3,749	91.9	36.7
1988	42.031	17.305	2.5	7.8	1,878	93.5	35.0
1989	42.449	18.023	2.6	14.6	1,616	94.6	35.2
1990	42.869	18.539	2.4	9.4	322	95.7	33.2
1991	43.296	19.109	2.4	7.5	234	97.5	33.2
1992	43.748	19.499	2.5	8.5	235	98.6	34.3
1993	44.195	19.806	2.9	7.0	144	98.2	38.4
1994	44.642	20.353	2.5	6.1	121	98.8	45.3
1995	45.093	20.845	2.1	6.4	88	98.5	51.4
1996	45.525	21.288	2.0	6.7	85	98.9	54.9
1997	45.954	21.782	2.6	2.5	78	99.4	60.1
1998	45.287	21.428	7.0	-9.3	129	99.4	63.5
1999	46.617	21.666	6.3	11.2	198	99.4	66.6
2000	47.008	22.134	4.4	5.6	250	99.6	68.0
2001	47.354	22.471	4.0	1.5	235	99.6	70.5
2002	47.615	22.921	3.3	8.6	322	99.6	74.2
2003	47.849	22.957	3.6	5.7	320	99.7	79.7
2004	48.082	23.417	3.7	-	462	99.7	80.7
2005	48.294	24.123	3.6	-	-	-	-

Source: Kim and Sung 2005, BOK 2005, BOK 2006