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# Does Political Instability Matter? U.S. Foreign Direct Investment (FDI) Policy and Political Instability in Korea

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**Abstract:** This study shows systematic and empirical findings of the determinants of foreign direct investment in case of Korea, which has experienced various political, social, and economic phenomena. This study especially investigates the determinants of U.S. foreign direct investment flows in Korea before the country was democratized. Six variables of political instability: They include riots (protest demonstration); labor strikes; external threat; data from domestic violence; assassination; and coup d'etat. They are categorized with regard to the data from the the Far Eastern Economic Review weekly magazine(1977 to 1991). This study finds that there is no significant relationship between political instability and FDI flows in Korea, unless the political instability is severe enough to affect the FDI policy and economic conditions, which was the case of 1980. Although investors normally say that political instability is important to their investment decisions, their actions do not confirm this. In making their decision, we found economic conditions and economic policy matters more in the case of Korea.

**Key words:** Korea, foreign direct investment (FDI), political instability

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*Korean Social Science Journal*, XXXI No. 1(2004): 137-166.

## I. Research Problems

As domestic markets for several commodities have become stabilized and as foreign markets have continued to grow, United States firms have increased direct investments abroad. The massive outflow of the foreign direct investment (FDI) began in the mid-1950s and has continued to grow; in 1993 total U. S. foreign direct investment was estimated at \$548 billion (U.S. Bureau Economic Analysis Survey of Current Business 1994). In 1950, U. S. foreign direct investment was \$11.8 billion. It was \$51.8 billion in 1966 and finally, jumped from \$395.4 billion in 1977 to \$2392.0 billion in 1991 (Wallace 1990). Especially into the Republic of Korea (hereafter referred to as Korea), the United States FDI first entered in 1962 and mushroomed during the late 1980s (University of California, San Diego and KDI 1991, 66).

Regarding foreign direct investment inflows, both economists and business people, not political scientists, have shown greater interest in determinants of the FDI. Generally, there are several political and socioeconomic factors that affected the FDI behavior. Political factors include internal political instability, Communist influence, and relations with neighboring countries. Socioeconomic factors include restrictive economic policy, market potential and social cultural difference (Piper, 1971). Many studies stress either political factors or economic factors, and sometimes considers both. However, none of these studies explain an integrated and well-balanced picture of economic and political factors. This paper tries to explain systematic and empirical findings of the determinants of foreign direct investment in case of Korea, which has experienced the various political, social, and economic phenomena. The dynamic experience of Korea will examine and explain the determinants of foreign direct investment flows. This study especially investigates the determinants of U.S. foreign direct investment flows in Korea before democratizing.

Since the beginning of foreign direct investment in South Korea,

Japan and the United States have shared more than 70% of the total FDI in Korea (Sakong, 1993: 269). From 1977 to 1991, Japan had shared 40.5 per cent of total FDI in South Korea by the amount of dollars, while the United States had shared 28.3 per cent. In terms of number of projects, the share of Japan and the United States had increased to 80 per cent (Sakong, 1993: 268). However, there was a difference between Japan and the United States in distribution of the FDI. Whereas Japanese FDI concentrated primarily in hotel service, textiles, and tourism, the United States investments were heavily weighted toward the petrochemical, transportation equipment, and electronic sectors. In 1991, distribution of Japanese FDI in the service sector in general occupied 63.7 per cent, particularly 87.0 per cent in hotels, while the United States shared 56.8 per cent of transport equipment and 41.0 per cent of chemical sector (Sakong, 1993: 270). Moreover, one-third of total Japanese investments were completed by Korean Japanese since more than a million Koreans live in Japan (Koo, 1985). With there is geographical closeness of Japan to Korea, these characteristics of the Japanese investments make the influence of political and economic factors less effective than that of the United States. This explains why this study focuses on the United States FDI in Korea. Lastly, this study focuses on the political stability, out of many political factors, because most managers consider it the most influential part of the FDI.

## **II. Theoretical Orientation**

Two schools of thought can identify the literature regarding the influences of political instability on motivating FDI behavior. The first school of thought suggests that political instability has a negative impact on the FDI behavior (Aharoni, 1966; Basi, 1963; Kobrin, 1978; Root and Ahmed, 1978; Schneider and Frey, 1985). Basi (1963) finds from his survey of international executives, that a nation's level of political stability is the second most important determinant in FDI

decisions following the extent of the potential market. Aharoni (1966) studies indicated similar results through interviews with international personnel. His conclusion indicates that a nation maintain a certain level of political stability to be considered as a place for the FDI. Kobrin (1971) hypothesizes that the probability of political conflict affecting the FDI operations depends highly on the nature of the conflict and the conditions under which it occurs. However, he implies if instability is to affect foreign investors significantly, it tends to do so through a change in government policy. Meanwhile, Schneider and Frey (1985) argue that political instability significantly reduces the inflow of the FDI.

Alternatively, the second school of thought claims that the relationship between the FDI and political instability is weak or insignificant (Bennett and Green, 1972; Bollen and Jones, 1982; Brewer, 1981; Green, 1972; Green and Cunningham, 1975). The empirical study of Bennett and Green (1972) shows that political instability has not discouraged marketing activity by U.S. firms. Green (1972) finds that the allocation of the U. S. FDI is not affected by political instability in the recipient countries, and he even showed that there was positive relationship between flow and instability. Using the Feierabend and Feierabend instability index for the measure of political instability, Green and Cunningham (1975) conclude that the political instability is not enough to determine investment allocation. Moreover, Brewer (1981) contends that, *ceteris paribus*, political instability does not provide an adequate indicator of an unfavorable investment climate. Bollen and Jones (1982) also insist that, once market size and a nation's development level are controlled, political instability has an insignificant impact on the FDI. Acknowledging the political influences on FDI, Root and Ahmed (1978) point out the dominant influence of economic factors on FDI. Moreover, Owen (1982), Lail (1983), Kim and Lyn (1987), Dunning (1980) exclude any impact of political instability on FDI, and instead identify six types of industry-specific determinants of FDI: technology, product differentiation, capital intensity, economies of scale and competition,

skill levels, and labor intensity. Especially, in the case of Korea, Lee and Ramstetter (1991) consider two factors to describe the fluctuations of FDI inflows over time: (1) the state and conditions of the Korean economy, and (2) major changes in Korean economic policy.

These studies expose inconsistency considering the influence of political instability on the FDI behavior. That is to say, most studies done by the first school of thought actually do not measure the actual investment behavior since they have dealt with the perceptions of the survey respondents. In addition, they disregard the different criteria that exist from one culture to the next, which means political instability can be applied to each country differently. Thus, most of these studies use an index, which gives different weight to each factor for political instability and this applies to all the countries uniformly. Since they disregard the different context of each country, it creates the validity problem of that political instability index when it applied to all countries.

Regarding the political instability index, the existing statistical research used various indices related to political instability: the Business Environment Risk Index (BERI), World Political Risk Forecast (WPRF), the Political System Stability Index (PSSI), the Institutional Investors Credit Rating Index (IICRI), and the Political Instability Index, which is composed of riots, deaths from domestic violence, political assassinations, armed attacks, protest demonstrations, regime support demonstrations, political strikes, successful coups, unsuccessful coups, and negative government sanctions. For example, according to Schneider and Frey (1985, p.163), BERI is composed of political instability (with a weight of 12%), attitude to foreign investors and profits (6%), threat of nationalization (6%), and quality of bureaucracy (4%). Lastly, Feierabend and Feierabend index includes demonstrations, riots, strikes, assassinations of political figures, coup d'état, and civil war. Usually, those indices use value for each variable to differentiate the weight of political instability. However, it is still arguable how accurately each factor measures the weight of each variable. Finally, the existing

research presents conceptual and statistical weaknesses. By examining the specific case between the U. S. FDI and political instability at a single country's level, Korea, this study will overcome the limits and weaknesses of previous empirical studies regarding the impact of political instability on FDI flows.

### III. Hypothesis

According to Billet (1991), political instability can be conceptualized by acts undertaken either by the government or by members of a society, those have a negative impact on sociopolitical environment, including production process. The general forms of political instability are usually violent events and large scale protest movements. The change of government through coups d'état, assassination, terrorism, death from domestic violence or civil war are some of the most severe and obvious instability indicators. Riots, protest demonstration, and labor strikes are usually weaker measures of political instability in a nation. Thus, political instability includes both mild and extreme measures.

Although the research relating to political instability weight each political instability factor differently, no systematic or scientific approach to measurement is applied. Thus, there is less consensus among the researchers of which factor is the most influential to political instability. Without considering and studying these facts intensively, conventional wisdom or its hypothesis contends that increased political instability affects decision-makers to undertake less FDI.

Unlike this traditional hypothesis, this study will test the hypothesis that political instability in general does not necessarily affect FDI unless those political instabilities are directly related to the change of economic policy, especially FDI policy and economic conditions as is the case of Korea. Thus, we do not expect the negative relationship between political instability and FDI inflows. However, if

FDI policy and economic conditions are not favorable, this can not happen at all. Furthermore, even though both FDI policy and economic conditions are constant, we expect political instability will not decrease the U. S. FDI flows in Korea unless it is in direct relation to the change of the FDI policy.

There are several reasons that we assume the insignificant relationship between U.S. FDI and political instability in the case of Korea. First, we assume that U.S. FDI has not been affected by political instability but rather by economic conditions, because foreign investor consider more favorable economic factors such as high economic growth rate, good quality labor, low inflation rate, and so on. In the case of Korea, economic conditions were less stable from 1977 to 1982, while they improved suddenly after 1983. Thus, FDI into Korea was not affected by political instability in general. However, we also try to examine if these conditions are constant and whether this political instability will make any impact on the U.S. FDI flows in Korea. We expect this is not the case in Korea even under the same economic conditions.

Second, Korean FDI policy had been very restrictive until the mid-1980s, which resulted from a general fear of foreign dominance over Korean industries and Korean government's choice of development strategy. Actually, the Korean government took action on the liberalization of its FDI policy in 1984, since it realized that the Korean economy needed to open its market to foreign investors. Therefore, FDI is assumed to be affected by this policy change. In addition, we also examined the relationship between the FDI and the political instability under the same FDI policy and same economic conditions. That is to say, the period before 1984 and after that will be considered two different conditions for FDI.

Finally, Korea is often described as a country, which has radical students' movements, confrontation with a hostile communist country, and incessant possibility of a military coup that has been dominant for the past four decades. However, it is rather a part of the unique Korean culture, than a real threat to political stability. Thus, we assume that

political instability in Korea does not lead to reducing FDI flows.

The dependent variable is the total U.S Direct Investment in Korea each year from 1971 to 1977. These total U.S FDI ranged from agriculture and mining to manufacturing and the service sector. This study simply focuses on the total FDI flows than that of specific sector. The independent variable employed in the study is political instability, which represents the factors, which had been identified by the previous studies as important in determining the allocations of FDI. Those factors were riots, including protest demonstration, labor strikes, external threat, death from domestic violence, assassination, and coups d'etat.

As suggested above, this study is confined to an individual country's level, especially between the U.S. and South Korea. Since we significantly doubt the generalization of the previous studies with regard to the negative relationship between the FDI and the political instability at the aggregate level, the hypothesis tested is that the relationship between the U.S. FDI in Korea and political instability in Korea is insignificant or weak.

#### **IV. Data and Methodology**

For this study, we will used six variables of political instability, which are riots including protest demonstration, labor strikes, external threats, death from domestic violence, assassination, and coup d'etat. These variables are selected from Political Instability Index and Feierabend and Feierabend instability index. We have disregarded some variables from these two indices, in which the influence in Korean society have been minimal or has not existed at all.

However, although the certain weight from any index can not be applied to a Korean case, as Korean experts and from my own experiences, we apply our own weight to certain factors. For example, assassination of political figures, military coup, and deaths from domestic violence, we think, should be considered as factors to cause



extremely political instability while external threats, labor strikes, and protests are related to mild political instability. We think external threats should be considered to be a minor political instability factor, while it is assumed as an extreme political instability measure, since it is related to armed attack and terrorism. However, in the case of Korea, these armed attacks mostly perpetrated by the North Korean army and security forces had occurred so regular by that South Koreans do not feel threatened, except the severe cases. In terms of an external threat, it will be explained and described in detail to some extent. In brief, we will depend on both the data and description of historical background of each factor to prove and show the weight of each factor.

The variables in this study can be defined and categorized: riots and protest demonstrations are widely exercised by either students or active citizens, while labor strikes are mainly acted upon by workers. Assassination implies the attack on a key political figure such as the president, while an external threat is more organized violence from the outside enemy. Coups d'état is a means of changing the ruling elite in the absence of any developed political institutions, and deaths from domestic violence occur mainly as a result of mass riots. For example we discovered that appropriately 1,000 students from Seoul National University clashed with riot police in an anti-government demonstration in the issue of June 23, 1978 of the *Far Eastern Economic Review*, which belongs to the variable of riots and demonstration. The issue of April 14, 1988 of *Far Eastern Economic Review* pointed out that about 1,000 workers fought riot police in Seoul after they received a rally calling for better labor conditions. This is included in the variable of labor strikes. An assassination was found in the issue of the November 3, 1979 *Far Eastern Economic Review*, in which President Park was assassinated by Kim, Director of Korean Central Intelligence Agency. External threat included the news in the issue of December 6, 1984 of the *Far Eastern Economic Review*, which said that four North Korean and South Korean Soldiers were killed in an exchange of gun fire. The Kwangju incident, which is found in the

issue of May 30, 1980 (*Far Eastern Economic Review*), is one of the deaths reported from domestic violence. Finally, coups d'état are found in the issue of December 23, 1980 of the *Far Eastern Economic Review*.

Data was collected from the *Far Eastern Economic Review* weekly magazine from 1977 to 1991, totalling 810 issues. We count the number of events of each factor of political instability on each year from the magazine. As we read each issue, we focus on how many different events relating to political instability were printed in these issues.

**Table 1.** Comparison of Labor Strikes in Korea from 1977 to 1991 between Sources

Year	Number of Labor Strikes reported in Far Eastern Economic Review	Real Number of Labor Strikes
1977	0	96
1978	1	102
1979	0	105
1980	0	407
1981	0	186
1982	0	88
1983	0	98
1984	0	113
1985	1	265
1986	1	276
1987	12	3,749
1988	5	1,873
1989	10	1,616
1990	3	322
1991	0	234

Source: *Far Eastern Economic Review*, 1977-1991.

Ministry of Finance and Economy, Republic of Korea 1996

Certainly, the number of events does not match the exact number of real occurrence for each factor in a given year, especially in the case

of protest demonstrations and labor strikes. However, assassination, coup d'état, external threat, and deaths from domestic violence are accurate since these events are so rare in that the magazine carried these events. Also, it suggests a validity problem since there is no certainty regarding how the magazine obtained the information, and in addition there had been a severe media censorship in Korea. However, as suggested above, most of the major political events are covered in the data collected. Regarding the demonstration and labor strikes, we made sure that it reflected the trend of the events by showing the actual data, in case of labor strikes, as in Table 1.

Surely, this study focuses on the general trend of both political instability and FDI flows. Since it is difficult to estimate the weight of each factor of political instability, this study has to describe and explain of each factor of political instability, considering the historical background, to allow this study to be more exhaustive. It should be noted that data for the amount of U.S. FDI for those periods is obtained from the United States Department of Commerce.

Since the events of political instability have occurred throughout the year, we examined that a political event in a given year affects FDI in that year. But we also try not to miss the possibility that any political event happened at the end of the year which would the FDI in the following year. In that case, we will provide a more detailed historical explanation, if it is valid, to test our hypothesis. In brief, this study will examine the impact of political instability in Korea on the U.S FDI through a qualitative method.

## **V. Findings**

### **1. Political Instability in Korea (1977-1991)**

Table 2 shows the number of events that had been reported for each factor of political instability annually. With regards to protest, it had increased steadily from 1977 to 1988. This reflects the trend of

protests. Although student movement had been very active in 1970s and 1980s, there was great difference in terms of their freedom to demonstrate. During 1970s, the style of democracy movements, including student and intellectuals, were marching or issuing a statement for democracy. But, in 1980s, students threw stones and petrol bombs at riot police. During the era of Chung Hee Park (1961-1979), the government had suppressed student movement and public demonstration by using force. Protesters were instantly arrested. Thus, most student movement practiced some kind of underground activity, such as organizing study group and organizations. The only time that students demonstrated in public was after an opponent leader was expelled out of the National Assembly. Also, students demanded some

**Table 2.** Political Instability in Korea from 1977 to 1991

Year	Protest	Labor Strikes	External Threat	Death from Domestic Violence	Assassination	Coups d'etat	Total
1977	10	0	2	0	0	0	12
1978	5	1	3	0	0	0	9
1979	16	0	1	0	1	1	19
1980	18	0	5	3	0	0	26
1981	15	0	1	0	0	0	16
1982	20	0	10	0	0	0	30
1983	26	0	12	0	0	0	38
1984	26	0	5	0	0	0	31
1985	30	1	4	0	0	0	35
1986	68	1	6	0	0	0	75
1987	50	12	2	0	0	0	64
1988	52	5	1	0	0	0	58
1989	17	10	1	0	0	0	28
1990	7	3	1	0	0	0	11
1991	12	0	1	0	0	0	13

Source: Far Eastern Economic Review (1977 - 1991)

political reform and democracy immediately after the assassination of Park.

However, after the new government led by Doo Hwan Chun stepped in, the student movement was heavily suppressed again until the government liberalized and permitted freedom of speech and press to a certain extent, in 1983. After that, student protests and public demonstrations began to increase more rapidly and violently. Especially, it reached the peak when both students and the general public demanded a direct presidential election and democratic reforms in 1986 and 1987. After the democratic reforms, including direct presidential election, the student movement turned its ideas over to Korean reunification in 1988. However, student movement was decreased, significantly, after public support for their violent activities worsened, and legal and peaceful procedures to achieve democratic reform was demanded by the general public. In brief, we can conclude protest and demonstration was extremely intense in 1986 and 1988.

Relating to labor strikes, there were few labor strikes reported from 1977 to 1986. However, there were a lot more labor strikes reported from 1987 to 1989. Actually, from the table 1, this trend is comparatively accurate. From 1977 to 1986, real labor strikes never exceeded more than 407, and it increased suddenly to 3,749 in 1987 and continued to maintain a high number in 1988 and 1989 (by 1,873 and 1,616 comparably). It also decreased in 1990 and 1991. Overall, we can say labor strikes were intensive during 1987 and 1989.

With regards to an external threat, which was either act of espionage and armed attacks from the North Korean military force and the Counter Intelligence Corps, several external threats were carried out from 1977 to 1986, with the exception of 1983 when relatively more harsh external threats including the downing of Korean Airline Flight 007 and the Rangoon bombing by North Korean agents. The Rangoon bombing in October 1983, coupled with the downing of Korean Airline (KAL) flight 007 the previous year, opened the eyes of South Koreans that the danger from North Korea was real. The Rangoon bombing followed, by little more than a month, the downing

of KAL flight 007 by a Soviet Fighter plane, killing all 269 people abroad. This tragedy heightened South Korean's feeling of international vulnerability. Finally, the external threat was reduced significantly after 1987. In short, external threats were heightened in 1983.

In connection with the death from domestic violence, there was only one time that Korean people experienced deaths from riots. In 1980, in the city of Kwangju, citizens and students demanded democracy. At that time, the military rulers responded with Special Warfare troops to crack on down the riots. The confrontation became serious when the soldiers arrested, beat, and killed innocent people. People began to arm and the death toll suddenly increased to more than 190, officially. The number of three from the table 2 indicates the magazine reported three different events of the deaths at different time and different places relating this Kwangju massacre. Briefly, May of 1980 is the only time that Korean people went through massive death from violence. On May 1980, General Chun tightened martial law, and dismissed the legislature. Martial law authorities dispersed the student demonstrators. Chun and the clique of Korea Military Academy officers who seized power with him decided to teach the country the dangers of defying martial law. In the large southwestern city of Kwangju, however, students refused to disperse. The demonstrations in Kwangju were the first test for military rulers, and they were dealt with ruthlessly. There were at least 193 dead (the official government counts) and very possible more-although not the 2,000 claimed by emotional students and opposition leaders (Macdonald 1990, 58). Chun's violent path to power, capped by the bloody Kwangju massacre, helped push dissidents down an uncharted road of radicalism. No longer were anti-government protesters mostly drawn from the ranks of university students, as they had been in the 1970s. Liberalism and human rights had less appeal for a generation whose friends and family had been bayoneted, shot, and clubbed by their own government. The dissidents in the 1980s veered toward the socialist, nationalist, class-based struggle that the government had always

feared.

With regard to the assassination of the authoritarian president, Park was assassinated by his political aide in October 26, 1979. After this assassination, several young military officers including Chun and Roh completed a military coup. These events happened at one time in 1979, during a fifteen year period.

In summary, the weight of the factor affecting political instability out of consideration, political instability was recorded relatively high during 1986 and 1988 period. From 1977 to 1985, it had increased steadily while it suddenly declined in 1989. However, if we consider the weight of each factor; external threat, death from domestic violence, assassination, and Coups d'état, the years of 1979, 1980, and 1983 must be considered as the years which went through a more unstable political situation than in other years. In brief, 1979, 1980, 1983, 1986, 1987, and 1988 might be considered politically unstable years.

## **2. Total Annual U. S. Foreign Direct Investment in Korea**

Table 3 presents U.S. FDI in Korea from 1977 to 1991. As it indicates, U.S. FDI flows into Korea had fluctuated from 1977 to mid-1980s. However, it started to rise rapidly from 1987 and has maintained its swift growth until 1991. If we investigate in detail the fluctuation of pre mid-1980s, U.S. FDI flows had increased from 1978 to 1979 and declined the following year. Again it recovered from the previous year in 1981 and 1982, but it dropped again in 1983. After that it had increased gradually or maintained the status quo until 1986. Summing up, U.S. FDI declined by great portion in 1980 and 1983 while it increased rapidly in the late 1980s in table3.

**Table 3.** United States Direct Investment in Korea from 1977 to 1991 (million of dollars)

Year	U. S. Direct Investment in Korea (current dollars)	U. S. Direct Investment in Korea (constant dollars based on 1987)	Increasing Rate from the Previous Year (%)
1977	395	699	
1978	418	686	-2
1979	689	1041	51
1980	575	792	-24
1981	779	980	24
1982	817	968	-1
1983	650	739	-24
1984	716	783	6
1985	743	785	0
1986	782	807	3
1987	1178	1178	46
1988	1501	1445	23
1989	1855	1711	18
1990	2178	1929	13
1991	2392	2048	6

Source: U. S. Department of Commerce, Survey of Current Business, August 1992

### **3. The Relationship between U.S. FDI Flows in Korea and Political Instability in Korea**

Generally, figure 1 shows that political instability in Korea does not necessarily lead to a decrease of U.S. FDI flows in Korea. Although figure 1 shows a positive relationship between U.S. FDI flows in Korea and political instability in Korea, this does not negate my original hypothesis since I was concerned of the negative impact of political instability. Also, we stated that 1986 and 1988 are politically unstable in spite of a relatively higher political instability than in other years. We argue that we have to focus on which year has a politically unstable



year rather than other years, in absolute sense rather than relative sense, which might not be a real difference in terms of political instability. Thus, we insist that the difference of political instability among 1986, 1987, and 1988 is insignificant, while it is significantly between those years and after the year of 1989.

Figure 1: The Relationship between U.S. FDI Flows in Korea and Political Instability in Korea

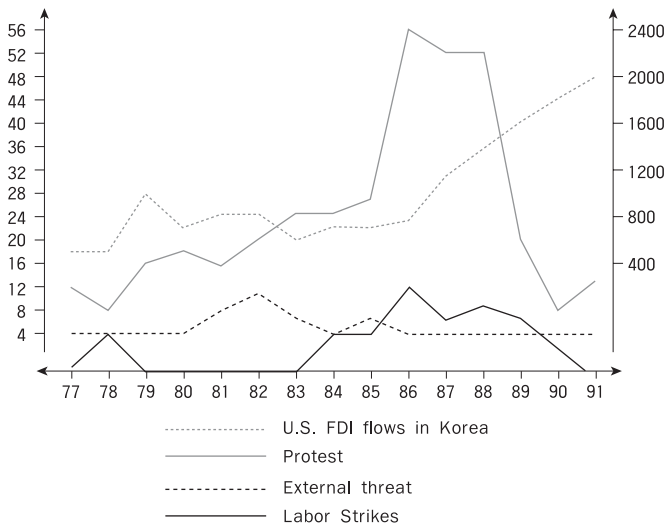


Source: U.S. Department of Commerce, Survey of Current Business, 1992, August  
Far Eastern Economic Review from 1977 to 1991

Regarding the period from 1977 to 1986, there was fluctuation that we need to observe with more depth analysis. As we found from the political instability, we suspected that the year of 1979, 1980, and 1983 were politically unstable if we consider the weight of those events which had some extremity. Also, we observed that U.S. FDI flows increased in 1979, decreased in 1980 and 1983, and stayed about the same in 1982. We consider the possibility that the political instability, especially in the case of those events that occurred at the end of the year, affects U.S. FDI flows in Korea for the following year. In that case, we looked at the year of 1980 which might be affected by the assassination of the president, the military coup at the end of 1979, and the year of 1984 which might be affected by the Rangoon bombing

and the downing of the KAL flight 007 at the end of 1983. In 1980, the flows had declined while it had increased in 1984. Thus, we find political instability in 1980 had some impact on U.S. FDI flows while those political instabilities in 1983, 1986, 1987, and 1988 did not make any significant impact on the U.S. FDI flows to Korea.

Figure 2: The Relationship between U.S. FDI Flows in Korea and Each Factor for Political Instability in Korea



Source: U.S. Department of Commerce, Survey of Current Business, 1992, August  
Far Eastern Economic Review from 1977 to 1991

Since we considered the relatively extreme political instability and mild political instability, figure 2 shows the relationship between the flows and each factor for political instability. As we observed from the figure, a great number of protests, demonstrations, labor strikes and external threats in general do not seem to affect U.S. FDI while other factors may show some relationship. However, we need to look at them in detail with more analysis to find any causal relationship, which will be discussed in the analysis section.

## **VI. Analysis and Discussion**

### **1. Impact of Political Instability on FDI under the Two Different FDI Policy**

The preceding findings suggest that political instability in Korea in general from 1977 to 1991 did not affect the flows of U.S. FDI in Korea during that period. That is to say, its relationship is insignificant and weak. However, it is certainly necessary to investigate this with a more careful look. As we indicated from the hypothesis, it is necessary to examine the relationship between the FDI and the political instability under the different FDI policies. Since the Korean government has had at least two different FDI policies before 1984 and after 1984, it is appropriate to think of the FDI policy as constant factor.

#### ***Before 1984***

Since the Korean government introduced the Foreign Capital Inducement Promotion Act in January 1960, there had been several efforts made to promote foreign investment. However, as Bello and Rosenfeld (1990) note, in practice the Korean government protected its domestic market, and “enacted some of the toughest restrictions on foreign investments of any nation.” For example, it gave preference to joint ventures over wholly-owned subsidiaries, and specified project-eligibility, foreign-ownership and investment-scale criteria for evaluating applications for FDI (Song, 1997: 80-93).

The project-eligibility criteria specified the following projects as ineligible for approval: 1) projects that would disrupt domestic demand and supply of raw materials and intermediate products; 2) projects that would compete in overseas markets with domestic firms; 3) projects that would aim solely at providing financial support for existing domestic firms; and 4) projects that would aim solely at profiting from land speculation. In addition, the foreign-ownership criteria specified an upper limit of 50 percent for the foreign-

participation ratio (Joint Korean- U.S .Academic Symposium, 1993: 135).

These selectively restricted FDI policies are related to several factors. The first and most important factor has to do with industrial policy, which means government interventions in trade, finance, skills, and institution building, with strongly selective aspects to practically all interventions. Korean leaders have consistently viewed uncontrolled foreign direct investment as highly threatening to national development goals due to the foreign economic and political influence it tends to engender and to the expropriation of capital that occurs over the long term (Mardon, 1990: 119). Korean development strategy in 1970s was heavily emphasized on heavy and chemical industries such as chemicals, basic metals, and fabricated metal products and equipment. To achieve this new objective, the government undertook a broad range of policy instruments such as import protection and fiscal preferences for the heavy and chemical industries. However, early in 1979 the government reversed its preference toward heavy and chemical industry and its previous position on FDI, lifting some restrictions.

Second, there had been widespread fear of foreign domination of Korean industries, which let the government be accommodating on this matter. Especially, Koreans remain highly sensitive to the potential domination of Japanese industrial power within their own country (Sakong, 1993: 119).

### ***After 1984***

Korean FDI policy reform was introduced in 1984 with the realization that Korea had reached a stage in which FDI would have to play a more important role and therefore that the promotion of an FDI-friendly environment was essential.

Major revisions such as the replacement of a positive-list system with a negative-list system were introduced. Foreign investment is available in all industries except those industries on the negative list. The revised act abolished restrictions on the repatriation of profits and

principal and on foreign-ownership ratios, creating an incentive system to attract foreign investment in the areas where advanced foreign technology was needed (Joint Korea- U.S. Academic Symposium, 1993: 136).

For evaluating applications for foreign investment, Korea now has the following three groups of industries: (1) “prohibited” industries in which foreign investment is prohibited, e.g., public utilities, public transport, health institutions, mass media and publishing; (2) “restricted” industries in which foreign investment is at present restricted in principle but for which approval may be obtained from the Minister of Finance; and (3) “liberalized” industries which are not on the negative list and are to be in principle approved. To the restricted category belong industries such as construction and certain food items for which joint venture with a domestic firm is a requirement, and retail businesses which meet specified requirements as to the number of affiliated shops and the size of shop-floor (Joint Korea-U.S. Academic Symposium, 1993: 136)

As of May 1991, there were 6 prohibited, 6 restricted and 510 liberalized industries in the manufacturing sector; 32 prohibited, 125 restricted, and 254 liberalized industries in the services sector, and 13 prohibited, 24 restricted, and 29 liberalized industries in the agriculture, forestry, fishery and mining sector. The liberalization ratio was thus 97.7 percent for the manufacturing sector, 61.8 percent for the service sector, and 43.9 percent for the third sector as of May 1991 (Joint Korea-U. S. Academic Symposium, 1993: 132-138). It is, therefore, fair to say that there are now almost no restrictions on foreign investment in the Korean manufacturing sector while there are remaining restrictions in the non-manufacturing sectors.

Based on these two major different policies, we may explain the trend of FDI more accurately. First, under the favorable and liberalized FDI policy after 1984, U.S. FDI had increased and even more substantially after 1986, even though the political instability recorded high during 1986 and 1988. Thus, even under the constant policy factor, we can not find any negative relationship between U.S. FDI and

political instability after 1984 in Korea. Second, under the restrictive and selective FDI policy before 1984, U.S. FDI has fluctuated from 1977 to 1984 as figure 1 shows. Thus, during this period, FDI policy could not explain much of the fluctuation except the generally low trend of FDI flows. However, it gives a hint for those abrupt increase of FDI in 1979, which might have resulted from the liberalization policy of early 1979, since the extreme political instability in 1979 did occur at the end of the year which is almost impossible to affect U.S. FDI flows of that year (Song, 1997: 84-103).

Another important policy change during this period occurred in November 1981, when the responsible agency regarding foreign investment was changed from the Economic Planning Board (EPB) which was the traditional ally of foreign investors to the Finance Ministry and half a dozen other agencies such as the Minister of Commerce and Industry, Ministry of Health, Ministry of Energy and Resource and Ministry of Agriculture and Fisheries. This meant that much of the specific authority over foreign investment was divided and there would be a possibility of increased red-tape. Thus, many foreign investors feared the tougher bureaucracy with those lower level officials with protectionist interests (Far Eastern Economic Review, February 19, 1982, 41). This change is assumed to affect those declines of U.S FDI flows in 1982 and 1983.

In brief, the FDI policy change explains the general trend of U.S. FDI flows but it could not explain the short-term fluctuation, especially in 1980 and 1981. Now, it is necessary to take a look at the state of Korean economy and its conditions.

## **2. The Impact of Political Instability on U.S. FDI Flows under Korean Economic Conditions.**

As we suggested, it is hypothesized that overall rapid economic development make the political instability insignificant and weak in relation to the U.S. FDI with the favorable FDI policy. The economic conditions and state generally are considered as the economic growth

rate, inflation rate, and balance of payments (Schneider and Frey, 1985). As table 4 indicates, Korea enjoyed a high GNP growth rate from 1977 to 1991, except 1980. In terms of inflation, it recorded double digits from 1978 to 1981 and decreased to a single digits from 1982 and maintained pretty low digits after that. Relating to balance of payments, it had recorded deficit from 1978 to 1985, but suddenly recovered and recorded surplus from 1986 and maintained that trend until 1989.

**Table 4.** Major Economic Indicators in Korea from 1977 to 1991

Indicator	Real GNP growth rate	Inflation rate	Current account balance (millions of dollars)
1977	9.8	16.6	12
1978	9.8	22.8	-1,085
1979	7.2	19.6	-4,151
1980	-3.7	24.0	-5,321
1981	5.9	16.9	-4,646
1982	7.2	7.1	-2,650
1983	12.6	5.0	-1,606
1984	9.3	3.9	-1,373
1985	7.0	4.2	-887
1986	12.9	2.7	4,617
1987	13.0	3.4	9,854
1988	12.4	5.9	14,161
1989	6.8	4.7	5,055
1990	9.0	8.9	-2,179
1991	9.1	10.1	NA

Note: The rate of inflation is based on GNP deflator.

Sources: Economic Planning Board. Major statistics of Korean Economy, various issues: International Monetary Fund. 1989 and May 1991. IFS Yearbook: The Bank of Korea. 1990. National Accounts: DRI/McGraw-Hill. 1991. World Markets Executive Summary, vol.1.

In general, the Korean economy in the late 1970s and early 1980s suffered from several difficult problems simultaneously, such as high

inflation, and the rapidly improving balance of payments which led to accelerating domestic liquidity growth. Also, rapid oil price increases and a sharp reduction in the nation rice production due to cold weather accelerated this worsening economic conditions (Song, 1997: 73-88).

As table 4 indicates, the Korean economy has had an economic boom since the mid-1980s that was because of a favorable domestic and international environment that was so called “three low phenomena” (Clifford, 1994: 239-41). “Three lows” or “three blessings” were the falling dollar, low dollar interest rates, and low commodity prices. In 1985, the economy of Korea began to turn around quite rapidly thanks to them (Clifford, 1994: 239-40). First, the September 1985 Plaza Accord, in which the five major industrial countries agreed to continue driving the dollar lower, prompted an unprecedented export boom in Korea. Since the Korean won was loosely pegged to the dollar, the devaluation against the Japanese yen and West German mark allowed Korea’s export industries, including automobiles, consumer electronics, ships and steel, to take market share from Japanese and European producers. Second, low dollar interest rates resulted from the strategy of driving down the dollar. Third, low commodity prices included oil prices. These three blessings did not merely produce a boom of unparalleled magnitude in Korea, but also solved two of its chronic economic problems, the current account deficit and foreign debt. Exports produced a surplus, which in turn was used to pay off debt.

Overall, the impact of political instability under the same economic condition is less significant from 1977 to 1991. The impact of political instability since mid-1980s is insignificant when economic conditions were much bigger than before, because FDI increased accordingly with the increasingly favorable economic condition in spite of political instability.

However, the impact of political instability before the mid-1980s shows some contradictory record. Under the same bad economic conditions, U.S FDI decreased in 1980 when the political instability



was pretty high in 1980 (We should consider 1979 as politically stable since the extreme political stability occurred at the end of 1979), and 1983 when the political instability is relatively high because of an external threat. However, those external threats, including Rangoon bombing and the downing of KAL flight 007, occurred at the end of 1983, so that we assume those events might affect the following year if they have impact on U.S. FDI flows. Thus, we have to investigate whether political instability was pretty high in 1982.

It is difficult to say exactly how much the external threats in 1982 contributed to the political instability, since most of events are related to espionage acts. For example, only two cases and three cases in 1982 and 1983 involve the actual North Korean armed attacks against South Korea while the other eight cases and nine cases in those years are related to espionage acts which actually were prosecuted as those title. Although it was not apparent, change of responsible agency for FDI in 1981 is more explicable to the decline of U.S FDI in 1983, than the political instability which was represented mostly from this external threat. Another reason that we think the political instability in 1982 was not so serious was that the new government stabilized and controlled the country very well from the early 1981 as it shows from the table 2.

### **3. Political Instability as a Culture of Korea**

First of all, political instability does not refer to political risk. If a coup is an accepted form of political change in a country, its occurrence may not severely disrupt the political system when it is a means of changing ruling elites in the absence of developed political institutions (Kobrin, 1978: 114). Even though this is not the case in Korea, its culture and recent history shows that active student movement, labor disputes, espionage acts were pretty common and most of them are unrelated to economic issues. There is a popular saying: "When a cousin gets a house, I get a stomach ache." It hints at the radical egalitarianism that makes Korea's affluence so politically

troubling. Whereas social tensions were muted when the country was poor, with wealth has come resentment at the widening gap between rich and poor. In Korea, bitterness and anger are close to the surface of everyday life, often bursting out in spasms of shouting or in the head shaving, hostage-taking, and humiliations that are part of the country's union movement. This culture of rage is based on the unique brutal history of Korea. Right after liberation from Japanese colonial rule in 1945, the peninsula was sliced in half, creating two Koreas and splitting several million families. Also, military governments constantly oppressed the freedom of the public. Moreover, Korea had a time-honored tradition of student protest against unjust rule. In Confucian society students and scholars were supposed to be the conscience of the nation, risking their careers, even their lives, when a protest against an illegitimate ruler became necessary. One of the reasons that every Korean government takes student protests so seriously is that Korean students do have the moral right to try to overthrow governments. In short, in terms of political instability causing political risk affecting economic issues in Korean society, military coups, assassination, and deaths from domestic violence can be the significant factors to affect economic issues.

#### **4. Year of 1980 and 1981**

As we found and analyzed above, the year of 1980 and 1981 are the years that economic conditions and economic policy cannot explain the increase and decline of U.S. FDI flows in those years. As we noticed from the table 2, we know that political instability in 1980 was high because of the assassination of the president, military coup, and deaths from domestic violence. Did it directly affect the decline of U.S. FDI flows in Korea in 1980? We are not sure that it directly affected the foreign investors' behavior. However, it affected them indirectly by suggesting potential policy change. That is to say, U.S. foreign investors worried that they could not expect the continuation of favorable FDI policy, which had been suggested by Park, since he was

assassinated (Clifford, 1994: 171-3).

Explaining 1981 is trickier since U.S. FDI increased with relative political stability. We assume that it is the result of economic recovery, which gave a momentum to foreign investors to consider more investment in 1981.

## **VII. Conclusion and Implications**

This study finds that there is no significant relationship between political instability and FDI flows in Korea, unless that political instability is severe enough to affect the FDI policy and economic conditions, which was the case of 1980 in Korea. However, this might be the only case in Korea since Korea has a unique history, culture, and economic policy and conditions compared to other developing countries. Thus, it might be necessary to compare the impact of political instability on FDI flows in other developing countries such as NICs (Newly Industrializing Countries) and Southeast Asian countries to examine whether Korea is the unique case.

The principle constraint of the study is the difficulty of measuring the weight of each factor for political instability. Certainly those who value of the political instability index on each factor is not appropriate to apply the case of Korea since one time of assassination, deaths from domestic violence, and military coup were far influential than one time of demonstration and labor strikes. Even, business people would apply different weights to certain specific events when evaluating a nation's political instability. However, by describing the background of each event, it can be argued that this method was justified as discussed earlier. It is possible, however, that future research could be directed toward developing an index of political instability, considering decision of investment decision makers, its hosting countries' culture, and each factor's own characteristics.

Given the constraints of this measure, it appears that although U.S. investors say that political instability is important to their

investment decisions, their action do not confirm this. Thus, there is gap between investors' belief that political instability should be a prime factor in determining investment sites and the finding that this criterion is not applied in the decision-making. In making their decision, we found economic conditions and economic policy matters more in the case of Korea. Political instability only matters when it affects FDI policy.

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