

Static and Dynamic Consequences of a **KORUS FTA**



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DYNAMIC CONSEQUENCES OF A KOREA-U.S. FREE TRADE AGREEMENT: FOREIGN DIRECT INVESTMENT

** Arthur Alexander*

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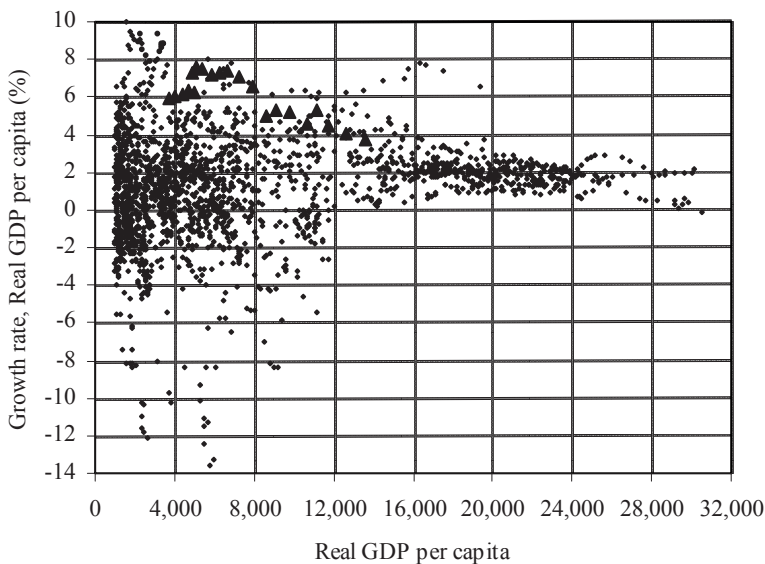
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I. Long-Term Perspective

The trade agreement between Korea and the United States will have implications beyond trade. Chief among these is the probable stimulation of direct investment into Korea by U.S. companies and those from other countries. Despite rapid increases in foreign investment during the past decade or so, Korea is notable for its relatively low receptivity to foreign firms. Therefore, the likely increase of such activities will have a disproportionate effect on the Korean economy.

Before considering the possible effects of FDI in Korea, it might be useful to place that country in a broader perspective. Korea's position is shown in *Figure 1*, which charts the experience of 116 non-oil-dependent countries with populations greater than 1 million and GDP per capita greater than \$1,000.

Figure 1. Annualized 10-Year Growth Rate of Real GDP per Capita and Real GDP per Capita, 1975–2005, 2000 dollars at purchasing power parity



Source: World Bank (various years).

The figure plots annualized 10-year growth rates from 1975 to 2005 on the vertical axis and real per capita GDP at the beginning of the 10-year period on the horizontal axis. These 2,100 observations from the World Bank include countries for which there are at least 10 years of consecutive observations. Korea's experience is shown by the triangles to the upper left. Korea is still a developing country. Its growth rate has been impressive and its national income per person has doubled in just the past 10 years, but it is still two-thirds the level of the World Bank's group of rich countries.

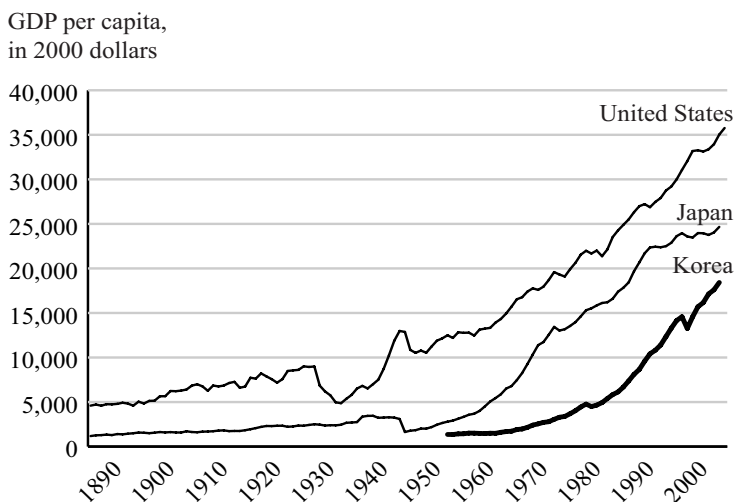
The economies represented toward the left of the chart include the very fast growing ones. Relative backwardness and competent policies have the potential to generate truly outstanding growth. However, being poor is no guarantee of growth; that part of the chart also includes many collapsing economies with negative growth over extended periods. Policies matter, as do harder-to-measure ingredients such as institutions and habits.

One important point to draw from this chart is that growth rates converge toward 0–2 percent as we move to the right. The U.S. data are at the upper bound of this range while Switzerland includes the points near zero. The country with greater than 2 percent growth at \$24,000–28,000 income is Norway, which benefited from North Sea oil production. Ireland is the high flyer at \$16,000 GDP per capita.

Illustrating how hard it is to exceed 2 percent per capita growth for more than a few years, the United States barely managed to bump through the 2 percent ceiling during the 10 years that spanned the late 1990s, which included an Internet and telecommunications investment bubble, a booming stock market, and historically low unemployment rates.

If Korea pursues good economic policies, it can expect to mature along the lines of the rich economies and find its growth rate decelerating to the 0–2 percent range. However, it is not at that stage yet. As is evident in Figure 1 and emphasized in *Figure 2*, Korea is still likely to experience fast growth for several years.

Figure 2: GDP per capita in the United States, Japan, and Korea, 1886–2005, in 2000 dollars

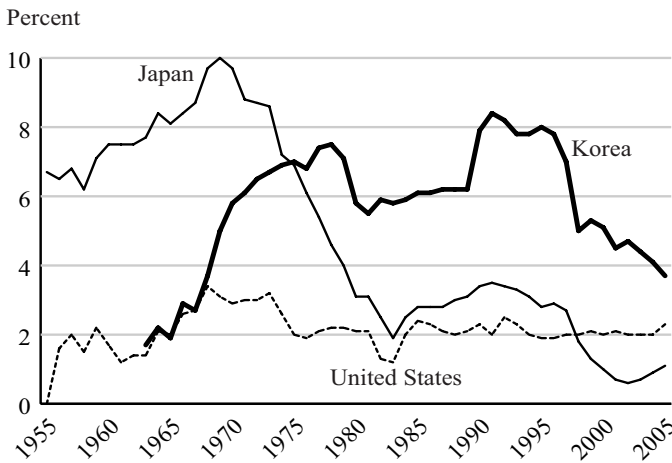


Sources: World Bank (various years) for Korea; historical statistics for the United States and Japan.

In 1886, Japan's productivity only enabled it to produce one-quarter of the U.S. output per person, an output level reached by Korea 70 years later. The bonanza of compound growth brought about rapid convergence, and Japan reached 80 percent of U.S. output per person by 1990; its subsequent slowdown ended the race toward the top, which many observers had predicted for Japan when extrapolating 1980s trends. Korea's rate of expansion since 1960 averaged a bit less than Japan's miracle years during its postwar reconstruction, but lasted longer. As is typical now with successful developers, growth is occurring faster than in the past; it took Korea only 50 years to achieve what Japan did in a little under 100 years and the United States in 150 (according to estimates by Angus Maddison [2003]). One implication of such fast growth is that institutional adaptations and changes that occurred slowly among the early developers must be accomplished much faster in countries like Korea, placing strains on the political system.

If Korea manages the task of completing its passage from developing economy to rich nation, its growth inevitably will slow. The economy already has been decelerating since its high-growth sprint ended in the 1990s. *Figure 3* shows the growth rates implicit in Figure 2, averaged over 10-year periods to reduce short-term volatility.

Figure 3: Annual 10-Year Growth Rate of Real GDP per Capita in the United States, Japan, and Korea, 1955–2005



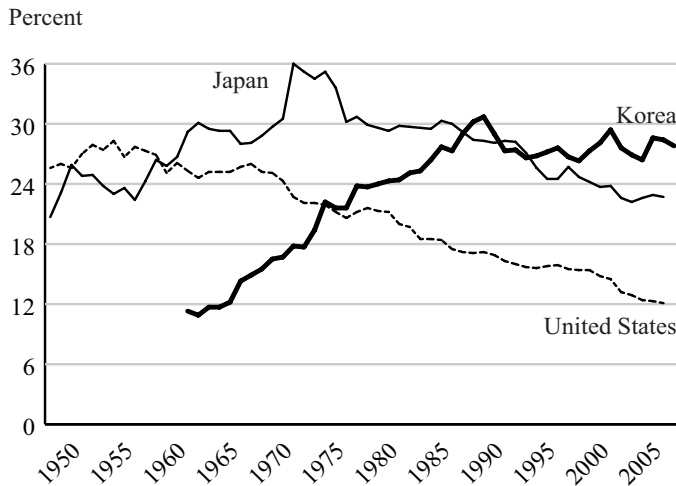
Sources: World Bank (various years) for Korea; historical statistics for the United States and Japan.

As of 2005, Korea's growth of real GDP per capita over the preceding 10 years was 3.7 percent. When Japan hit that rate in 1979, it attained 2 percent only four years later, although Japan was heading downward at a faster pace than Korea is now. Japan's asset bubble raised growth for several years, but the country paid the price of that outburst with almost 15 years of sub-par performance. Nevertheless, one could project that Korea's growth will approach the 2 percent range of rich economies

within 10 years, probably less. Given that outlook, the pressure from a free trade pact to change the structure of the economy should be welcome. Without such change, stagnation, or worse, is possible.

One example of pending structural change will be in manufacturing. *Figure 4* shows the share of manufacturing in Japan, the United States, and Korea. U.S. manufacturing peaked in the 1950s and since has shrunk to 12 percent of GDP. Japan’s manufacturing decline lags the United States by about 30 years. Korea’s manufacturing sector should soon begin falling as a share of the economy.

Figure 4: Share of Manufacturing Output in GDP in the United States, Japan, and Korea, 1947–2006



Sources: World Bank (various years) for Korea; national income statistics for the United States and Japan.

Far from being a disaster, deceleration and structural change would represent an outstanding achievement. However, reaching vigorous maturity is not automatic. Economies, their policymakers, and politicians must confront the pressures arising from these shifts. Foreign direct investment (FDI) will be one force pushing Korea to face these challenges.

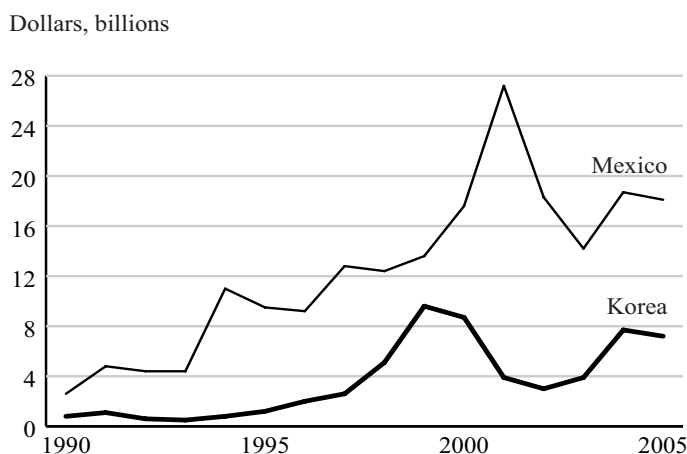
II. Changing Structure of FDI

Increased foreign investment can proceed from two sources following a free trade agreement. First, FDI tends to follow trade. As barriers to the transfer of goods decline, companies often benefit from shipping parts to the trading partner and reshipping finished goods to markets elsewhere; alternatively, a trader may invest in local production intended for local sale. Second, improved rights and obligations of

investors under a treaty contribute to a more inviting investment environment, even without additional trade. The combination of more trade plus a better investment climate doubles the incentives for FDI.

Korea's FDI inflows are shown in **Figure 5**, along with Mexico's. Mexico makes an interesting comparison because of the effect of the North American Free Trade Agreement (NAFTA). The intention to negotiate a North American treaty was announced in mid-1990; it came into effect at the beginning of 1994. At the end of that year, Mexico had plunged into a foreign currency and current account crisis, sparked primarily by domestic, election-based fiscal policies. When the crisis eased and the economy revived in 1996, FDI into Mexico shot up, doubling within four years.

Figure 5: Inward Flows of Foreign Direct Investment in Mexico and Korea, 1990–2005, billions of dollars



Source: UNCTAD (various years).

Prior to the East Asian financial crisis of 1997–98, Korea had imposed restrictions on foreign ownership of domestic company shares. Subsequently, these restrictions were relaxed and then eliminated entirely. Foreign ownership of shares rose from 15 percent in 1997 to 40 percent in 2005. Foreign investors now hold more than half of all shares in many leading companies, including eight banks. Korea's inward FDI increased at a rapid rate after 1997, particularly as many of the foreign participants in joint ventures consolidated their holdings by buying out their local partners and engaging in the major restructurings occurring in that period. However, after this initial surge, the flow of foreign money slowed. One explanation given for the slowdown was concern over a presumed *de facto* government policy to discourage FDI (Graham 2003, 111).

An additional retardant to foreign investment was the lack of transparency into Korean companies' financial affairs. Of special concern were possible commitments and

obligations within the industrial conglomerates (*chaebol*) that were not apparent in the published accounts. Improvements to accounting standards since the financial crisis, together with the prosecution of prominent business leaders for outright fraud, have made accurate information about Korea's businesses more accessible and believable.

A lingering concern is public-sector corruption, with local businesses attempting to influence official actions through outright bribes or other questionable practices. In 1998, Transparency International (2006, 294–302) ranked Korea number 42 out of 84 countries on its corruption perception index (ranked from least to most corrupt); Korea shared its position with Zimbabwe and Malawi. Analysis by Transparency International showed virtually no change in Korea's performance between 1995 and 2004, although the most recent information for 2005 moves Korea up from the 50th percentile level of countries to the upper one-quarter of the less corrupt. Surveys of business executives indicate that the level of corruption is associated with the level of confidence of investing in a country. According to a Pricewaterhouse Coopers study cited by Noland (2002, 4), if Korea could achieve the average transparency level and freedom from corruption of the top group of countries, it would triple its FDI inflow.

The Paris-based Organization for Economic Cooperation and Development (OECD) points to another hindrance to FDI: contentious industrial relations, which impact negatively on business confidence and investment. A 2003 poll of Korean and foreign CEOs showed that about half were reluctant to invest in Korea because of labor-management problems. Labor problems account for almost one-third of the complaints made to the investment ombudsman by foreign firms operating in Korea, with a negative impact on prospective foreign investors (OECD 2004, 84). In the recommendations of its 2004 Korea survey, the OECD highlighted the importance of improved labor relations as a key factor toward removing impediments to inward FDI (OECD 2004, 21).

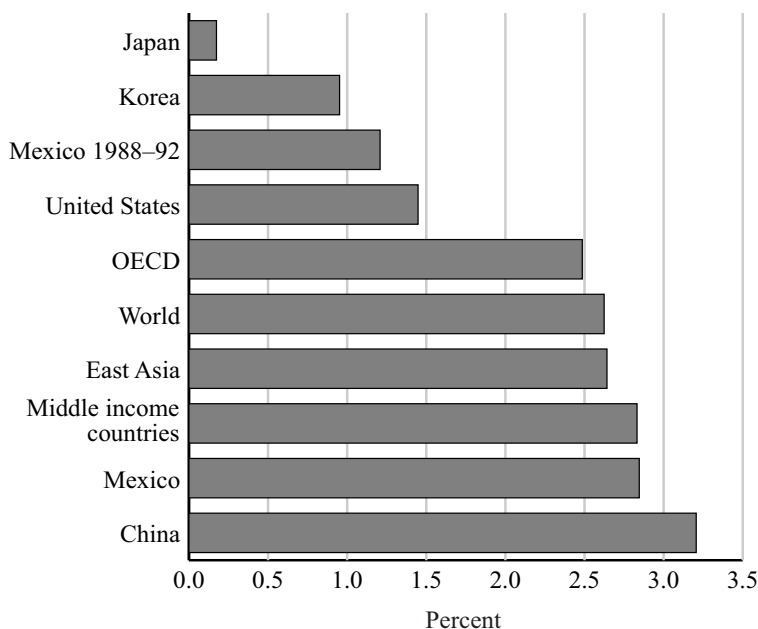
The OECD also notes, however, the great improvements made to the FDI environment since 1998. This opening began with the Foreign Investment Promotion Act in 1998. This act has been amended three times to further promote FDI in light of the experience gained since first passage. Under the rationale of creating an environment friendly to foreign investors, 99.8 percent of all business lines (out of a total of more than 1,100) were open to foreigners; limitations on foreign participation remain in 26 sectors, and two sectors (television and radio broadcasting) are fully restricted. Another 1998 law removed restrictions on foreign ownership of real estate. Public relations campaigns to improve attitudes toward foreign ownership, plus the creation of a foreign investment ombudsman to centralize and deal with complaints, have further improved the climate (OECD 2004, 139–40).

The authorities have identified more than 150 issues related to the FDI environment that appeared to restrict investment. By March 2005, 55 of these were reported to have been reformed or deregulated (OECD 2005, 41).

Despite these many improvements, inward FDI peaked in 1999 as the initial surge ran out of steam. Then the collapse of the telecommunications investment boom in 2000 caused a sharp fall of foreign investment throughout the high-tech world, including Korea; investment recovered in 2004, but not to the 1999 level.

FDI value relative to the size of the economy, though, remains small. **Figure 6** shows flows into selected countries and regions over the past five years as a percentage of GDP. For comparison, Mexico is shown for the five years preceding discussions about a trade treaty. Clearly, Korea's experience, like the experience of its neighbor, Japan, has been well below typical performance and more like Mexico's before NAFTA.

Figure 6: Inward Flows of Foreign Direct Investment as a Percentage of GDP, in various countries and regions, 2000–04 average

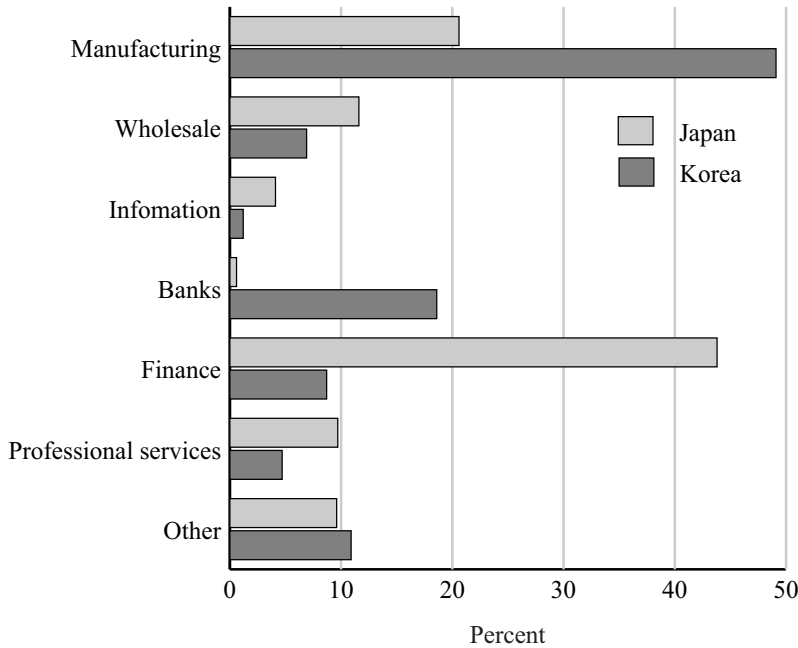


Source: UNCTAD (various years).

Which industries might benefit from increased investment? **Figure 7** shows the share of U.S. FDI by broad industry group in Japan and Korea. Japan may serve as a guide to Korea's future. First, it is an Asian economy, sharing the same geographic forces that would operate also in Korea. Second, its financial sector and other industries

arguably are somewhat more liberalized than Korea’s and more advanced technologically, representing Korea’s capabilities a few years hence.

Figure 7: U.S. Foreign Direct Investment Capital Flow, by Industry, in Japan and Korea, 2001–05 average



Source: BEA (various years).

Note: Percentages are percentages of the total FDI in each country.

Korea has been relatively more concentrated in manufacturing and less in finance. However, there has been more U.S. investment in Korean banking than in Japan, largely the result of a few large transactions. Wholesale trade and professional services also have been represented more in Japan than in Korea. Because the United States is predominantly a services economy, it should not be a surprise that its investments are in those areas, especially in another rich country like Japan, which is notable for a service sector with inferior productivity and product compared with the United States.

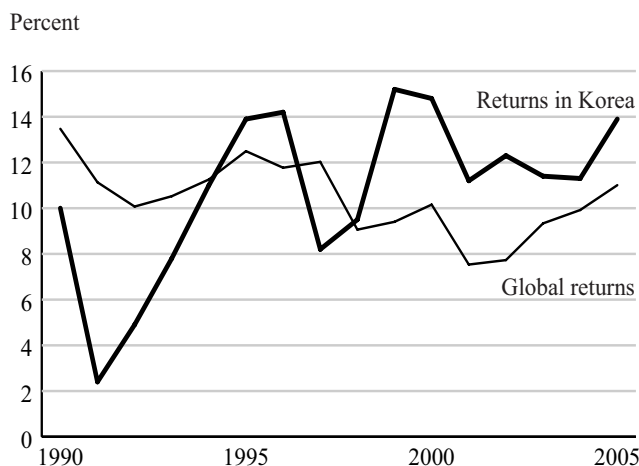
Inspection of annual data indicates that Korea is indeed moving in the expected direction. **Table 1** shows the share of annual capital outflows from the United States to Korea by major industry group. The shifts implied by the Japan-Korea comparison are already occurring. Just since 1999, manufacturing has fallen by half and finance has grown from almost nothing to assume a major share. Even more changes can be expected as a result of the free trade agreement in which business services and financial regulatory reform are prominently featured.

Table 1: U.S. Direct Investment Capital Outflows to Korea, 1999–2005, percentage of total U.S. FDI to Korea

Industry group	1999	2000	2001	2002	2003	2004	2005
Manufacturing (total)	70.9	66.3	55.7	43.7	54.2	19.4	32.0
Computers & electronics	22.7	43.4	12.9	-13.0	11.4	5.2	-11.5
Banks	-13.8	7.1	7.8	1.1	-3.2	52.0	19.4
Other finance & insurance	3.5	2.5	7.5	53.0	36.7	15.9	22.8
Other	39.4	24.1	28.9	2.2	12.3	12.7	25.8

Source: BEA (various years).

The shifting focus of U.S. investors in Korea is consistent with their following profitable opportunities. The returns earned on U.S. FDI have averaged the same in Korea as in the rest of the world, as shown in *Figure 8*. Returns earned in Korea over the past 15 years are the same as those produced globally, although global returns to the United States on FDI are less volatile than those from Korea because worldwide returns are diversified across many economies.

Figure 8: U.S. Investors' Rate of Return on Foreign Direct Investment, Globally and in Korea, 1990–2005, percentage

Source: BEA (various years).

Note: Returns are calculated as a ratio: (direct investment income without current-cost adjustment, net of withholding taxes) / (U.S. direct investment position abroad on a historical cost basis).

In addition to changes in the industry mix of FDI, foreign investors are altering their approach to new ventures. One approach is for a foreign company to build a new venture from the ground up, a so-called greenfield investment. Another is for the foreigner to gain control of an existing domestic company through merger or acquisition.

The local emotional impact of a greenfield investment is more muted than it is for mergers or acquisitions, in which a local company comes under foreign control. According to UNCTAD data, 80–90 percent of FDI in the developed world is via mergers and acquisitions (UNCTAD 2006). In contrast, until 1998, only one-third of the inflows into Korea were by that method (UNCTAD various years).

However, the situation changed after 1998 when Korea's share of FDI through mergers and acquisitions reached the levels seen elsewhere, largely because of changes in laws and regulations that made it easier for anyone, especially foreigners, to acquire shares in a company. The preference of firms to invest via acquisitions is likely to persist.

A new kind of entity is now engaged in FDI, particularly through mergers and acquisitions. The older pattern was for an industrial company to buy a foreign one that had production capacity, technology, a customer base, or other things valued by the acquirer. In the past decade or so, private equity companies have entered the market. These entities collect large amounts of funds from investors and use them to buy companies around the world with the prospect of improving their performance, raising profitability, boosting the companies' value, and selling them at a profit. Many private equity firms are now active in Korea. Illustrative of this phenomenon, nonbank holding companies now account for 40–50 percent of the FDI outflow from the United States; although this category includes other types of establishments, private equity funds seem to account for a large share.

Private equity companies often are called vulture funds, or worse, in target economies. Like middlemen in many societies, they are not viewed as adding value through their activities, but rather are alleged to live by sucking the value produced by others. Although this view is incorrect, it conditions emotions and policies. A recent example is the purchase by Lone Star Funds of the distressed Korea Exchange Bank; the purchase price of \$1.2 billion and later sales price of \$6.6 billion generated estimated profits for the fund's investors of \$4.5 billion. Public outrage sparked several government investigations of the transaction.

The shifting nature of foreign investors has meant that oversight has moved to the financial regulators and other agencies. A few foreign investors have expressed their fears that FDI decisions are being governed by other than transparent, regulatory criteria.

III. Dynamic Effects from More and Different FDI

A central rationale for trade agreements is the presumed economic boost from expanded trade and investment. Research on the positive effects of FDI, however, has been

mixed. One problem in such studies is that the cause and effect links between investment and the possible consequences of such investments have been difficult to disentangle. For example, does investment follow economic growth in a country, does investment cause growth, or is there a mutually reinforcing effect? Although this problem is well known, not many studies have convinced skeptics that they have addressed the issue adequately.

Research by Carkovic and Levine (2005, 197) comes closest to dealing with the problems of cause and effect. Using a combination of cross-country and time series panel data, these authors test explicitly for the effect of FDI on subsequent economic growth, holding other things constant. They conclude, based on as rigorous a method as to be found in the literature, that there is no independent effect of FDI on economic growth: “This study finds that the exogenous component of FDI does not exert a robust, positive influence on economic growth. . . . Specifically, there is no reliable cross-country empirical evidence supporting the claim that FDI per se accelerates economic growth.”

As definitive as these results are, the issue does not rest without further examination. The authors note that anything that generates economic growth will also stimulate FDI; therefore, burgeoning investment would be an indicator, at a minimum, of favorable economic circumstances. “While sound economic policies may spur both growth and FDI, the results are inconsistent with the view that FDI exerts a positive impact on growth that is independent of other growth determinants” (Carkovic and Levine 2005, 219). It is possible, however, to disagree with such stark assessments on the basis of the study’s own findings. In particular, FDI has no effect when trade is held constant. However, when trade and FDI are allowed to vary (that is, when trade variables are not included in regression equations), FDI has a robust effect on growth (Carkovic and Levine 2005, equations 1–3, 207). Because trade growth is a foremost outcome of trade agreements, positive effects from FDI can be projected.

Studies using econometric techniques similar to those used by Carkovic and Levine show a robust relationship between financial openness (which includes portfolio as well as direct investment) and growth in a sample of developing countries. In particular, having the right combination of policies in place appears to enhance the positive effects of openness. “Financial openness has a negative impact on economic growth in countries with weak institutions. . . . The impact of increased financial openness becomes positive for higher levels of institutional quality. The highest impact occurs for Italy, Singapore, Chile, and South Korea, whose institutional quality lies in the seventieth percentile of the world distribution” (Calderón and Fuentes 2006, 60–61).

Of particular interest to Korea because of the likely appearance of economic maturity in a few years are the results of another widely cited paper that uses the new

econometric techniques. This research finds that long-run growth is much more dependent on increases in total factor productivity than on investment. These scholars also find a powerful connection between national policies and productivity growth; the ratio of total trade to GDP is among the five policies that they consider (Easterly and Levine 2001, 208–10). Although this study did not consider FDI explicitly, investment's links to trade suggest that there would be positive complementarities with FDI. Such an inference is supported by findings from a Korea Ministry of Commerce, Industry, and Energy survey that labor productivity was 25 percent higher in foreign-controlled companies than in domestic firms (OECD 2005, 171).

The main lesson from reviews of FDI's effects across countries and over time, positive and negative, is that they are conditional. There is not a uniform pattern of outcomes; they seem to depend on conditions in the host country and firms. Best results are associated with more open trading environments and more domestic competition. Positive productivity spillovers from the foreign-operated firm to others are highest in sectors with high competition rather than protection from imports (Lipsey and Sjöholm 2005, 35). Positive effects also seem to be associated with higher labor force education and training and higher levels of technology in the receiving industry or firm.

Analysis of research and development (R&D) in Korea suggests that the country's linkages to the global scientific community are weak. One reason given for poor international collaboration is the low level of FDI. "International isolation may limit the scope for technological progress, as foreign sources of knowledge are increasingly important for innovation, leading to growing co-operation across national borders" (OECD 2005, 106). For a maturing economy such as Korea, R&D becomes a key source of productivity improvement, and R&D links to FDI become doubly important. A positive development is that the number of foreign R&D centers located in Korea doubled to 122 since 1997.

According to a summary of FDI research, restrictions such as domestic content requirements, joint venture mandates, and technology-sharing regulations are the kinds of host policies most likely to interfere with practices shown to be most effective for host development. "These restrictive measures lead to outdated technology, inefficient production processes, and wasteful use of host country resources" (Moran, Graham, and Blomström 2005, 377). Korean officials will have to guard against falling into such practices.

IV. Conclusions

Korea is approaching economic maturity. Its future growth will depend more on productivity improvements than on additions to the capital stock. Foreign investment will be a stimulant to productivity improvement. Structural impediments that reduce

the ability of firms to adapt to new conditions will retard productivity growth. Labor market restrictions that hinder the movement of people from firm to firm or across industries will likewise slow growth. The trade agreement with the United States will create the potential for direct investment by U.S. firms as well as companies from other countries, which could cause dislocations, especially because much of that investment will be in areas that differ from past patterns.

Despite the many benefits from FDI, there exists in Korea a negative public perception toward imports, foreign firms, and foreign investment. The government has made efforts to try to change these perceptions, especially among central government officials. Schemes to address these issues include rewarding public servants who promote FDI and the creation of the investment ombudsman. However, local governments, the news media, and the general public still harbor suspicions about the wisdom of further opening. A review of regulatory reforms in Korea notes that strengthening efforts to alleviate foreign perception of de facto discrimination against foreign investment remains a major challenge and will take time. This review notes that such suspicions are found in many of the most advanced countries and that a combination of specific policy and regulatory changes as well as better public relations on the importance to the nation of greater openness often are necessary to deal with the problem (OECD 2007, 12).

FDI in the future will employ different techniques than in the past, occur in different industries, involve a changed cast of government agencies, and use different financing methods. Koreans will be challenged to adapt to these changes. Given the enormous transformations that have occurred over the past 50 years, however, Korean companies, citizens, and their government have demonstrated an ability to cope, demonstrated by an economy approaching the level of the rich nations. There is little reason to believe that these coping skills have vanished.

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