The effects of conventional and unconventional FDI on the host country
A case study of the Korean automobile industry

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Abstract

Purpose – The purpose of this paper is to analyze and compare the effects of conventional and unconventional FDI on the host country in a more comprehensive and systematic way.

Design/methodology/approach – Both the OLI paradigm and the imbalance theory are linked to the diamond model in order to compare the effects of conventional and unconventional FDI on the host country. This methodology is then applied to the real world as a case study, FDI toward the Korean automobile industry.

Findings – Conventional FDI is often said to be more beneficial to the host country than the unconventional type. However, the actual effect of unconventional FDI is shown to be more positive with better management and is often larger than perceived. Therefore, unconventional FDI emerges as important as conventional FDI for sustainable economic development.

Practical implications – In general, unconventional FDI has often been criticized severely because of misperceptions derived from the dominance of conventional FDI on theoretical aspects, incomprehensive perspectives toward assessing the effects of FDI and negative political views. Therefore, rigorous and holistic case study analyses based on solid analytical tools are needed in order to better understand the effects of unconventional FDI and to draw up effective and proper FDI promotion policies.

Originality/value – This paper provides a way to better understand the effect of unconventional FDI on the host country comprehensively and systematically by expanding and deepening existing theories. Based on this, the effects of conventional and unconventional FDI on the host country are compared theoretically and empirically, particularly with the case of the Korean automobile industry.

Keywords FDI, Inward FDI, Conventional FDI, FDI effect, Imbalance theory, Korean automobile industry, OLI paradigm, Unconventional FDI

Paper type Research paper

1. Introduction

Over the last decade, outward foreign direct investment (OFDI) from lesser-developed countries (LDCs) has significantly increased. This has emerged together with the growing influence on the global economy of the BRIC grouping of Brazil, Russia, India, and China. In 2003, OFDI from LDCs accounted for around 6 percent (USD36 billion) of the global total (United Nations, 2004, p. 19). This grew to around 30 percent (USD383 billion) of the global total of OFDI (USD1,452 billion) in 2016 (United Nations, 2017). Notably, this OFDI from LDCs is led by China whose OFDI has surged to USD183 billion. This makes China now the second...
largest home country for OFDI (United Nations, 2017). Among Chinese OFDI, mergers and acquisitions (M&As) accounted for USD102 billion or almost 55.7 percent of the total. In fact, the trend of M&As has been leading the way as a form of OFDI since 2007 (Leowendahl, 2016).

There has been increasing focus among scholars and the media on two specific cases of M&As. The first is with firms from developed countries (DCs) acquiring companies from other DCs or LDCs, while the second is firms from LDCs acquiring other DC firms, a trend which has been more visible since the early 2000s (Hemerling et al., 2006; United Nations, 2006). In particular, companies in DCs have been the targets of Chinese or Indian companies. For example, GE Appliances was bought by Haier Group, a Chinese multinational consumer electronics and home appliances company. While in another case, Arcelor, a European steel company, entered into a merger with the Indian-owned multinational steel maker Mittal Steel.

Labeled as “unconventional” FDI by Moon and Roehl (1993, 2001), this kind of investment by multinational corporations (MNCs) from LDCs has greatly increased. As the presence of this unconventional FDI has become more noticeable, it has also become the subject of growing criticism. Globerman and Shapiro (2009) highlight US criticism over the mode of entry among this kind of FDI that brings about lower benefits than greenfield investment. They further question the motivation of investing Chinese companies in particular given that most of them are state-owned. Sauvant (2013) echoes this point and raises concerns on these motivations based on the fact that Beijing was not involved in the creation of the current international financial and trade frameworks. Bershidsky (2015) emphasizes the lack of reciprocity in investment policies between Europe and China as well as the excessive focus among Chinese MNCs on M&As rather than greenfield investment. However, it is important to consider the point that the decision on whether to pursue M&As or greenfield investments depends very much on the host country’s comparative advantage (Lee and Jang, 2016).

By contrast, conventional-style FDI, from DCs to LDCs is usually perceived in a positive way in most of the existing literature. For instance, FDI from the American “Big Three” carmakers, such as Ford, Chrysler, and GM, into developing countries has been recognized as a booster for economic development or as a beneficial transfer of technology and/or management skills. On the other side, the Chinese auto companies that took over Sweden’s Volvo and Korea’s SsangYong are often viewed in a more negative way (Xu and White, 2012; Waldmeir, 2013; Shirouzu, 2014).

In fact, FDI theories have traditionally concentrated on conventional types of investment[1]. By contrast, unconventional FDI, particularly M&As from LDCs, and its effects have been less of a focus for rigorous studies. It has often been criticized because economically sound analyses on unconventional FDI have been dominated by politically biased or narrow approaches. Furthermore, instead of examining the effects of FDI more comprehensively, many of them highlight only a few widely mentioned points. Therefore, a rigorous and holistic study using solid analytical tools is required in order to understand better the effects of unconventional FDI as well as conventional FDI.

This paper seeks to address the issue presented here by exploring and comparing these two different types of FDI with more focus on the unconventional form. It further seeks to analyze and compare the effects they have on hosting countries. To achieve this aim, this paper is organized in the following way. The first section explores and reviews the existing literature on FDI theories and the effect of FDI on hosting countries. The second section expands the existing framework and develops a new one to understand the effects of unconventional FDI more comprehensively. The third section, a case study, compares the effects of conventional and unconventional FDI on the Korean automobile industry by applying the two frameworks mentioned. Lastly, the concluding section summarizes the main implications to be drawn from this analysis on the effects of FDI.
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Muendler (2008), and Van Wyk and Lal (2008) deal with these two types of FDI together without any distinction.

To assess the effect of FDI on the host country, many of them, such as Nair-Reichert and Weinhold (2001) and Thangamani et al. (2010), focus only on arithmetization as an economic effect of FDI with aggregate data, overlooking the unmeasurable effects derived from FDI and its various motivations. This includes non-equity relationships, such as management contracts, franchising, and sub-contracting (for comprehensive details, see Masataka, 2008). These data limitations on FDI make their usefulness increasingly difficult, especially in assessing the impact of FDI, formulating policies, and undertaking econometric analyses (Sauvant, 2017).

For these reasons, Moon (2007b) and Jung and Moon (2008) adopt a broader view incorporating various measurable and unmeasurable factors and analyze them more systematically. This is because these two studies link FDI theory to the diamond model which incorporates not only the production factor conditions that most traditional theories have employed but also other important variables into a single model (Moon and Jung, 2010[3]). Thus, by utilizing the diamond model, a more comprehensive and systematic analysis can be conducted.

By incorporating many existing studies, Moon (2007b) and Jung and Moon (2008) delineate the effects of conventional FDI on the host country and have produced a comprehensive framework that is illustrated in Table I. First, regarding factor conditions, significant capital inflows can be rightly expected to create employment. However, arguments on unsuitable compensation can be raised when the wage level of MNCs’ home country (DCs) and the host country (LDCs) are compared, since the average wage of MNCs in their home country is usually higher than that in the host country. In terms of advanced factor conditions, MNCs would voluntarily bring new technologies as well as better managerial skills in order to achieve higher returns on their investment. The positive impact from this is that it will induce technology spill-overs in the host country and increase productivity.

Second, concerning demand conditions, as the investing MNCs export abroad, the market size of the host country can be increased due to the distribution capacity of these companies. Therefore, overall exports as well as the market size can eventually increase. There can also be indirect learning experiences through exports, such as market learning

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**Table I.** The effects of conventional FDI on the host country (based on OLI paradigm)

**Notes:** “Related and supporting industries” is referred to as “related sectors” to adjust to a different unit of analysis, FDI, in lieu of country which was the original unit of analysis for analyzing national competitiveness undertaken by Porter (1990); Porter and Stern (2001) used “context for strategy and rivalry” instead of “firm strategy, structure and rivalry.” In this study, “context for strategy and rivalry” is referred to as “business context.”

**Sources:** Based on Moon (2007b) and Jung and Moon (2008), with modification by the authors.
(Oh et al., 2016). On the other hand, these newly produced goods by MNCs – which are often better than the host country’s products in terms of quality – can be sold in the local market. In the short-term, this is seen as a source of consumption which could be perceived as “unnecessary” or “excessive.” However, from a long-term perspective, it can be interpreted as enhancing the consumer sophistication by introducing higher quality goods and widening consumer choices in terms of product variety.

Third, regarding related sectors, the existence of MNCs in the host country can generate industrial clusters and spill-over effects on suppliers. Since MNCs look for competitive business partners, such domestic companies have the opportunity to link their position to a global network by establishing partnerships with investing MNCs. At the same time, the relatively uncompetitive domestic companies will be cut off or eliminated from the value chain of MNC’s production activities. Lastly, for the business context, the participation of new foreign MNCs in the local market is likely to enhance local competition. This more intense competition may cause the crowding-out of relatively uncompetitive domestic firms, but this also leads to better resource allocation. In the end, it is more effective for sustainable economic development (Jung and Moon, 2008; Moon and Parc, 2014).

Linking FDI theories and the diamond model, which was the basis of the aforementioned analysis, has already been undertaken by Dunning (2003), Moon (2007b), Jung and Moon (2008), Moon and Jung (2010), and Moon and Parc (2014). The benefits of using the diamond model to analyze the motivations of FDI is as follows: first, it provides a comprehensiveness compared with other existing approaches which have led to rather biased views; second, this model categorizes systematically the motivations by their characteristics. For example, demand conditions are related to market size and sophistication. Thus, market-seeking and market-learning as FDI motivation are classified under this category. Thus, the same methodology can be applied in this paper. In order to justify the comprehensiveness of the framework, Moon (2007b) and Jung and Moon (2008) are compared with other existing studies in terms of the coverage of factors. As shown in Table II, it is clear that existing studies are not as comprehensive as Moon (2007b) and Jung and Moon (2008) who employed the diamond model.

Although, Moon (2007b) and Jung and Moon (2008) are more comprehensive and systematic, their analysis deals only with the effects of conventional FDI on the host country even though they do not specify the type in their analysis. In their studies, the agents of this FDI are MNCs which are assumed to have ownership advantage, such as advanced technology, management skills, larger global networks, better products, and higher competitiveness. In fact, the effects listed in Table I are mostly those based on the OLI paradigm and conventional FDI. Therefore, it becomes clear that an analysis is need that examines the effects of unconventional FDI on the host country by linking the imbalance theory to the diamond model.
3. A new framework: the effect of unconventional FDI on the host country

Linking the imbalance theory to the diamond model not only offers a more systematic and holistic perspective but also offers the advantage to compare the different effects of these two FDI within the same analytical framework. This study recognizes the various effects of unconventional FDI which are scattered throughout the existing studies. They are gathered here to present a more comprehensive understanding by using the same approach employed for analyzing the effect of conventional FDI on the host country.

Regarding factor conditions, capital inflows from LDCs should create jobs (Ernst and Young, 2013; Meunier et al., 2014). However, the magnitude of these effects is likely to be smaller than those from conventional FDI. This is because M&As seek to take over existing firms without creating a significant number of new jobs (Mencinger, 2003). This explains why unconventional FDI is often considered to bring about lower economic benefits than the conventional type, particularly greenfield investments. Meanwhile, looking at the technology aspect of FDI, MNCs from LDCs tend to acquire the host country’s advanced companies which then results in a technology drain (Meunier, 2014; Dollar, 2015). This reveals why many governments intervene during the negotiations for M&As to prevent the drain of advanced technology, which is considered to be harmful for the domestic industry of the host country (Sengupta, 2016).

In regard to demand conditions, MNCs from LDCs usually have their own global networks, even in lesser-developed markets. Thus, the size of the market can still be enlarged through unconventional FDI in the same way as conventional FDI (Shah et al., 2014). On the other hand, if FDI is meant to avoid trade barriers in the host country, the increase of the host country’s imports will be limited. Instead, substitutes are produced in the host country, thus DCs, and the price and cost for the same production will increase compared to before when the products were imported. There can also be less efficiency or lagging when utilizing acquired technology compared to the more advanced host country’s local companies in DCs.

Therefore, unlike conventional FDI, it is expected that there will be little positive effect on the sophistication of the local market through unconventional FDI. A good example in this regard was the prevailing misperception about Tata Motor’s (hereafter Tata) acquisition of Daewoo Commercial Vehicle Co. (hereafter DCV) in Korea. This case will be examined further in the next section. When it comes to price sensitive goods, due to price competitiveness, a relatively low quality, but acceptable, product can be more prominent in the market of the host country despite its low technology. This highlights how unconventional FDI is less engaged in enhancing the sophistication among customers.

For related sectors, the MNCs from LDCs may have difficulties or a reluctance to team up with the host country’s local partners due to cost or (semi-) product compatibility: the cost can be comparatively more expensive, and the technology in products may be more advanced in the host country compared to what exists in the home country (Chung et al., 2003). These MNCs may prefer to continue cooperation with other established sub-contractors (or partners) from its home country or elsewhere. Therefore, there is a risk of cutting off the existing local linkages from production activities in the value chain despite the access to advanced technology in the host country (Lee, 2014).

Regarding the business context, as M&As have dominated unconventional FDI in recent years, there has been less competition enhancement; that is the number of competing companies has not changed considerably. Moreover, workers from DCs are sometimes not willing to cooperate with companies from LDCs because of cultural differences and contrasting styles of management and operations. On some occasions, these barriers may even hinder the restructuring of a firm (Brennan, 2015). These firms from LDCs tend to engage in competition through price competitiveness, thus the profits among local companies can be dented. Last but not least, unconventional FDI from LDCs often seeks to
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This is considered as the first inward FDI in the history of the Korean automobile industry. Afterwards, the Korean government did not encourage inward FDI, but instead promoted technology partnerships with foreign companies (Park, 2007; Truett and Truett, 2012). These partner companies enjoyed an oligopolistic situation without any significant technological advance. However, Mainland China changed its trade and investment policies due to political tensions in the 1970s and began to prohibit the import of goods produced by companies operating in South Korea and Taiwan. Thus, Japanese companies began to pull out of their partnerships and were soon replaced by new partners from other countries, particularly the USA. For example, Shinjin Motors partnered with GM and established a joint venture, GMK for automobile assembly in 1972. This company later became Daewoo Motors (hereafter Daewoo). Kia Motors also had a partnership with Ford in the 1970s.

In the 1980s, the Korean government gradually relaxed its regulations on inward FDI as part of efforts to globalize the country’s economy (Park, 2007). The most noticeable FDI to the Korean automobile industry appeared when it faced great turmoil following the Asian financial crisis in 1997. It is interesting to note that most of the FDI invested in the Korean automobile industry before the late 1990s had a conventional aspect. Since the late 1990s however, unconventional FDI has increased as the development level of the Korean industry has further enhanced since the Asian financial crisis.

4.2 The effects of conventional FDI on the Korean automobile industry

The increase in FDI into the Korea automobile industry after the 1997 Asian Financial crisis was spearhead by companies such as GM and Renault S.A. (hereafter Renault) from DCs, and Mahindra & Mahindra, Ltd (hereafter Mahindra), Shanghai Automotive Industries Co. (hereafter SAIC), and Tata Motors (hereafter Tata) from LDCs in order to exploit their ownership advantage or disadvantage in investment. As a result, the Korean automobile industry naturally became more globalized. With the help of a depreciated Korean won following the Asian financial crisis, Korean automobile companies became the targets for M&As. While preserving price competitiveness, Korean companies were able to further enhance quality of automobiles through greater investment in R&D, notably through FDI. Since 2000, exports abroad increased, boosting the recovery of the Korean automobile industry (Parc, 2014b).

GM and Renault invested in Korea in order to expand their market and enhance the efficiency of their production, which is a typical characteristic of conventional FDI. Regarding factor conditions, GM (the USA) and Renault (France) brought significant capital inflows into Daewoo and Samsung Motors (hereafter Samsung), respectively, although the number of jobs did not change much in these automobile companies. For example, GM bought Daewoo in April 2002 for a bargain price of USD1.2 billion (Choe, 2006) and for Samsung, Renault took a 70 percent stake in the company which was worth USD560 million (OECD, 2002). Since then, Renault has increased its stake to 80.1 percent. In particular, Renault brought in a larger amount of investment for R&D, therefore generating technology transfers and productivity enhancement (Rasiah, 2008). As a result, advanced R&D and design facilities located in Yongin, Korea played a significant role in the development of Renault’s upper range and sport-utility vehicles (SUVs) worldwide (Nissan Motor Corporation, 2012). This outcome can be regarded as changes in factor conditions of the diamond model approach. More cars were produced and exported after the acquisitions as shown in Figure 1, and the number of foreign markets eventually diversified.

In terms of demand conditions, this conventional FDI enhanced consumer sophistication, particularly following the introduction by Renault of several new car models, such as SM5, SM6, SM7, and QM5, based upon European designs that generated positive feedback in Korea. GM Korea has also released models such as Impala and Malibu and gained around 10 percent of the market share in Korea since 2003 (Lee, 2008). Concerning related sectors,
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Metalworkers of Korea, 2012[8]. Given these numbers, if there had been no unconventional FDI from SAIC and Mahindra, the loss would have been very significant. It is evident then that even the apparent “negative” case of unconventional FDI has had some important positive outcome.

This is to say that without SAIC and Mahindra’s unconventional FDI to SsangYong, the long-term sustainability of the company – despite the fact that SAIC abandoned SsangYong several years later – would have been very much in doubt. With this takeover, there was a relative improvement in sales, operating profits, and even the number of jobs, although there is evidence that some of these numbers decreased after SAIC’s acquisition of SsangYong. These two M&As clearly offer very different facets of unconventional FDI; one is considered as successful, but the other less so. These different results may be more related to factors such as labor-management relations or the level of motivation among MNCs from LDCs, rather than unconventional FDI or its motivation per se. That being said, there is a very important point which should not be missed, but is often neglected; unconventional FDI saved these two financially weak companies that no other (domestic or foreign) company was willing to take over.

4.4 Implications from the analysis of the Korean automobile industry
The two FDI theories, the OLI paradigm and the Imbalance theory are linked to the diamond model. This framework conceptualizes comprehensively the effect of conventional and unconventional FDI by incorporating measurable and unmeasurable effects. From this comparative analysis, it can be argued that theoretically both conventional and unconventional FDI brings about rather positive effects. This argument is further supported by the case of the Korean automobile industry which received significant conventional and unconventional FDI, although there were several negative consequences such as technology drain and insignificant competition enhancement. To sum up, both types of FDI would have more probability of bringing about further positive effects than negative ones.

There is one interesting point in the case of SsangYong. The motivation of SAIC and Mahindra’s FDI to take over SsangYong was obviously driven by ownership disadvantages; thus they are typical unconventional FDI. However, these two companies brought about very different effects; SAIC was rather a case of failure while Mahindra was an example of success. This fact signifies that the positive effects of unconventional FDI is not upon its direction of flow (from LDC to DC) but rather upon other pre-determined reasons such as firm-specific factors or strategic reasons that can differ the effect of FDI. Exploring these factors and reasons are beyond the scope of this paper to examine in detail.

The current debate and related research have focused on examining the prevalent belief that conventional FDI is more beneficial than the unconventional type to the host country. In this context, it is noteworthy that there are a tangible number of studies that argue the existence of negative effects of conventional FDI which is different from the positive expectation. These various debates coupled with the findings from this paper suggest that the focus of the debate on the effectiveness of FDI should not be on the direction of its flow, but rather on how to foster a good business environment that investing companies can then contribute a positive effect to the industry as well as to the host country. Therefore, the policy decision on FDI should be more focused on these factors.

5. Conclusion
FDI has increased and its role in the global economy is today very influential for the future course of companies. In general, countries try to attract FDI in order to achieve more sustainable economic development. There are two types of FDI, conventional flows from...
DCs to LDCs generally with ownership advantage, and unconventional ones from LDCs to DCs with intention to overcome ownership disadvantage. Unconventional FDI is often criticized while the conventional form is usually welcomed. This is due to limited or even distorted analysis which can lead to negative public opinion and counterproductive policy decisions. Thus, a rigorous and comprehensive analysis is needed based on a solid theoretical background.

This paper incorporates both the OLI paradigm and the imbalance theory combined with the diamond model in order to properly assess the effects of conventional and unconventional FDI more objectively. At first glance, it seems that conventional FDI is more beneficial to the host country than unconventional FDI. However, it should be stressed that, so far, unconventional FDI is often related to the survival of a company at a critical moment, an aspect often left aside or even neglected by most studies. The case study presented here of the Korean automobile industry clearly demonstrates the different effects of both conventional and unconventional FDI on the industry.

In the Korean automobile industry, both conventional and unconventional FDI have entered for different motivations. Conventional FDI flowed into Korea to exploit its cheap labor and strategic location for production and exports, whereas unconventional FDI sought to acquire advanced technologies and management skills. However, both forms of FDI have been shown to be beneficial to the development of the Korean automobile industry regardless of the origin; most companies that received these inflows have shown improvement in terms of production and exports.

In particular, without this unconventional FDI, several Korean automobile companies, such as DCV and SsangYong, would not have survived their economic difficulties. This means a business entity itself would have disappeared, as well as the principal investment that was used to establish the firm. From this perspective, the actual effect of unconventional FDI is greater than what appears at first glance. It is evident then that unconventional FDI is as important as conventional FDI for sustainable economic development. In this regard, unconventional FDI from LDCs should not be denigrated, but rather understood as a source of positive investment. Furthermore, this Korean case hints at the importance of firm-specific factors or strategic factors that can bring about positive effects from both conventional and unconventional FDI. This interesting point needs to be further studied.

In the midst of great changes in the global political-economic environment, protectionism has been emphasized more by a number of countries including the USA. One of the current policies is to discourage free-trade regimes while seeking to encourage more FDI in the belief that it will lead to further job creation. Imposing trade barriers in order to “protect” one’s domestic economy may, in fact, trigger larger FDI flows from LDC firms in the hosting country with a specific motivation to circumvent trade barriers. Yet the “negative” perspectives on unconventional FDI continue to prevail. Such a policy is based on a limited view on the motivation and effects of FDI. This would hinder benefitting from various positive effects of FDI and can unexpectedly exacerbate public opinion on FDI and the competitiveness of the home economy. Thus, more consideration should be given to establish better FDI policies in order to enjoy its full benefits.

When dealing with both the effects of conventional and unconventional FDI comprehensively, this paper has left aside certain important issues related to both FDI, which are today often highlighted by a number of practitioners and media outlets, particularly in the case of unconventional FDI. These include M&As by state-owned companies, real motives of acquirers (e.g. unspecified and round-tripping investment), national security, and transparency. Incorporation of all these issues to the basis of this study would give more real-world practice and policy aspects on the effects of FDI. This could then be a good research topic for further studies.
Notes
1. It is important to distinguish the typologies of FDI. The definition of conventional and unconventional FDI is based on the country of origin; conventional FDI flows from DCs to LDCs, whereas unconventional FDI flows from LDCs to DCs. From a country perspective, if foreign FDI comes into a country, this FDI is called inward FDI. On the other hand, if domestic direct investment goes abroad from a country, this type of FDI is called outward FDI. The main point of this paper is the different effects of conventional and unconventional “inward” FDI on the host country.


3. Porter (1990) developed the diamond model which consists of four interrelated components: factor conditions, demand conditions, related and supporting industries, and firm strategy, structure, and rivalry, as well as two exogenous parameters government and chance.

4. This part relies upon Parc (2014b).

5. Completely knock-down (CKD): completely disassembled cars are shipped and then assembled locally.

6. In fact, Daewoo Motors took over SsangYong first, but as it encountered financial difficulties SsangYong was eventually sold off.

7. This decrease in production and export is alleged to be related to problems in SAIC’s management. However, it is noteworthy that during the aforementioned period, the labor-management confrontations became worse and there was also the impact from the Global Financial Crisis of 2007-2008. Refer to Kim (2012).

8. In 2003, USD1.00 was KRW1,191.61 (see World Bank).

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