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The Effects of Foreign Direct Investments on Major Economic Metrics: A Case Study of Post-Colonialism Republic of Korea

Zachary Park[1], Jake Chon[2], Eddy Jiang[3] and Ryosuke Suzuki[2#]

[1]Oakton High School, USA
[2]American School in Japan, Japan
[3]Blue Valley High School, USA
[#]Advisor

ABSTRACT

This study gives an overview of the origins, development, and measured effects of foreign direct investments (FDI). This paper briefly covers the economic impact of Japan's rule over Korea from 1910 to 1945, but it mainly focuses on the time period between South Korea's post-imperialism economy and the pre-pandemic market: roughly a 75-year time period from 1945 to 2020. This paper finds that foreign direct investment is strongly correlated with major economic metrics such as GDP, imports/exports, and consumer price indexes, especially in the most recent 20 years (2000-2020). These conclusions are based on data analysis using secondary data from the World Bank and supported by past literature. This study further theorizes that the recent economic success of South Korea is partially due to the major influence foreign direct investment has on economic prosperity through technology transfer. South Korea, a current powerhouse in the electronics industry through the early establishments of chaebols, a group of large family-owned conglomerates that dictated the early economic success of South Korea, would have significantly benefited from increased technological transfers. Therefore, this paper's data analysis focuses mainly on the 20 most recently available yearly data; however other periods are also briefly investigated.

Introduction

South Korea's rise from rags to riches finally began shortly after the Korean War. It burgeoned following the political and economic policies put in place as a result of the new government. Yet, the rapid industrialization and subsequent growth of the seemingly small country were surprising to many, to say the least. Historically marred by Japanese colonization, division of territory, and American occupation, to say that South Korea had unfavorable odds is an understatement. Nevertheless, South Korea's rise to become one of the Four Asian Tigers with a flourishing economy today is a success story. However, one of the vital factors that sparked South Korea's success was the foreign direct investment, mainly from the United States, which strongly influenced the South Korean economy, most notably leading to technological transfer. This paper serves to explore the strong foundations that were laid during the twentieth century in order for such rapid and substantial growth to occur, the emergence of FDI as a significant factor in South Korea's economic growth, as well as the corresponding impact of foreign direct investment on primary economic metrics in South Korea.

Background

Through World War II, the Korean War, and other significant events, South Korea has been influenced by many foreign countries, notably the US and Japan. This summary of South Korea's economic history will first describe the historical events that shaped South Korea's economy to be so heavily reliant on foreign countries leading up to the Korean War. Afterward, the effects of the Korean War and its aftermath will be explored in more detail. Finally, the description of the economic burst in the early 1960s, as well as the economic crises in 1997 and 2008, serve to explain how FDI became such a large factor in South Korea's economic growth.

Japan's colonization of Korea was a significant event and had major economic implications, especially for the infrastructure. Japan annexed Korea in 1910 and governed Korea until the end of World War II, 1945. Under Japan's rule, the Korean economy shifted from a once feudal agrarian society to a more industrial one (Savada & Shaw, 1990). Japan developed a robust infrastructure through this period by constructing transportation systems, industrial and government facilities, and heavy industries. Japan took what they had learned from their own industrialization through the Meiji Restoration and applied similar methods to Korea's economy. The government had a strong force in expanding economic infrastructure, increasing human capital through health and education, and raising productivity. These efforts were accomplished through the maximization of resources, new industries and enterprises, as well as close relations between the government and business leaders. During the beginning of Japan's involvement (1910-1912), Korea's economic production consisted of 84.6% of primary industries, including agriculture, fishing, and forestry (Savada & Shaw, 1990). In contrast to the period in which Korea had been well influenced by Japan (1939-1941), the same primary industries consisted of only 49.6% of total economic production, while 29% of total economic production consisted of the manufacturing sector at the time. During this time, Korea had an average GDP growth rate of over 3% (Mizoguchi, 1979). This figure was on par with other more developed countries such as the US and Sweden. Japan had a significant role in establishing Korea's infrastructure and setting Korea up for further economic growth.

However, from 1945 to 1960, Korea's economy took a turn for the worse. After World War II, Korea cut all ties with Japan, and although Japan had set the physical infrastructure for continued economic growth, there was a lack of skilled workers for Korea to keep on industrializing (Lim, 1968). In addition, the market for Korean products significantly declined as Korea severed relations with Manchuria and China in addition to Japan. Also, in 1945, Korea split into the Democratic People's Republic of Korea (DPRK) in the North and the Republic of Korea (ROK) in the South. The division served to be a problem for South Korea because due to North Korea's geographical location and abundance of mineral deposits, the Japanese had established heavy industries such as steel, chemical, and hydroelectric power mainly in the North (Savada & Shaw, 1990). The Korean war aggravated these economic troubles for South Korea.

Korean War Aftermath

The Korean War from 1950 to 1953 destroyed much of the Japanese infrastructure and economy from World War II (Lee, 2001). Although the Korean War started as a civil conflict between North and South Korea, it quickly became a proxy war between many international powers. The UN powers sided with South Korea; China and the USSR sided with North Korea. Included in the UN was the United States; the United States had provided foreign aid to Korea ever since World War II and continued during and after the Korean War. However, in the time period from 1953 to 1961, right after the economic devastation of the Korean War, South Korea became almost entirely dependent on foreign aid from the United States; South Korea became one of the "world's largest recipients of foreign aid per capita" (Seth, 2017).

Despite this large amount of foreign aid, the country was marked by poverty and corruption at this time. Its government could not stabilize its economy to pull it out of poverty. The country's first president, Syngman Rhee of

the Liberal Party, did little to help the people of South Korea. Needless to say, he was not an effective leader. He and his party were riddled with corruption, only caring to advance their own personal motives through authoritarian rule, including bribery, electoral manipulation, and strong-armed tactics. Rhee had been in power since 1948 but was beginning to quickly lose it as the public eye began to realize the regime's corruption. His struggle to maintain control resulted in increasingly harsh tactics to suppress his opposition in the name of national security. However, after his obviously fraudulent victory for a fourth term in 1960, he was exiled to Hawaii after a violent, student-led April Revolution (Seth, 2013).

During the first eight years after the Korean War, the economy suffered due to the lack of a strong government. Prior to the war, the Korean economy had been largely agrarian. However, devastated by the war, the economy now had to rely heavily on foreign aid from the United States, thus establishing the shift from an economy based on agricultural goods to one based on consumer goods. Foreign aid accounted for roughly 64% of the annual gross investment for South Korea. Because of this, the eight years following the war were marked by an average yearly economic growth rate of 3.5%, 0.7% higher than the previous eight-year period before and during the war. The average annual inflation rate also stabilized to 20% from 120%.

In 1960, after the exile of Rhee, a new constitution was drafted. This new constitution entailed a more democratic government with a parliamentary cabinet and Prime Minister Chang Myŏn in power. This administration, the Second Republic, only lasted one year. Strikes by labor leaders, teachers, and students called for the expulsion of any traces of the old regime and the enactment of better working conditions and pay. They also called for direct negotiations with P'yŏngyang and the withdrawal of US forces from the country. It was clear that this new government still wasn't able to establish order.

Economic Burst

Capitalizing on the country's instability, General Park Chung-hee led a group of army officers to overthrow the democratic government in 1961 for a militaristic government. Their main goal was to lift the country out of poverty. However, this goal looked grim. The country lacked industry and still hopelessly relied on the US. Yet, under the surface, the current was rapidly gaining momentum in human capital. Due to US assistance with technical training, South Korea had no shortage of skilled workers in economics, education, and finance. Under the Rhee administration, the Economic Development Council was created in 1958. Although the Rhee administration crumbled before the council could implement any plans, it provided the foundation for the Park administration to build on.

After 1961, large business conglomerates called chaebol began to control South Korea's economy (Rhyu, 2005). The people that built these chaebols included Chung Ju-young, founder of Hyundai; Koo In-hwoi, founder of what would be LG; and Lee Byung-chull, founder of what would evolve into Samsung. Together, Park and these entrepreneurs planned to industrialize the country's economy.

It's important to note that industrialization was facilitated by land reform (Seth, 2013). Before the war, South Korea was an agricultural society in which farmers owned extremely little to no land at all. Instead, the wealthy aristocratic class owned much of the land, while the farmers lived under a tenancy. Since the government was also made up of members of the aristocracy, they were reluctant to implement land reform. However, pressures from North Korea's land reform, dissatisfied farmers, and the US were growing. In 1949, a land reform act was passed, redistributing farmland to the farmers. The impact was profound. Previously peasants and farmers could now become entrepreneurial. Members of the aristocracy increasingly entered business and education.

Industrialization was also accelerated by rapid and drastic changes in the education system. The education system had been growing exponentially since before the Korean War. Even after the war destroyed many school buildings, classes were being held anywhere and everywhere, as long as there was space. Due to the shortage of teachers, class sizes were large. In order to create an educated society, the government in the 1950s invested in teacher education and training. They focused on establishing primary education, so higher education was largely left to private foundations. Enrollment skyrocketed. They also focused on maintaining equality between schools in rural and urban

areas. As a result, there was very little disparity between rural and urban areas. Thus, armed with a very educated population, South Korea was able to industrialize exceptionally rapidly.

The formation of chaebol after the war was propelled by the disposal of ex-Japanese enterprises, relief funds, and bank-financed loans. The ejection of previously Japanese enterprises and assets allowed domestic companies that received them to flourish. Relief funds, mainly from the US, were allocated to larger companies, further encouraging their growth. In 1954, the Korea Development Bank was established with the Korea Development Bank Act. This bank played a crucial role in the economic growth of the country. Interest rates of the loans from this bank were lower than the market inflation rate, making loans much easier to pay back, which in turn, facilitated investment and growth.

During Park's reign from 1961 to 1979, state intervention was necessary to spark growth through industrialization (Skocpol, Evans, & Rueschemeyer, 1986). The state carried a great responsibility to ensure that industrialization was not only successful but also sustainable. South Korea focused mainly on industrialization through learning (Amsden, 1992). The shop floor was the center of the early stages of industrialization, on which borrowed technology was made operational and then optimized. Managers applied science to production to reap greater economic returns and thus help South Korea get richer quicker. Multinational organizations were restricted from entry into South Korean markets as a means to ensure domestic growth and independence. The state focused on efforts to avoid dependency on external powers like the US. Industrialization through learning allowed for borrowing initial expertise and developing organizational patterns without high costs. However, implications of this method of industrialization included later problems with scale and versatility (So, 1990). This made later growth difficult for the country.

The implementation of institutions through strategies and policies in the country helped to smooth the wrinkles that industrialization through learning left in the economy (Bardhan, 2006). It is important to mention that South Korea's leadership emphasized the importance of strong institutions as a foundation for not only stimulating growth but also sustaining it. Once momentum was gained, growth was easier to maintain.

One of the setbacks Park's reign dealt with in the beginning was the relatively large gap between social and private return to investment (Kim, 1993). Chaebol played an essential role in bridging this gap. Their large size and diversified products, which minimized difficulties to entry, combined with government incentives, created enormous economic growth for the business groups. In fact, by 1987, the five largest chaebols accounted for 75.2 percent of the GDP in the manufacturing sector. However, this unprecedented growth caused unprecedented repercussions, both economically and socially. Chaebol created price distortions and defended the private sector, creating a "contradiction of autonomy." Due to the prevalence of capitalist practices within the chaebol, they advocated for independence and a reduction of government intervention in the economy. Externally, Western interference bolstered South Korea's economy. Easy access to US markets promoted highly competitive exports that were reflective of developed skills and technology.

As industrialization took off, the gap between rural and urban areas widened, posing a potential threat to the booming growth that the country was experiencing. Park's 1962 Five Year Economic Development Plan almost exclusively focused on industrial and export-oriented trade policies. This was very successful and marked what many consider the start of South Korea's economic burst. The success prompted a second five-year plan in Korea (1967-1971), which focused on attracting greater FDI (Seth, 2017). However, what these failed to focus on were the spiraling poverty and deteriorating social and economic conditions of the rural sector. This led to widespread dissatisfaction with Korean leadership. In the 1970s, the state addressed this problem with its community-based rural development strategy, Saemaul Undong. Its goal was to refocus efforts on developing the rural areas to be at the same level as the urban areas, encompassing modernization goals while maintaining traditional values. This strategy especially focused on infrastructure development, income generation, and attitudinal change. Also, due to land reform, a more equitable social and political structure was instituted. Competition among villages and government incentives further stimulated growth. By 1976, the average agricultural household income was higher than the average urban household income.

South Korea's industrialization was more labor-intensive than capital-intensive. Its labor was cheap and competitive, making it comparatively advantageous in entering into regional and international markets, exporting labor-intensive industrial goods, and importing capital-intensive production goods. The state particularly emphasized the

quality of labor. This was made possible by the strong education system that ensured a highly educated workforce. In fact, employees with a high school education or beyond among the skilled and semiskilled workers in the machinery sector rose from 17.6% in 1967 to 59.3% in 1984. Increased wages and progressive workplace practices contributed to productivity, and Unionism became prevalent. Also, during this time, South Korea began to see how FDI benefited its economic growth and redoubled its efforts to attract FDI, changing its inward policy for the second time after 1960 to 1980 from 1984 to 1997 (Koojaroenprasit, 2012).

Economic Crises

1997 Financial Crisis

The Asian Financial Crisis was a series of economic downfalls across various nations in East and Southeast Asia, including South Korea. Initially started in Thailand, it was in large part started in each nation due to financial contagion. However, the major economic damage was the result of the contagion alongside multiple domestic factors (Asian Financial, 1997).

In South Korea's case, the crash resulted from long overdue problems in the nation's economic structure. The rapid growth and industrialization of South Korea during the post-World War II mid-late 20th century was largely due to the major government economic interventions (Lee, 1999). However, during the 1990s, these policies were rendered obsolete and inadequate for South Korea's now complex and booming economy (Lee, 1999). The policies that had once brought the South Korean economy out of the ashes were now causing major problems and disproportion across various industries (Lee, 1999).

The government had realized that such intervention was unsustainable and had enacted various policies such as the Foreign Capital Inducement Law of 1966 to increase foreign capital. Although these offered great benefits for FDIs, they caused heavy loan borrowing from Korea from the 1960s to the 1990s, as it soon became the fourth most indebted nation (Yoo & Moon, 1999). This all came crashing down in 1997 when Hanbo Steel Corp, the nation's leading steel producer, alongside various other major chaebols such as Sammi Steel Co., Jinro, Ssangbang Wool, and New Core Group, defaulted on their loans (Yoo & Moon, 1999). The economic effectiveness of Chaebols had long been questionable at best, and by the end of 1997, the 30 biggest chaebols had a debt-equity ratio of approximately 519% (Lee, 1999).

Prior to 1997, East Asia had been a significant driving power in the global financial market, with preexisting high American and Japanese capital, as well as an ever-increasing strong push from the EU due to a fear to potentially "lose out on the economic miracle taking place in Asia" (CEC, 1994) (Bello, 1999). However, this interest left as quickly as it came in as the Korean Won halved in its values, and many more chaebols defaulted on their debts, adding to what is now known as the Korean Financial Crisis (Bello, 1999) (Asian Financial, 2012).

South Korea was at a point where it was reported to be "just 10 days away from a major financial catastrophe;" however, newly elected president Kim Dae Jung negotiated various deals and loan packages amongst unions, corporations, and governments to reignite the failing economy (Asian Financial, 2012). With the negotiation of a $58 billion loan from the IMF in exchange for new policies, major deregulation in trade, and other financial reforms, president Kim Dae Jung was able to reestablish the Korean economy while setting new regulations for banks, chaebols, and FDIs (Asian Financial, 2012). This marked the third time in which the inward FDI policy was changed in South Korea (Koojaroenprasit, 2012).

2008 Financial Crisis

South Korea's 2008 financial crisis was different in that it was mostly due to external factors rather than internal issues. The Great Recession, caused by the United States housing market crash, left many nations to yet fully recover from its effects (Sharma, 2013). The turmoil caused by the fall of Bear Stearns and Lehman Brothers greatly influenced the Korean economy as KOSPI, the Korean stock exchange, fell 50% between October 2007 and February 2009 (Kim & Kim, 2013). Through various econometric testing, it has been proven that there is a high likelihood that the Lehman

Brothers crash caused transmitted economic turmoil beyond ordinary interdependence between the Korean and global economies (Kim & Kim, 2013). However, the Korean government had been successful in minimizing the damages through varying new aggressive policies as well as reforms made during the 1997 Financial Crisis, evident in 2010 with its 6.2 % economic increase despite the worldwide global financial market downfall (Sharma, 2013) (Kim & Kim, 2013).

Data and Results

The main purpose of this study is to examine the potential influences of foreign direct investments on various other major economic metrics to identify FDI's impact on the Korean economy from 1970-present times. The paper utilizes publicly available data on both FDI as well as other metrics to visually display the relation of two or more datasets. A Pearson correlation coefficient is used to numerically evaluate the strength of the link between FDIs and economic metrics.

Pearson Correlation Coefficient

The Pearson Correlation Coefficient, commonly also known as the correlation coefficient or Pearson's r, is a widely used measurement system to calculate the linear relationship between two separate samples. Simply put, the Pearson Correlation Coefficient is determined by finding the covariance, another widely used statistical measurement, for the two variables and finding its ratio with the product of the two variables' standard deviation. In the equation below, let x_i and y_i equal the datasets' x and y variables, respectively. $\bar{x}$ and $\bar{y}$ represent the arithmetic mean of values for each. In this paper, the Pearson Correlation Coefficient is used to compare and contrast various relationships in South Korean economic metrics.

Equation 1: Pearson Correlation Coefficient

$$r = \frac{\Sigma\,(x_i - \bar{x})\,(y_i - \bar{y})}{\sqrt{\Sigma\,(x_i - \bar{x})^2\,\Sigma\,(y_i - \bar{y})^2}}$$

Comparisons

Note: All graphs were created using secondary data from the World Bank (https://data.worldbank.org)

When net FDI (USD billions) is compared with the general GDP (USD billions), a direct relationship between the two metrics can be found between 2000-2021. Based on well-established data, we calculated the Pearson product-moment correlation coefficient of GDP and Net FDI in South Korea to be around 0.92. This finding is reinforced by past literature that studied the impact of FDI on GDP in both the Republic of Korea as well as other East Asian nations (Koojaroenprasit, 2012) (Ferrer & Zermeñob, 2015).

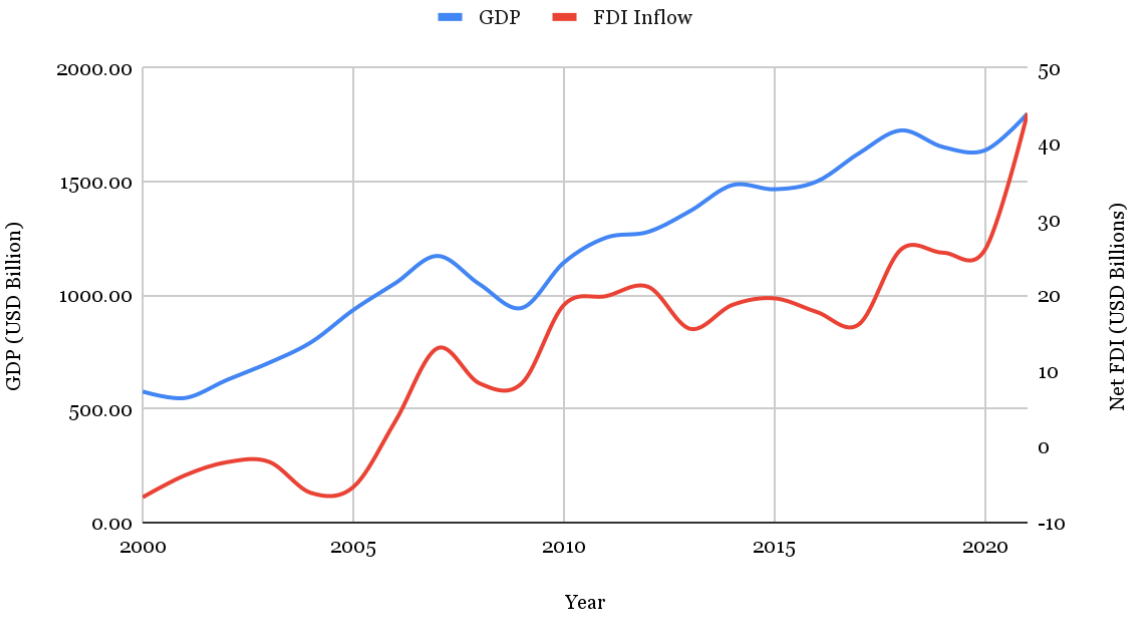

Figure 1. Year vs GDP, FDI (USD Billions) from years 2000-2020

However, further investigations are necessary as the correlation between GDP and FDI drops to -0.19 between the years 1980-2000. The rapid departure of foreign capital may describe this discrepancy during the 1997 financial crisis. As previously noted, the 1997 financial crisis in South Korea resulted in a mass departure of foreign capital as investors became wary of the security of the Korean Won (₩), explaining the high negative values near the end of the century.

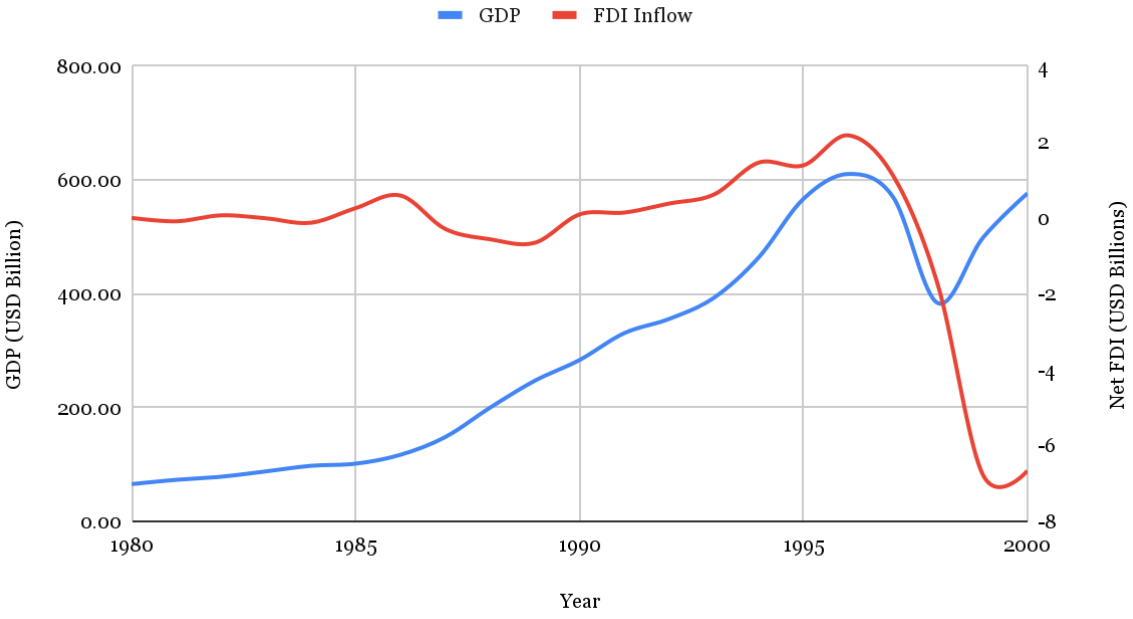

Figure 2. Year vs GDP, FDI (USD Billions) from years 1980-2000

Additionally, the strong correlation exhibited between 2000-2020 compared to 1980-2000 may be explained by the technology transfers caused by the inflow of FDI in South Korea. Literature postulates, "In the new growth theory, FDI is an important factor which contributes to economic growth through technology transfer efficiency improvement" (Koojaroenprasit 2012). This is especially the case in a technology-focused economy such as South Korea. The high net FDI in South Korean Chaebols has allowed these companies to lead the world in innovation and technology, ultimately leading to the mass exportation of highly valued and sought-after South Korean goods, contributing to the growth of South Korean GDP.

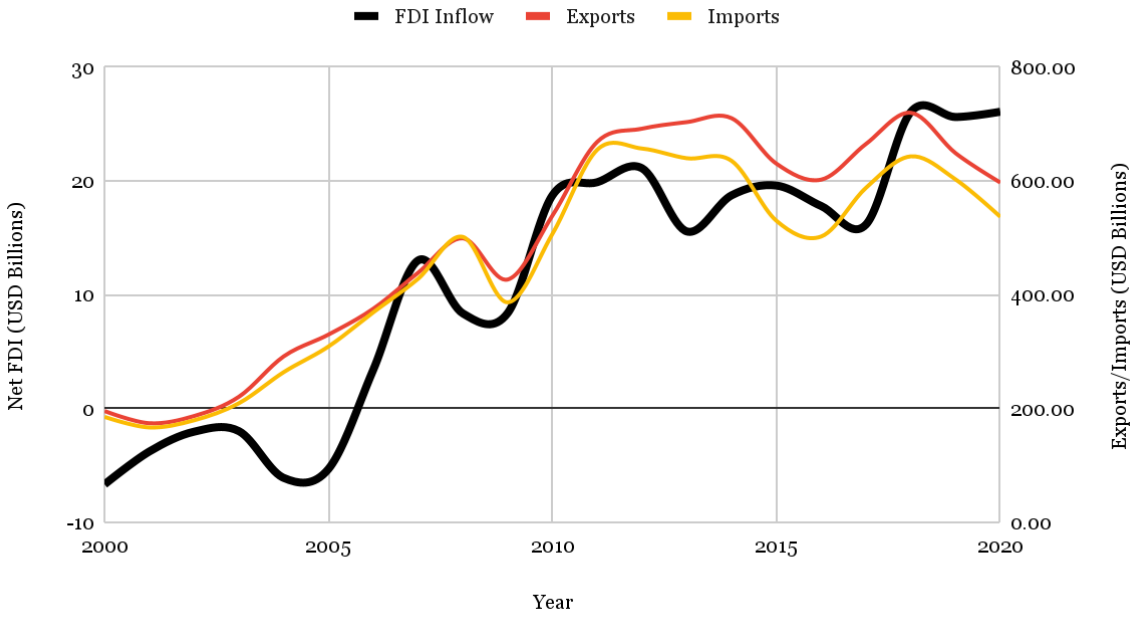

Figure 3. Year vs Net FDI, Exports, Imports (USD Billions) from years 2000-2020

Similarly, net FDI also exhibits a correlation with nation exports and imports. During this period shown in the graph, FDI correlated at 0.92 and 0.91 with exports and imports, respectively. Their visual graphs also demonstrate a high correlation with the exports and imports, seemingly almost mimicking the pathway of FDIs a couple of years prior. The strong correlation was expected due to the establishment of a strong relationship between FDIs and GDP, as both exports and imports have a major direct influence on a nation's GDP.

Personal remittance (in USD billions), a metric measuring the capital transferred between residents to non-residents both as recipients as well as senders, also shows a close relationship, as net FDI (in USD billions) and personal remittance show a similar graphical shape. Numerically, the two datasets have a Pearson Correlation Coefficient of around 0.80, exhibiting relatively weaker but, nonetheless, strong relations.

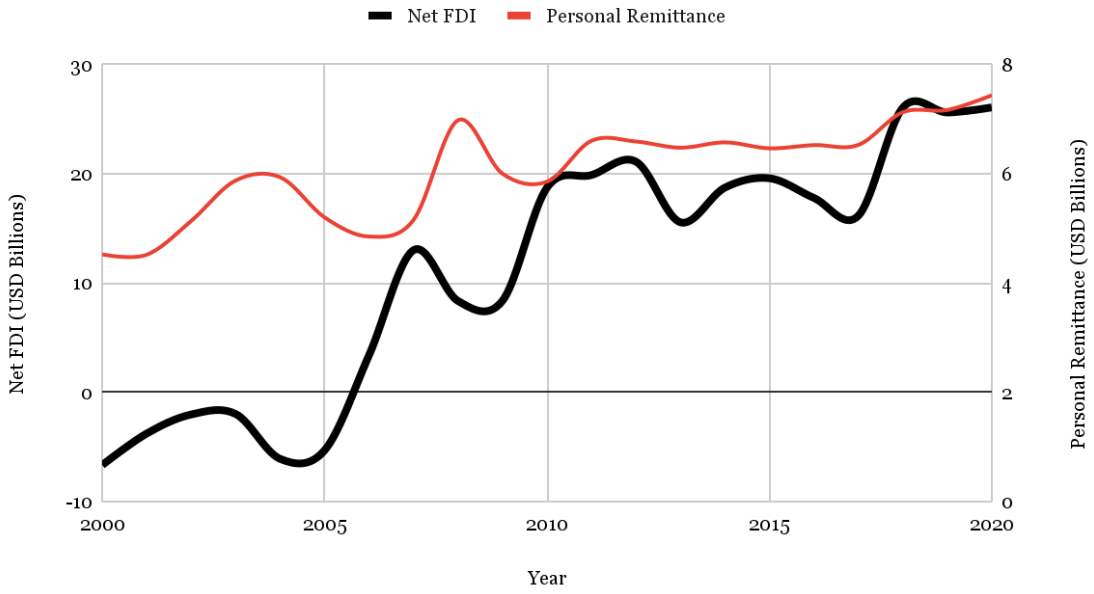

Figure 4. Year vs Net FDI, Personal Remittance (USD Billions) from years 2000-2020

Table 1. Full list of the Pearson Correlation Coefficients with Net FDI across different time periods

Metric	1980-2000	2000-2020	1970-2020
FDI Inflow = GDP%	-0.8813974393	-0.788703022	-0.1243859745
GDP (USD Billion)	-0.1912076332	0.9165286316	0.8370926125
GDP Growth %	-0.01369477857	-0.6135039535	-0.5144852155
GDP Per Capita (USD)	-0.1630860582	0.9140988409	0.8227444
Unemployment Rate %	-0.5792776903	-0.03296012034	-0.1398057704
Consumer price index (2010 = 100)	-0.396196043	0.9401540238	0.7212084023
Inflation, consumer prices (annual %)	0.1883116305	-0.5986233187	-0.3602596232
Exports of goods and services (current US$ Billions)	-0.4020532708	0.9212456908	0.8712118899
Imports of goods and services (current US$ Billions)	-0.2685616198	0.9127786873	0.8666319877
Personal remittances, received (current US$)	-0.4179568657	0.8035388299	0.6531552803

Table 1 shows the Pearson Correlation Coefficient with other major economic factors' relations with net FDI in the time periods of 2000-2020, 1980-2000, and 1970-2020.

Discussion

Through our data analysis of secondary data, it was found that foreign direct investment had an extremely strong correlation with major economic metrics. Various past studies across several time periods reinforced these findings. Past literature related to this study are analyzed below to explain the observed phenomenon.

(Ferrer & Zermeñob, 2015) It was found that FDI had a strong correlation with GDP growth in China between 1995 to 2012. However, the possibility of cointegration between the two variables is not definitive, as the non-stationary nature of the FDI and GDP series causes problems in mathematical modeling and estimations of the application of the Engle-Granger causality test. Despite this limitation, through the Johansen procedure, it was found that FDI and GDP growth would indeed have a long-term relationship (cointegration). Two important notes regarding this study were that GDP and FDI were found not to have a link in several nations, including this paper's research focus: South Korea. Furthermore, FDI was the result of GDP growth and not vice versa. The second phenomenon was explained by the fact that FDI seemed to have nominal influences due to low capital.

(Borensztein et al., 1998) In this cross-national study, it was noted that FDI does indeed have a major role in the technological transfer. It was even found that it had a relatively higher impact, on average, when compared with domestic investments. However, the major impact of FDI on technological transfer seemed to be dependent on the human capital of the host nation due to an increase in regression performance when human capital was included in the model. The study specifically found that in order for FDI to have a positive impact, a secondary school attainment threshold of around 0.52 was needed. These findings regarding the interactions of human capital with FDI were backed up by past literature with slightly different research focuses.

(Goliuk, 2017) Building upon Borensztein et al., a previous study shows that tech transfers have a variable impact on GDP growth; however, in South Korea's case, it was found that the most substantial relationship between GDP and an innovation metric was high-technology export. Such a relationship does make sense in South Korea, where electronic equipment, machinery, and vehicles (all excluding railways) represented 55% of South Korea's exports in 2020, amassing a value of approximately 281.72 billion US dollars. ("South Korea," n.d.) This study's findings were in agreement with Borensztein et al. in that it also saw human capital as a significant contributor to economic growth.

As of writing, no clear, direct investigation has been done on the effects of foreign direct investment across several nations in relation to their level of technological transfer. Therefore, in future studies, we hope to compare the FDI correlation with high innovation nations to technologically lower nations.

Conclusion

It is fascinating to see South Korea's rise as one of the rising tigers of Asia, achieving a GDP of around 2 trillion dollars as of 2022, making it one of the highest GDP ranking countries in addition to being one of the most developed and innovative countries. The purpose of this study was to see FDI's role in South Korea's economic takeoff and rapid growth of GDP. This study shows that FDI positively impacts GDP and South Korea's economy through the proven correlation between FDI and technology transfers, nation imports, and nation exports, which have a massive influence on the overall GDP. These factors strongly impact South Korea's GDP because of South Korea's export economy and its heavy focus on both technology and innovation. In future studies, we hope to compare FDI correlation with these same factors (technology transfers, nation imports, and nation exports) on GDP in less technology-based export economies.

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