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*For my dearest father
(1950-2016)
With all the love and memories*

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List of Abbreviations

ATM	Automatic Teller Machine
CCP	Chinese Communist Party
DPRK	Democratic People's Republic of Korea
ETDZ	Economic and Technological Development Zone
FDI	Foreign Direct Investment
FFE	Foreign Founded Enterprises
FIZ	Foreign Investment Zone
FSC	Financial Supervisory Commission
FTZ	Foreign Trade Zone
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GTC	General Trading Company
HCI	Heavy and Chemical Industry
IKP	Invest Korea Plaza
IMF	International Monetary Fund
KAIS	Korea Advanced Institute of Science
KDI	Korea Development Institute
KIST	Korea Institute of Science and Technology
KOTRA	Korea Trade-Investment Promotion Agency
M&A	Merger and Acquisition
MNC	Multinational Corporation
MOC	Ministry of Commerce
MRFTA	Monopoly Regulation and Fair Trade Act
NBFI	Non-Bank Financial Institution
OECD	Organization for Economic Co-operation and Development
OFIO	Office of the Foreign Investment Ombudsman
PRC	People's Republic of China
R&D	Research and Development
RMB	Renminbi (Chinese Currency)
ROK	Republic of Korea
SEZ	Special Economic Zone
SOE	State Owned Enterprise
SME	Small and Medium Sized Enterprise
TVE	Township and Village Enterprise

UNCTAD	United Nations Conference on Trade and Development
US	United States
USD	United States Dollar
WTO	World Trade Organization

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1. Introduction

After the People's Republic of China (PRC or China hereafter) was founded in 1949, a highly centralized economic system was adopted in China. After around three decades, 1978 was the turning point for the Chinese economic development. The Third Plenary Session of the Eleventh Chinese Communist Party (CCP) was held in Beijing. Afterwards, instead of political movements (e.g. the Great Leap Forward, the Cultural Revolution), the economic construction became the top priority for China. Together with the economic reform, China also launched the "Open Door Policy". This meant that one of the most closed economies in the world started the process of liberalizing its trade policy and its domestic market¹.

During 30 years of reforms and openness, the Chinese economy was achieving rapid growth. The comprehensive national power together with international competitiveness have constantly been growing. The Chinese merchandise trade (percentage of Gross Domestic Product-GDP) was only at 20.1 in 1980, whereas in 2001, it had gone up to 38.5². China's foreign trade had expanded all over the world, and reached over 200 countries and regions having started from a very limited number in 1978³.

China's accession into the World Trade Organization (WTO) brought a new era to the development of Chinese foreign economic trade and pushed the economic trade cooperation between China and the world into a new epoch. This created new opportunities for the world economy and for a stable prosperity in the new century⁴. "Since 2002, trade openness has surged again. An enormous systemic transformation was necessary to convert China from one of the world's most economically isolated economies into a global economic player."⁵

In 2011, China's GDP was 7318.50 billion current US dollars⁶. The total value of imports and exports reached 3641.86 billion US dollars⁷. In the 2011 WTO world merchandise trade fig-

¹ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006.

² World Bank Data Base. Available at: <http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS>. Accessed: 17/09/2013.

³ Shi, Guangsheng. "WTO Opens An Era of New Opportunities", source: "China after WTO", compiled and edited by Brahm, Laurence J. Beijing: China Intercontinental Press, 2002. At that time Shi was the minister of Ministry of Foreign Trade and Economic Cooperation, People's Republic of China.

⁴ Ibid. P iii

⁵ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P378.

⁶ World Bank Data Base. Available at: <http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS>. Accessed: 17/09/2013.

⁷ 中国统计年鉴 Chinese Statistical Year Book 2012, P4.

ures, China ranked first as an exporter, as an importer it ranked second after the United States (US)⁸. China had thus surpassed Japan and became the world's second-largest economy.

In September of 2013, the China (Shanghai) Pilot Free Trade Zone (FTZ) was established. It has carried out institutional reforms and innovation in the domains of investment, foreign trade, finance and post-filing supervision to form a legal framework for investment and trade within the zone. And not long after that, the negative list for investment management was adopted in order to simplify foreign trade supervision procedures, promote a financial system reform to realize the Renminbi (RMB) capital account convertibility and advocate post-filing supervision as a way to transform government functions⁹.

However, Shanghai FTZ was not to be the only FTZ in China. In 2014, the Chinese State Council decided to introduce its experience nationwide. New FTZs would be in Guangdong, Tianjin and Fujian. All in all, the FTZs got enlarged from 28.78 square kilometers to 120.72 square kilometers. FTZs could be seen as the new milestone for the Chinese economic development as they provide more space for new reform experiments¹⁰.

The Republic of Korea (South Korea or Korea hereafter) is the creator of the "Miracle of Han River"¹¹. From 1910 to 1945, the Korean peninsula was under Japanese colonial control. On August 15th of 1948, the Republic of Korea was established by Rhee Syngman as its first president. The Democratic People's Republic of Korea (DPRK or North Korea) was established in the same year. Both governments claimed being the only legal government on the Korean peninsula, which made a conflict unavoidable. Four years of civil war almost destroyed everything that was left from the Second World War¹².

Between the 1950s and the early 1960s, Korea was one of the poorest nations in the world. The political and the economic situation was miserable. For Korea to have gone from this sort of messed-up, disorderly, broke country into a wealthy democracy would have been impossible to imagine. But the Korean people succeeded to change this situation¹³.

⁸ WTO trade data, Available at: www.wto.org/statistics. Accessed 17/09/2015.

⁹ China (Shanghai) Pilot Free Trade Zone. *Introduction*. Available at: <http://en.china-shftz.gov.cn/>. Accessed 02/05/2015.

¹⁰ Ibid.

¹¹ Korea.net. *The Korean Economy - the Miracle on the Hangang River*. Available at: <http://www.korea.net/AboutKorea/Economy/The-Miracle-on-The-Hangang>. Accessed: 21/07/2016.

¹² Eckert, Carter J., Ki-baik Lee, Young Ick Lew, Michael Robinson, Edward W. Wagner. *KOREA OLD AND NEW: A History*. Seoul, Cambridge, Massachusetts and London: HARVARD UNIVERSITY PRESS, 1990.

¹³ Rauhala, Emily. *South Korea: One of the World's Great Success Stories Heads to the Polls*. TIME talks to Daniel Tudor, author of 'Korea: The Impossible Country'. Available at: <http://world.time.com/2012/12/06/is-south-korea-the-greatest-success-story-of-the-last-century/#ixzz2t6FRIMtM>. Accessed: 06/12/2012.

Figure 1. Institutions Matter: Real Per Capita GDP in North and South Korea¹⁴



As Figure 1 shows, from 1950 to the early 1970s, the real GDP per capita in South Korea was exactly the same as in North Korea. After South Korea had reformed its economic structure and had undergone four decades of development the GDP per capita is now about 17.5 times higher in South Korea than in North Korea¹⁵. In 2012, the Korean GDP was 1130 billion current US\$, the total value of import and export achieved 1068 billion US\$¹⁶. Korea ranked 13th in terms of trade from 2000 to 2002, twelfth from 2003 to 2006, eleventh from 2007 and 2008, tenth in 2009, and ninth in 2010. Following the United States, China, Germany, Japan, France, Netherlands, and Britain, Korea has become the world's eighth biggest trading partner¹⁷.

In 2013, China and Korea achieved a bilateral trade volume of 229 billion US dollars. Compared to 6 billion US dollars in 1992, the growth of bilateral trade is over 36 fold. At the beginning of 2015, China and Korea have initiated their Free Trade Agreement (FTA)¹⁸. The China-Korea FTA negotiations, which were concluded after 12 rounds of talks over the past three years, have significantly reduced barriers to bilateral trade, except for those on rice and motor vehicles. The agreement covers 17 areas, including trade of goods and services, in-

¹⁴ Perry, Mark J. and Diem, Carpe. *Institutions Matter: Real Per Capita GDP in North and South Korea*. Available at: <http://www.intellectualltakeout.org/library/chart-graph/institutions-matter-real-capita-gdp-north-and-south-korea>. Accessed: 16/03/2015.

¹⁵ Ibid.

¹⁶ UN data bank. Available at: <https://data.un.org/Default.aspx>. Accessed: 02/12/2015.

¹⁷ Korea.net, *Korea to become eighth biggest trading partner*. Available at: <http://www.korea.net/NewsFocus/Business/view?articleId=104050>. Accessed: 03/12/2012.

¹⁸ 中韩自贸区结束实质性谈判, Ministry of Commerce of the People's Republic of China Available at: <http://gaohucheng.mofcom.gov.cn/article/activities/201411/20141100794831.shtml>. Accessed 30/03/2015.

vestment and trade rules, and topics such as e-commerce and government procurement. The Chinese Ministry of Commerce mentioned in November 2014 that the agreement will be signed in 2015 and take effect in the second half of 2015¹⁹. When completed, the China-Korea FTA will help foster a unified market between the two countries with a combined total population of 1.35 billion and a GDP of 11 trillion US dollars²⁰. The FTA agreement which was being signed between China and Korea is being seen as a milestone for the economic development of East Asia.

After more than 30 years of “Reform and Open Door” policy, China now became the second largest economy in the world. Korea, however, had created the “Han River Miracle”. Together with other countries in the region²¹, the East Asian economic development, or so-called “The East Asia Miracle²²”, has been an interesting topic for economists and academic scholars for a long time. In the 21st century, Asia has been a very active place for economic activities. China and Korea have become two of the most significant rising powers in the region, and this makes these two countries an interesting target for investigation.

According to Bramall “One of the most remarked-upon features of the Chinese economic development since 1978 has been the pace at which the People’s Republic has opened up to foreign trade²³.” Almost at the same time, the export-oriented trade policy created rapid economic growth in South Korea. China is a socialist country controlled by the communist party with a socialist market economic system. Korea is a capitalist country but the government plays a significant role in the economic activity. Both countries’ economic development started from a very low level and made remarkable achievements. They are thus two countries following different paths, but having the same destination.

In most studies, foreign trade is seen as the major reason for economic growth. This paper will discuss the relationship between foreign trade and economic development after 1978 in China, and after the 1960s in Korea. These two time periods were chosen because both countries started implementing new economic policies, especially their foreign trade policy. It will begin with discussing the topic and research question and then provide a brief literature review. After that, the theoretical framework will be developed in order to create a basis for the analytical part of this paper. In the analytical section the theoretical framework will be applied

¹⁹ Xinhua News. *China, ROK wrap up FTA talks*. Available at: http://news.xinhuanet.com/english/2015-02/26/c_134018054.htm. Accessed: 30/03/2015.

²⁰ Hu, Yifang,. *FTA to reshape Sino-Korea relations*. Available at: http://usa.chinadaily.com.cn/business/2015-01/26/content_19405208.htm. Accessed: 16/03/2015.

²¹ Japan is also a country who had created the economic development, but this paper will only focus on China and Korea.

²² World Bank, Policy Research Working Paper 5347: Trade and Regional inequality, Washington D. C., 2010.

²³ Bramall, Chris. *Chinese Economic Development*. London and New York: Routledge, 2009. P360.

to the case of China and Korea. At last, the conclusion – different routes to the same destination – will be presented.

1.1 Research Question

The research question this paper will try to explore is: What role did foreign trade play in economic development in China and Korea?

During the last few decades, foreign trade, and especially the export share in GDP has shown a significant positive effect on efficiency, which is also an important factor in industrialization and modernization in China and South Korea. In the meantime, problems started to show up. This paper focuses on these sectors: technology spillover and utility of Foreign Direct Investment (FDI); income inequality and institutional advancement. The research question above implies that other deriving questions must be addressed as well. Those are the following:

- What was the initial condition of the economic reform in Korea and in China?
- Was international trade the reason for technology spillover and utility of FDI in these two countries?
- Does income inequality exist in Korea and China?
- Does institutional advancement happen also due to international trading activities?

1.2 Relevance of the Topic

“International transfer of technology has emerged as an important issue in the literature on international trade and economic development²⁴.” In the 18th century, the world was transformed fundamentally by new powers unleashed by the industrial and scientific revolutions. Modern technologies for transportation and communication, i.e. steam ships, the railway and telegraph knit the whole world together more tightly than before²⁵. The Industrial Revolution put Britain on the path of becoming the first truly modern economy. There were many other factors (social, political, geographical etc.) which caused the Industrial Revolution, but Britain’s trade with its colonies and neighbors played the most important role in fueling the new industrial activities and spreading prosperity to other countries. Before the British became the

²⁴ Marjit, Sugata. *“International Trade and Economic Development: Essays in Theory and Policy”*. Oxford and New York: Oxford University Press, 2008. P224.

²⁵ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P190.

workshops of the world, a large number of raw materials was imported and manufactured goods were exported to America, Asia, and Africa²⁶.

A similar situation could also be found in other regions (i.e. North America, Japan and Australia). These examples show that trade liberalization was necessary and also created opportunities for economic development. But it was not sufficient, and other factors accompanying the opportunities were also realized²⁷.

Does international trade also have positive effects economic growth and development in China and South Korea? After the PRC was founded in 1949, the CCP installed the Soviet command economic and political system in China. Until the late 1970s, the Chinese economy was still at a very low level. In 1978, the GDP was only 364.52 billion Yuan, the GDP per capita was only 381 Yuan, and the total value of imports and exports was at 20.64 billion United States Dollars (USD)²⁸. After 1978, compared with the reform experiences in Russia and other East European countries (the former Socialist countries), China took each step of its economic transformation relatively slowly but rather stably. From the beginning of the reform era until today, from import substitution to the later introduced export oriented trading policy²⁹, China had gone through similar experiences Latin America and other East Asian countries had made. With its gradual movement towards a market economy and statistic annual reports of high growth rates, China is attracting the attention of more and more scholars and economists.

Since 1905, the Korean peninsula was reduced to a formal Japanese protectorate and started a colonial era. Unexceptionally, the “[C]olonial economic policy also focused initially on the exploitation of raw materials and agriculture, and little development of modern business was envisioned, especially if it was not Japanese owned³⁰.” But in some way, the Japanese colonization of Korea did promote modernization, industrialization and even westernization.

The Korean War destroyed almost everything which was left from World War II. After the War was over, the only concern for Korea was how to manage to live and get food. People could not afford to worry about democracy and national independence at that time. In addition,

²⁶ Stiglitz, Joseph E. and Charlton, Andrew. *Fair Trade For All: How Trade Can Promote Development*. Oxford, New York: Oxford University Press, 2005. P11.

²⁷ Ibid. P12.

²⁸ Data from 中国统计年鉴 Chinese Statistical Year Book 2012. Chinese Statistical Year Book 2012. Further analyzed in term paper: ZHAO Bo: “From the Development of Township and Village Enterprises (TVEs) To See the Transition of Chinese Economic System.”

²⁹ Wu, Jinglian. *Understanding and Interpreting China's Economic Reform*. 当代中国经济改革教程 (In Chinese). Shanghai: Yuandong Press, 2010.

³⁰ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P246-247.

the sudden decrease of aid by the United States in the late 1950s was considered a serious economic crisis in South Korea. Regarding the situation, the Korean government and intellectuals emphasized that economic plans had to be designed in order to overcome the situation³¹.

From the 1960s on Korea focused more on economic construction. “During the four decades following the Korean War, it evolved from one of the most abject states in the region to one of the most vibrant, a manufacturing powerhouse that has virtually eradicated poverty, malnutrition, and illiteracy. In a region of fast growth, since the 1960s Korea has increased its per capita GDP more quickly than any of its neighbors³².” Today, Korea is the largest exporter in the world for memory chips, ship building, LCD panels along with many other products. The total export was over 422 billion USD in 2008, per capita income has surpassed 20,000 USD, and Korea’s economic size is approaching 1 trillion USD, which is larger than that in any European country except for the United Kingdom, France, Germany, Italy and Spain³³.

The main trade and economic development policy during this period was export promotion. This distinguished Korea from many other developing countries as most developing countries focused on import substitution as they did not have enough capital and foreign reserves for import. Instead, Korea looked outward and adopted export-oriented policies. Import was, however, not freely allowed; but, in as much as such import was related to export, import was also allowed under favorable regulations. On one hand Korea rightfully chose an open-door trade policy based on Ricardo’s Comparative Advantage Theory. But, on the other, the country did not have many choices as foreign currency earning was a pre-requisite to import factors of production such as capital goods, raw materials and technology³⁴.

The target of this paper is to analyze different resources and try to find out the similarities and the differences between China and South Korea. International trade escalated the economic development in the two countries. But, is international trade the root reason of development and creation of inequality? Did it influence institutional advancement in both country cases? Comparing China and South Korea, these two high-performing Asian economies, will thus be the analytic subject of this paper.

³¹ Park, Tae-Gyun. *Different Roads, Common Destination: Economic Discourses in South Korea during the 1950s*. Modern Asian Studies, Vol. 39, No. 3 (Jul., 2005), pp. 661-682, Published by: Cambridge University Press. Available at: <http://www.jstor.org/stable/3876589> . Accessed: 18/03/2015.

³² McKinsey & Company Report: *South Korea: Finding its place on the world stage*. McKinsey Global Institute. April, 2010. Available at: http://www.mckinsey.com/insights/winning_in_emerging_markets/south_korea_finding_its_place_on_the_world_stage . Accessed: 03/05/2015.

³³ Sung, Keuk Je. *Was There an Economic Miracle in Korea?* Source: Development Experience of the Korean Economy. Edited by: Keuk Je Sung. Seoul: Kyung Hee University Press, 2010. P11.

³⁴ Ibid. P13.

1.3 Methodological Approach

To answer the research question, a framework based on the theoretical findings will be introduced. This theoretical framework, which is discussed in detail in the corresponding section of this paper, will be applied to the case of China by using data after 1978, and for Korea after the 1960s. Since this paper is to focus on international trade and economic development, it is logical that GDP data, as well as the total amount of import and export should be considered as a measurement. Other indexes cannot be overlooked, such as the Research and Development (R&D)/GDP ratio, development of laws and regulations after 1978, and especially the data after China became a member of WTO in 2001. For Korea, the focus is to be on the time after 1960, and when Korea became a member of the Organization for Economic Cooperation and Development (OECD) in the 1990s, especially the post-crisis era (after 1997).

1.4 Literature Review

There is a huge amount of scientific literature on international trade and economic development in general. China and Korea appear to be very attractive topics for many scholars and economists in their research areas.

David Ricardo believes that a country benefits highly from foreign trade³⁵. The next section will discuss this in further detail. Stiglitz argues that trade will open foreign markets for domestic firms, reduce costs, introduce more competition to the domestic economy, improve the efficiency of local firms, and affect the rate of economic growth³⁶. Krugmann believes that trade is an effective push for production. Trade causes the market to expand, and also encourage the producers to produce more products efficiently. China and Korea derive gains from trade from this specialization. And once trade is allowed, consumers in countries that are involved can purchase a large variety of products³⁷.

Lewis argues that trade stimulates growth in many ways, for example, trade stimulates demands by introducing new goods to a community, and in doing so it may stimulate the desire to work more effectively. At the same time, trade also reduces the community's need for working capital, brings new solutions, new techniques, or new ideas of social relationships etc.

³⁵ Ricardo, David. *The Principles of Political Economy and Taxation*. Mineola, New York: Dover Publications, Inc., 2004. Originally published: London; New York: J.M. Dent & Sons, 1911.

³⁶ Stiglitz, Joseph E. and Charlton, Andrew. *Fair Trade For All: How Trade Can Promote Development*. Oxford, New York: Oxford University Press, 2005. P25.

³⁷ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy, seventh edition*. Boston, San Francisco: Pearson Addison Wesley, 2006. P33-34.

Trade also stimulates specialization, since division of labor, specialization, knowledge and capital grow together³⁸.

Marjit discusses the role of comparative advantage in technology trade, and he believes that technology transfer internationally is an important issue for international trade and economic development³⁹.

Naughton believes that trade liberalization positively affects China's economic reform since its beginning, and the WTO membership symbolizes China's participation in the global economic community⁴⁰. Bramall explores that opening up to the foreign trade is one of the most remarked-upon features of Chinese economic development since 1978⁴¹.

Keller⁴², Xu, Bao and Yin⁴³ rather focus on international trade and technology spillover. They argue that international trade has played a key role for technology spillover in China. This was important for productivity upgrading during the reform era⁴⁴.

Sun and Heshmati provide a comprehensive study of the interactive impact between trade and economic growth, mainly focused on four issues: facilitating capital accumulation; industrial structure upgrading; technological progress and institutional advancement, and also the regional imbalance development in China⁴⁵.

Wu explores the development of foreign trade policies in China (from import substitution to export-oriented, and then towards the open market), and mentions the positive effects of Special Economic Zones (SEZs) and Foreign Direct Investment (FDI) to economic development in China. The positive effects are the following: Firstly, the SEZs effectively utilized international resources, participated in the competition on the international market. Secondly, the openness of these areas successfully escalated the economic development, and became the

³⁸ Lewis, W. Arthur. *The Growth of Economic Growth*. London and New York. Routledge Library Edition – Economics, 1955. P70.

³⁹ Marjit, Sugata. *“International Trade and Economic Development: Essays in Theory and Policy”*. Oxford and New York: Oxford University Press, 2008.P224.

⁴⁰ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006.P377.

⁴¹ Bramall, Chris. *Chinese Economic Development*. London and New York: Routledge, 2009. P360.

⁴² Keller, Wolfgang. *“International Technology Diffusion”*, source: *Journal of Economic Literature*, Vol. 42, No. 3 (Sep., 2004), pp. 752-782. Published by: American Economic Association. Available at: <http://www.jstor.org/stable/3217250>. Accessed: 25/06/2013.

⁴³ Yin, Xiangshuo. *“China's trade policy reforms and their impact on industry”*. Source: *China's Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996.

⁴⁴ Keller, Wolfgang. *“International Technology Diffusion”*, source: *Journal of Economic Literature*, Vol. 42, No. 3 (Sep., 2004), pp. 752-782. Published by: American Economic Association. Available at: <http://www.jstor.org/stable/3217250>. Accessed: 25/06/2013.

⁴⁵ Sun, Peng and Heshmati, Almas. *“International Trade and Its Effects on Economic Growth in China”*, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010.

most active economic regions. Thirdly, these regions became the bridges between the inner land and the international market. And finally, the SEZs together with the South-East coastal areas became the experimental areas for modern market economy in China⁴⁶.

Myrdal believes international trade has resulted in a tendency for the inequalities between rich and poor countries to grow, and international market forces have been unfavorable for a poor country by creating a highly unbalanced economy and by causing a secular deterioration in terms of trade. But Meier has a different opinion. He believes policies of protection and deliberate industrialization at the expense of agriculture and foreign trade will not be the remedy. And he believes under certain situations, foreign trade could also be the engine of growth for poor countries⁴⁷.

Anderson and Marcouiller discuss that bilateral trade is affected by institutional quality in the trading countries. Better institutions will lead to larger trade volume⁴⁸. Romalis' main finding is that institutional differences are in fact a significant determinant of trade flows⁴⁹. Potter argues that in order to meet the transparency and rule of law requirement of the international trading organization, the legal institutional reform was connected with trade liberalization⁵⁰. Westphal argues that the government's selective industrial policies have contributed importantly to Korea's rapid achievement of international competitiveness in a number of industries⁵¹.

To sum up, international trade opens markets for domestic products, reduces costs, pushes technology spillover forward, introduces further competition within the domestic economy, improves the efficiency of local firms, and affects the rate of economic growth. Trade liberalization also causes inequality and institutional advancement. Because of the limited time and

⁴⁶ Wu, Jinglian. *Understanding and Interpreting China's Economic Reform*. 当代中国经济改革教程 (In Chinese). Shanghai: Yuandong Press, 2010.

⁴⁷ Meier, G. M. "International Trade and International Inequality". Source: Oxford Economic Papers, New Series, Vol. 10, No. 3 (Oct., 1958), pp. 277-289, Published by: Oxford University Press, Available at: <http://www.jstor.org/stable/2662009>. Accessed: 13/09/2013. Original source from Myrdal, Gunnar. Development and Under-Development: A Note on the Mechanism of National and International Economic Inequality, Cairo, 1956.

⁴⁸ Anderson, James E. and Marcouiller, Douglas. *Insecurity and the Pattern of Trade: An Empirical Investigation*, Source: The Review of Economics and Statistics, Vol. 84, No. 2 (May, 2002), pp. 342-352, Published by: The MIT Press. Available at: <http://www.jstor.org/stable/3211782>. Accessed: 10/09/2013.

⁴⁹ Romalis, John. "Factor Proportions and the Structure of Commodity Trade", Source: The American Economic Review, Vol. 94, No. 1 (Mar., 2004), pp. 67-97, Published by: American Economic Association. Available at: <http://www.jstor.org/stable/3592770>. Accessed: 10/09/2013.

⁵⁰ Potter, Pitman B. "The Legal Implications of China's Accession to the WTO". Source: The China Quarterly, No. 167 (Sep., 2001), pp. 592-609, Published by: Cambridge University Press on behalf of the School of Oriental and African Studies. Available at: <http://www.jstor.org/stable/3451062>. Accessed: 01/09/2013.

⁵¹ Westphal, Larry E. Industrial Policy in an Export-Propelled Economy: Lessons from South Korea's Experience, Journal of Economic Perspectives – Volume 4, Number 3– Pages 41-59– summer 1990. P41.

space, this paper will discuss the connection from three basic aspects. First, international trade is an important channel of technology spillover and the utility of FDI. Second, it caused the inequality. Third, liberalization of trade is the requirement for institutional advancement.

2. Theoretical Framework

The theoretical framework will be split into four parts. The first part discusses the classical principles about international trade, such as *Division of Labor* and *Comparative Advantages*. In the second part, two main effects of international trade, namely *Technology Spillover* and the *Utility of FDI* will be introduced.

The third part will discuss the connection between *income inequality* and *foreign trade*. And the fourth part, after discussing the connection of *institutional advancement* and *foreign trade*, an analytical model that compiles those aspects, will be introduced. All these parts will focus on providing the theoretical background which is needed to analyze the case of China and South Korea.

To summarize, in this paper the following criteria will be used to analyze the effects of international trade: firstly, technology spillover and FDI, secondly, unbalanced development – inequality, and thirdly: institutional advancement. This framework will be applied to the case of the economic development in China and Korea. At the end, after summarizing all points discussed, the conclusion will be presented at the very end.

2.1 Division of Labor and Comparative Advantages

International trade is the exchange of goods and services across national borders or territories. It is also known as world trade, import and export trade or overseas trade in island nations, such as Great Britain, Japan, etc. In principle international trade is no different than domestic trade. But, unlike domestic trade, international trade faces a higher risk under the current situation.

From 1500 to 1750, the school of economic thought that came into existence in Europe was referred to as Mercantilism⁵². Back in the sailing age, trade created opportunities for increasing the king's power in places where diplomatic power was weak or not existent. Mercantilists have a rather static view of global resources and also an endless desire after valuable metals, such as silver and gold. But, they do not distinguish between capital and money. Mercantilists believe international trade was rather seen as an effective way for the government to increase wealth⁵³.

⁵² Zhang, Sufang. *International Trade Theory and Practice (Second Edition)*, 国际贸易理论与实务 (In Chinese). Beijing, University of International Business and Economics Press, 2010. P3.

⁵³ Hinton, R. W. K. "The Mercantile System in the Time of Thomas Mun", Source: The Economic History Review, New Series, Vol. 7, No. 3 (1955), pp. 277-290, Published by: Wiley on behalf of the Economic History Society. Available at: <http://www.jstor.org/stable/2591154>. Accessed: 02/09/2013.

Adam Smith was a professor of moral philosophy at the University of Glasgow in the 18th century. His great masterpiece, *The Wealth of Nations* was published in 1776⁵⁴, and it was seen as the “pioneering analysis of market capitalism⁵⁵”. In this book, one notion is that spontaneous trade between individuals in the market economy will tend to create an efficient allocation of resources. And will thus be conducive to a relatively high level of income which market economy can create. Smith also believes that people can stay protectionist, conquering and monopolistic to make a lot of money. But, they can make even more money if they become active in free trade. When they can make other individuals wealthy, the others will buy more of their products⁵⁶.

The opening sentence of the first chapter sets the course for the rest of the book: “The greatest improvement in the productive powers of labor, and the greater part of the skill, dexterity, and judgment with which it is anywhere directed or applied, seem to have been the effects of the division of labor⁵⁷”. Smith believes that with the division of labor, workers will be able to concentrate on fewer processes (or maybe just one process) during the manufacturing activity. And the specialization of labor makes the working time shorter by switching from one process to another. While the market expanding lifts up the demand, in order to fulfill it, producers need to work more effectively. Consequently, trade encourages technological invention and productivity upgrading⁵⁸. After all the work has been divided, some people focus on making shoes, some work in a farm, some bake bread, etc. “When individuals own different goods, have different desires, or both, there is an opportunity for trades that benefit all parties to the trade⁵⁹.” But, how are all of these activities coordinated? Smith believes there is an *Invisible Hand* behind all the producing activities and that “the free exchange of goods through market forces was the most efficient means of organizing an economy⁶⁰.” The divisions of labor, together with another important opinion of Smith’s *Invisible Hand* create the possibility and necessity for people to trade their products on the market.

⁵⁴ Stiglitz, Joseph E. *Economics*. 2nd edition. New York and London: Stanford University, 1996. P151.

⁵⁵ Gregory, Paul R., and Robert C. Stuart. *Comparative Economic Systems*, Sixth Edition. Boston; Houghton, 1999. P95.

⁵⁶ CCTV “*Rise of the Great Nations*”. 大国崛起-工业先声. Available at: <http://finance.cctv.com/special/C16860/20061117/103785.shtml>. Accessed: 15/03/2013.

⁵⁷ Smith, Adam. *The Wealth of Nations. Books I-III, Books IV – V*. England: Penguin Books, 1999. P109.

⁵⁸ West, E. G. *Adam Smith's Two Views on the Division of Labour*, Source: *Economica*, New Series, Vol. 31, No. 121 (Feb., 1964), pp. 23-32, Published by: Wiley on behalf of The London School of Economics and Political Science and The Suntory and Toyota International Centres for Economics and Related Disciplines. Available at: <http://www.jstor.org/stable/2550924>. Accessed: 18/06/2013.

⁵⁹ Stiglitz, Joseph E. *Economics*. 2nd edition. New York and London: Stanford University, 1996. P52.

⁶⁰ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P196.

“By preferring the support of domestic to that of foreign industry, the merchant or businessman intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.⁶¹”

David Ricardo was born in 1772, four years before *The Wealth of Nations* was published. In 1799, an accidental perusal of this book attracted Ricardo’s attention to focus on economic studies⁶². David Ricardo’s *The Principles of Political Economy and Taxation* was published in 1817. He believes that many production elements are not the reasons for increasing the rate of profits, and that a country will benefit highly from foreign trade.

“Foreign trade, then, though highly beneficial to a country, as it increases the amount and variety of the objects on which revenue may be expanded, and the rate of profits is never increased by a better distribution of labor, by the invention of machinery, by the establishment of roads and canals, or by conveyance of goods. These are causes which operate on price, and never fail to be highly beneficial to consumers; since they enable them, with the same labor, or with the value of the produce of the same labor, to obtain in exchange a greater quantity of the commodity to which the improvement is applied; they have no effect on profit⁶³.”

Ricardo used the example of Portuguese specialization in wine production, which could then be exchanged for English cloth to mutual profit, and further developed the idea of *Comparative Advantages*⁶⁴. When factors such as labor, capital and other resources are able to move freely between countries and all the factors/resources in each country were fully employed⁶⁵, then “a country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries. Trade between two countries can benefit both countries if each country exports the goods in which it has a *comparative advantage*⁶⁶.” Ricardo’s *Comparative Advantage* trade theory was undoubtedly a brilliant intellectual discovery in its day, and was being accepted by

⁶¹ Smith, Adam. *The Wealth of Nations. Books I-III, Books IV – V*. England: Penguin Books, 1999. P32.

⁶² Ricardo, David. *The Principles of Political Economy and Taxation*. Mineola, New York: Dover Publications, Inc., 2004. Originally published: London; New York: J.M. Dent & Sons, 1911. Pviii.

⁶³ Ibid. P81.

⁶⁴ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P196.

⁶⁵ Ibid. P123.

⁶⁶ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy, seventh edition*. Boston, San Francisco: Pearson Addison Wesley, 2006. P26.

the majority of economists⁶⁷. Adam Smith and David Ricardo were seen as the founders of the classical system of political economy⁶⁸.

“A country’s relative export performance in individual product categories has been taken to reflect its *revealed* comparative advantage within the manufacturing sector. Relative export performance has been used as an indicator of comparative advantage in preference to export-import ratios or net exports, since inter-country differences in the commodity pattern of imports are greatly influenced by the system of protection applied⁶⁹.”

For applying comparative advantages to reality, Krueger described three premises. First, for the case of developing economies, due to the fact that they lack capital, advanced technology and well educated labor, their production structure will be oriented toward primary products. Second, when these developing economies adopt a free trade policy, because of the lack of products from the manufacturing industry, their comparative advantage would stick with the primary commodity production. At last, as these economies have no alternative plan, both the global income and price elasticities of demand for primary commodities will be low⁷⁰.

2.2 Technology Spillover and FDI

In the 18th century, “the Industrial Revolution was the aggregate of the economic and social consequences that followed from the development of new productive techniques in some British industries⁷¹.” The Industrial Revolution was a milestone for Britain to enter the modern industrial era. There were other reasons (social, political and geographical factors, etc.) also, but British overseas trade with its colonies and neighbors played an irreplaceable role in the growth of the new industry and spread the prosperity to the other countries⁷². There was hardly disagreement about the importance of foreign trade and the growth of industries, and also the expansion of foreign trade and rapid economic growth in the 1900s. First, foreign trade during that century expanded more rapidly; second, export industries grew more rapidly than

⁶⁷ Cypher, James M. and Dietz, James L. *The Process of Economic Development*, 3rd Edition. London and New York: Routledge, 2009. P119.

⁶⁸ Ricardo, David. *The Principles of Political Economy and Taxation*. Mineola, New York: Dover Publications, Inc., 2004. Originally published: London; New York: J.M. Dent & Sons, 1911.

⁶⁹ Balassa, Bela. *Comparative Advantage Trade Policy and Economic Development*. New York, London, Toronto, Sydney and Tokyo: Harvester Wheatsheaf, 1989. P19.

⁷⁰ Krueger, Anne O. *Policy and Economic Development: How We Learn*. Source: *The American Economic Review*, Vol. 87, No. 1 (Mar., 1997), pp. 1-22. Published by: American Economic Association. Available at: <http://www.jstor.org/stable/2950851>. Accessed: 28/03/2015.

⁷¹ Davis, Ralph. *The Industrial Revolution and British Overseas Trade*, Atlantic Highlands, N. J.: Leicester University Press, Humanities Press Inc., 1979. P62.

⁷² Stiglitz, Joseph E. and Charlton, Andrew. *Fair Trade For All: How Trade Can Promote Development*. Oxford, New York: Oxford University Press, 2005. P11.

the industrial sector; third, the index and data about economic growth were strongly connected with the expansion of foreign commerce, and easily to be collected. Many scholars believe that the growth of foreign trade played a significant role as a cause to the growth of the British economy⁷³.

As the oversea market expanded, British firms needed to improve their productivities in order to fulfill purchasing requirements. Advanced technology was the key. Cypher and Dietz define technology as “the knowledge applied to the production process⁷⁴.” It has a better chance of being combined in the production process to contribute to greater productivity and to higher levels of output. Technology depends not only on the machines or tools, but also depends on the skills and effectiveness of the users or operators of those tools and the knowledge. It refers to not just any projects, but rather to a way of thinking or doing things.

“Technology progress reduces costs, increases productive efficiency, conserves society’s resources, and establishes the capacity for a higher standard of living for greater numbers of persons⁷⁵.” International trade offers the most effective spillover channel for technology movements from one country to another⁷⁶. Recent research work shows that technical change led to productivity growth in OECD (Organization for Economic Co-operation and Development) countries, but domestic sources are not the major ones. Instead, they come from abroad. In today’s world, modern technologies almost all come from developed countries; less developed countries comparatively are quite marginal in the global process of innovation. Theoretically less developed countries are able to choose and purchase the “better” technology. But in fact, it takes a lot of time and skills to really identify appropriate technologies which are also available. Even though the “better” technology or developed technology could be purchased directly, well-educated manpower is required in less developed countries for digesting the technologies. And at the same time, normally it takes a lot of efforts and resources to adapt new technologies that work in the local factories. Developed countries increasingly treat their technologies as another kind of resource and fence off their intellectual property rights. “Whatever the global environment in which a country operates, it must invest resources in

⁷³ Floud, Roderick and McCloskey, Donald. Ed. *The Economic History of Britain Since 1700, Volume 1: 1700-1860*. Cambridge: Cambridge University Press, 1981. P87.

⁷⁴ Cypher, James M. and Dietz, James L. *The Process of Economic Development, 3rd Edition*. London and New York: Routledge, 2009. P423.

⁷⁵ Ibid.

⁷⁶ Xu, Helian; Bao, Qun and Lai Ming Yong. “Export composition and Technology Spillovers in China: An Empirical Study Based on the Extended Feder Model”. Source: “Market Development in China: Spillovers, Growth and inequality”, edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007.

research and development in order to discover and adapt new, more productive technologies⁷⁷.”

Technology has positive effects on productivity upgrading. “Productive (or technical) efficiency is then measured by comparing observed input coefficient points for an establishment with the input coefficients on the efficiency frontier for the same factor proportions. Productive efficiency may thus be viewed as how closely the establishment attains the lowest possible real cost for the output it produces⁷⁸.” Blomström also explains the four factors that influence the technological structure of an industry:

1. “Rate of technical progress: A rapid technological progress may increase the dispersion between the best-practice firm and the industry average.
2. Competitive pressure: greater competition, both domestic and international, results in a more efficient structure.
3. Market growth: rapidly growing demand for an industry's output increases the dispersion in industry structure.
4. Ownership structure: ownership structure has an influence on relative performance of the plants or firms within an industry. Multinational corporations (MNCs) are usually held to represent advanced technologies, and may therefore be an important source of structural change⁷⁹.”

Technology/knowledge spillover between countries can happen in different ways, namely through international trade, by imports of middle-level products and equipment. Thus a country can increase the productivity of its own resources. The communication channel will also be opened by trade activities, and as a result foreign technologies can be introduced to the host countries. At last, foreign technology expansion will positively affect the host country's R&D. The measured spillover effect on productivity is through FDI rather than international trade⁸⁰. In a nutshell, FDI affects the host country's economy directly and indirectly. As foreign joint ventures or MNCs enter the domestic market, FDI influences the host economy directly by capital investment, providing a more competitive market environment, installing advanced equipment and technology, and by increasing employment. Indirectly, the MNCs

⁷⁷ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P352.

⁷⁸ Blomström, Magnus. “*Foreign Investment and Productive Efficiency: The Case of Mexico*”, Source: The Journal of Industrial Economics, Vol. 35, No. 1 (Sep., 1986), pp. 97-110, Published by: Wiley. Available at: <http://www.jstor.org/stable/2098609>. Accessed: 29/07/2013. P99.

⁷⁹ Ibid.

⁸⁰ Hejazi, Walid and Safarian, A. Edward. *Trade, Foreign Direct investment, and R&D Spillovers*. Source: Journal of International Business Studies, Vol. 30, No. 3 (3rd Qtr., 1999), pp. 491-511, Published by: Palgrave Macmillan Journals. Available at: <http://www.jstor.org/stable/155462>. Accessed: 29/07/2013. P491-494.

business connections with the local firms will influence these firms by updating their productivities as well. One more issue needs to be mentioned in particular: after local people have been trained in such a firm and then later move to a local firm, the level of human capital can be raised⁸¹.

“Economists refer to the output of this creative action as intellectual property⁸².” Joseph Schumpeter was an economist who emphasized the role of innovation in a market. He argued that the economy was characterized by a process of creative destruction. An innovator could, through his new product or lower costs of production, establish a dominant position in a market. But eventually, that dominant position would be destroyed, as a new innovator could take his place⁸³.

In other words, innovation is an ongoing process for the whole world, and there will be no final winner. As for example the Vienna Technical Museum shows in its different collections, such as Everyday Life & Environment, Energy & Mining, Information & Communication, Production Technology, Technical Principles & Music, Traffic & Transport⁸⁴, the importance of innovation and technology development is evident. “Modern economies are based on innovation. Imperfect competition is widespread in the sectors of the economy in which innovation is most important. Government plays a crucial role in innovation, not only protecting intellectual property (through patents and copyrights) but also in supporting basic research⁸⁵.” Governments also have other influences on the development of economy, which the next section will discuss further.

Basic research can normally not be done by private firms. It requires more patents, time and investment, and especially the protection for intellectual property rights. “A number of governmental policies encourage technological advance: patents; direct spending on research; tax incentives to encourage corporate R&D; temporary protection from technologically advanced foreign competitors; and relaxing antitrust laws to allow potential competitors to work together on research projects⁸⁶.” Innovation improves the technology, which can escalate the growth of economy. And economic growth requires more advanced technology, so more investment to R&D is highly required at the same time.

⁸¹ Tong, Sarah Y, and Hu, Youxin. “*Productivity Spillovers from FDI: Detrimental or Beneficial?*” Source: “*Market Development in China: Spillovers, Growth and inequality*”, edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P191.

⁸² Stiglitz, Joseph E. *Economics*, 2nd edition. New York and London: Stanford University, 1996, P413.

⁸³ Ibid.

⁸⁴ Technology Museum Vienna website. www.technischesmuseum.at. Accessed: 29/03/2015.

⁸⁵ Stiglitz, Joseph E. *Economics*, 2nd edition. New York and London: Stanford University, 1996. P427.

⁸⁶ Ibid. P428.

For its long-term growth, a country requires a range of types of human capital embodied in a range of unskilled, skilled, and professional workers. The people fulfilling the following private- and public-sector needs, which are neither exhaustive nor mutually exclusive, are critical requirements for an economy to grow:

(1) a large number of literate workers who can perform relatively simple monotonous tasks effectively and efficiently (e.g. skilled workers, who often increase productivity by improving how they work, and unskilled workers who perform routine mechanical tasks); (2) middle-level managers and supervisors who, in collaboration with their subordinates, enforce the rules of their organizations and units, and top-level managers and supervisors who, also in collaboration with their subordinates, create the rules of the organizations to induce the workers to be productive, and who perform strategic tasks, such as the setting of goals for their organizations and managing their subordinates; (3) people who have the capacity and talent to learn new ideas, including ideas for public-set operation, and technologies quickly, to teach and explain them to others, and to apply them for practical purposes; (4) discoverers and innovators who create and invent, including those who develop new scientific theories and technology, and those who establish new enterprises for the pursuit of profits and for public service; (5) top leaders for the whole society⁸⁷.

As this paper has mentioned in the previous part, technology is knowledge applied to the production process⁸⁸. In the modern industrialized period, different economies are trying to develop or produce new products, and also improve the ways of making existing products. Innovations together with R&D are the areas that firms put more concentration to⁸⁹. For technology development, well-educated labor is highly required. Especially for avoiding the middle income trap⁹⁰. Generally speaking, in high- and higher-income economies the R&D/GDP ratio is higher than that in low- and lower-middle-income economies. Low- and lower-middle-income economies more focused on the identification and adaptation of foreign technologies. Middle-income economies will increase that ratio, and the developed countries R&D/GDP ratio will typically be above 2%. As can be seen in Table 1, in terms of the Research and Development expenditure in 1996, Brazil, China, India, the Russian Federation were all under 1%, whereas Germany, Japan, the United States and the Republic of Korea

⁸⁷ Chu, Ke-young. *Economic Development and Human Capital Formation in Korea*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.P381.

⁸⁸ Cypher, James M. and Dietz, James L. *The Process of Economic Development*, 3rd Edition. London and New York: Routledge, 2009. P423.

⁸⁹ Stiglitz, Joseph E. *Economics*. 2nd edition. New York and London: Stanford University, 1996. P412.

⁹⁰ Jankowska, Anna; Nagengast, Arne J. and Perea, José Ramón. *The Middle-Income Trap: Comparing Asian and Latin American Experiences*. OECD report. OECD development center. NO. 96. May, 2012. Available at: <http://www.oecd.org/dev/50305488.pdf>. Accessed: 23/03/ 2016.

were all over 2%. The situation changed after 2000, especially in 2009. R&D expenditure (percentage of GDP) in China achieved 1.7, approaching other advanced countries.

Table 1. Research and Development Expenditure (Percentage of GDP)⁹¹

Country\Year	1996	2000	2006	2009
Brazil	0,72	1,02	1,01	1,17
China	0,57	0,90	1,39	1,70
Germany	2,20	2,47	2,54	2,82
India	0,63	0,75	0,77	(no record)
Japan	2,77	3,00	3,41	3,36
ROK	2,42	2,3	3,01	3,56
Russia	0,97	1,05	1,07	1,25
U.S.	2,55	2,71	2,64	2,90

The World Bank policy research report *The East Asia Miracle*⁹² claims that foreign export will be able to help with some imperfections in the domestic market of knowledge, and also offers the possibility to purchase through a variety of mechanisms on the international market. Those mechanisms include: “purchase of new equipment; direct foreign investment; technology licensing; transfer of nonproprietary technology; information from customers; knowledge from returning nationals; domestic research⁹³.” Among the mechanisms, FDI is an important part of international capital movement, and also has become an important element of development strategies⁹⁴. In most cases, developing countries lack knowledge, capacity, and especially abilities and resources to develop new technologies. FDI, as a combination of capital and advanced technology and new managerial and updated marketing skills, flows from de-

⁹¹ World Bank Data Base. Available at: <http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS>. Accessed: 17/09/2013. Data from new economy - four BRIC countries, developed countries in the world (U.S., Germany, Japan), also from the region (ROK).

⁹² World Bank policy research reports: *The East Asia Miracle: Economic Growth and Public Policy*. Oxford, New York: Oxford University Press, 1993.

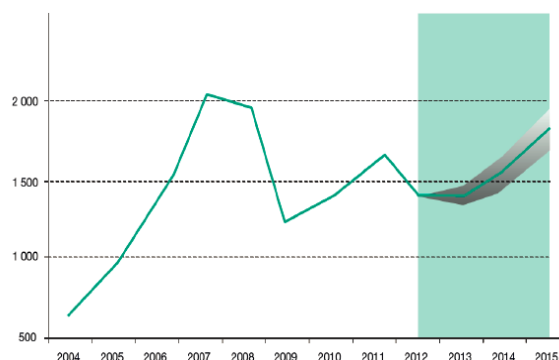
⁹³ Ibid. P318.

⁹⁴ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy*, seventh edition. Boston, San Francisco: Pearson Addison Wesley, 2006. Tong, Sarah Y, and Hu, Youxin. “*Productivity Spillovers from FDI: Detrimental or Beneficial?*”, source: “*Market Development in China: Spillovers, Growth and inequality*”, edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P190.

veloped countries to less developed countries. Through technology direct transfer and indirect spillovers, foreign investment provides an important mechanism to reduce the gap between developed and less developed countries⁹⁵.

Flows in 2013 are expected to remain close to the level of 2012, and could rise in 2014 – 2015 as can be seen in Figure 2.

Figure 2. Global FDI Flows 2004 – 2012, and Projections 2013 – 2015 (Billions of USD)⁹⁶



Few factors need to be noticed from the table: 1) Forecasts for 2013 are close to the 2012 level; upper range is at \$1.45 trillion aligned with the pre-crisis average, 2) FDI may slowly increase to \$1.6 trillion in 2014 and \$1.8 trillion in 2015, 3) However, significant risks to this growth scenario remain.

Multinational firms could be seen as the major power for international borrowing and lending. Subsidiaries are set in foreign countries. Instead of direct lending, FDI is an alternative way for developing countries to receive capital. Subsidiaries are part of the multinational firms' communication of capital and technology. All these factors help in terms of a smooth transfer among countries within the firms. Multinational firms sometimes invest more to the subsidiaries in the other countries than in their home countries. Design and produce can be placed in different parts of the world, so that a product from these types of companies cannot be declared as made in one specific country⁹⁷. In the past few decades, FDI was being increased while multinational corporations from all over the world expanded overseas production and sales across borders.

⁹⁵ Tong, Sarah Y, and Hu, Youxin. "Productivity Spillovers from FDI: Detrimental or Beneficial?" Source: "Market Development in China: Spillovers, Growth and inequality", edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P190.

⁹⁶ Fujita, Masataka. *World Investment Report 2013, Global Value Chains: Investment and Trade for Development*. Available at: <https://www.imf.org/external/pubs/ft/bop/2013/13-25.pdf> . Accessed: 13/09/2015.

⁹⁷ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy, seventh edition*. Boston, San Francisco: Pearson Addison Wesley, 2006. P159.

The FDI grew faster than the world economic output and trade during the same period. As for the FDI trend, world sales of foreign subsidiaries of MNCs increased from 3 trillion dollars in 1980 to 14 trillion dollars in 1999, which is twice as much as world exports. The total foreign production in 1999 increased to almost 1/10 of the world GDP from 1/12 in 1982. FDI flows in 1999 were 865 billion dollars, which is 14 percent of global domestic capital. The ratio is far higher than 2 percent than those two decades ago. Similarly, the ratio of FDI to world GDP increased to 16 percent from 5 percent during the same period. The number of transnational corporations whose headquarters are in the 15 industrialized countries increased to 40,000 at the end of the 1990s from 7,000 at the end of the 1960s. Until the 1960s, FDI was a business activity in which MNCs only from industrialized countries were engaged. However, as transportation and telecommunications evolved, and world trade and investment were liberalized, FDI came to be recognized as a strategic tool which companies from both industrial and developing countries should consider⁹⁸.

Blomström believes that foreign firms will be able to influence the growth and productivity of domestically owned firms, because they can introduce advanced technologies, marketing and management skills, together with direct investment to the domestic industries which they enter⁹⁹. Quite often, MNCs are seen as the driving power for spillover effects of FDI, both from a theoretical and empirical perspective¹⁰⁰. First, when MNCs choose to enter a foreign market, they will likely take the more advanced technology and managerial practices with them. Second, business cooperation between MNCs and local domestically owned firms will also provide learning opportunities. It can reduce costs and also speed up the productivity improvement for local firms. Third, MNCs create a certain amount of job opportunities. And with training programs that MNCs offer, local employees can later become skilled workers. If they move to local firms or start their own businesses, those people can become the human capital for domestic industries¹⁰¹.

⁹⁸ Jun, Yongwook and Kim, Dong-Soon. *Korean Chaebol: Going Global and Over-Expanded FDI*. Source: South Korea: Challenging Globalisation and the Post-Crisis Reforms. Edited by Kim, Young-Chan; Kim, Doo-Jin and Kim, Young-Jun. Oxford: Chandos Publishing, 2008. P25.

⁹⁹ Blomström, Magnus. "Foreign Investment and Productive Efficiency: The Case of Mexico", Source: The Journal of Industrial Economics, Vol. 35, No. 1 (Sep., 1986), pp. 97-110, Published by: Wiley. Available at: <http://www.jstor.org/stable/2098609>. Accessed: 29/07/2013. P97.

¹⁰⁰ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy*, seventh edition. Boston, San Francisco: Pearson Addison Wesley, 2006.; Tong, Sarah Y, and Hu, Youxin. "Productivity Spillovers from FDI: Detrimental or Beneficial?", source: "Market Development in China: Spillovers, Growth and inequality", edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P190.

¹⁰¹ Tong, Sarah Y, and Hu, Youxin. "Productivity Spillovers from FDI: Detrimental or Beneficial?" Source: "Market Development in China: Spillovers, Growth and inequality", edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P191-192.

If modern economy is based on innovation, educated labor could be seen as the major pushing power for that. As this paper has mentioned previously, the R&D/GDP ratio in more advanced economies is relatively higher than that in low- and lower-middle-income economies. At the same time, the budgets for education investments in these two kinds of economies vary. But the most fundamental challenge for less developed countries is to find the balance between economic growth and tackling inequality. “A society in which most of the population has access to education and employment opportunities stands the best chance of achieving both growth and equity¹⁰².”

2.3 Income Inequality

The openness of trade does not always make every person in the country better off. Instead, it creates winners and losers at the same time. The ideal trade or trade liberalization will be overall beneficial, but in reality, it seldom occurs. International trade together with worldwide competition has increasingly been lacking fairness¹⁰³.

Since the 19th century, after the Industrial Revolution, global productivity has improved a lot. At the same time, inequality is an unavoidable phenomenon in the modern society. “The conflict between economic efficiency and income equality has long been recognized in economics¹⁰⁴.” In countries with rapid economic growth, income levels have risen. But the household income gap has widened sharply. The World Bank World Development Report *Reshaping Economic Geography* of 2009 discusses the huge inequality in the world: “Half the world’s production fits onto 1.5 percent of its land. North America, the European Union, and Japan – with fewer than a billion people – account for three-quarters of the world’s wealth¹⁰⁵.” The Organization for Economic Co-operation and Development (OECD) was founded in 1961¹⁰⁶. China, India, Brazil, Indonesia and South Africa, are key partners of the OECD and contribute to its work in a sustained and comprehensive manner. Together with these five economies, the

¹⁰² Lee, Hyun-Hoon, Lee Minsoo and Park, Donghyun. *Growth Policy and Inequality in Developing Asia: Lesson from Korea*. ERIA Discussion Paper Series. Available at: <http://www.eria.org/ERIA-DP-2012-12.pdf>. Accessed: 28/03/2015. P14.

¹⁰³ Stiglitz, Joseph E. and Charlton, Andrew. *Fair Trade For All: How Trade Can Promote Development*. Oxford, New York: Oxford University Press, 2005.

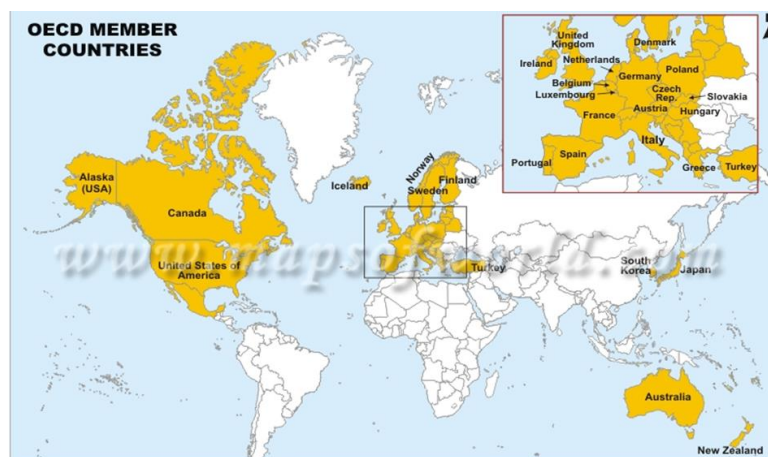
¹⁰⁴ Zhai, Fan and Li, Shantong. *The impact of WTO accession on income disparity in China*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P122.

¹⁰⁵ World Bank, World Development Report 2009: *Reshaping Economic Geography*. Washington D.C., 2009. P: xiii.

¹⁰⁶ OECD is seen as rich men’s club. The GDP per capita for the member countries are over 10,000 USD a year. OECD official website. Available at: www.oecd.org. Accessed 15/04/2016.

OECD brings around its table 39 countries that account for 80% of world trade and investment, making it the significant role in addressing the challenges facing the world economy¹⁰⁷.

Figure 3. Location of OECD Member Countries in World Map¹⁰⁸



Another research paper by the World Bank examines the relationship between openness and within-country regional inequality across 28 countries over the period from 1975 to 2005. The authors find that trade has a positive and significant association with regional inequality, and also discuss the inequality within the countries.

“This means that changes in trade regimes have had a more polarizing effect in low and middle-income countries, whose structural features tend to potentiate the trade effect and whose levels of internal spatial inequality are, on average, significantly higher than in high-income countries. It is far from certain that the temporality and benign implications of any potential growth in within country regional disparities resulting from changes in trade patterns will materialize. In particular, in cases where increasing polarization takes place during periods of low growth – meaning that not all regions within a country end up better off than before changes in trade patterns took place – in cases when trade widens an already wide gap between rich and poor regions, and in cases when new territorial inequalities resulting from trade reinforce pre-existing social, political, cultural, or ethnic divides, the rise in inequalities may not just be a temporary stage, but one that becomes entrenched¹⁰⁹.”

¹⁰⁷ OECD official website. Available at: www.oecd.org. Accessed 15/04/2016.

¹⁰⁸ Map showing the location of OECD Member Countries in World, Available at: <http://www.mapsofworld.com/oecd-member-countries.htm>. Accessed: 10/07/2015.

¹⁰⁹ World Bank, Policy Research Working Paper 5347: Trade and Regional inequality, Washington D. C., 2010. P3.

In the previous section, this paper discussed the relationship between international trade and technology spillover. “Technology progress reduces costs, increases productive efficiency, conserves society’s resources, and establishes the capacity for a higher standard of living for greater numbers of persons¹¹⁰.” It has a better chance of being combined in the production process to contribute to greater productivity and to higher levels of output¹¹¹. At the same time, “changes in technology can lead to reduced demands for labor in some sectors, or reduced demands for some types of labor, and increases in the demand for labor of other types.” In other words, changes in technology cause the restructuring of capital and labor.

As Krugman discusses in his *International Economics*, international trade does not only refer to the movement of goods and services, it also refers to the movements of other factors. Factor movements include three aspects: firstly, labor migration; secondly, international capital transfer; and thirdly, international connections to multinational corporations¹¹². For many reasons, levels of economic development are unequal in different regions and countries. Some regions have advanced technology and productivity, whereas some have cheap labor or loads of raw materials. International trade activities have reallocated all of those factors for manufacturing activities. After the Industrial Revolution, Britain became the most powerful nation and the growth of foreign trade rebuilt the structure of the English labor force. In 1700, around 68 per cent of the British labor force was in agriculture; and by 1800, this number reduced to only 36 percent. The expansion of foreign trade is strongly connected to this transition. The export industries grew from 100 to 544 while the domestic industries grew from 100 to 152 over the century. In calculating the total commerce and industry, export industries occupied around 60 percent. The expansion of overseas trade during that century (1700-1800) was the major reason for the British economy becoming more specialized in manufacturing than dependents on agriculture. That process continued until the late 19th century¹¹³.

The study based on the international factor movements was widely accepted as “factor endowment theory”, or Heckscher-Ohlin (HO) theory, which was being provided by Heckscher and Ohlin¹¹⁴. As the American scholar Leamer argues:

¹¹⁰ Cypher, James M. and Dietz, James L. *The Process of Economic Development*, 3rd Edition. London and New York: Routledge, 2009. P423.

¹¹¹ Ibid. P424.

¹¹² Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy*, seventh edition. Boston, San Francisco: Pearson Addison Wesley, 2006. P147.

¹¹³ Floud, Roderick and McCloskey, Donald. Ed. *The Economic History of Britain Since 1700, Volume 1: 1700-1860*. Cambridge: Cambridge University Press, 1981. P90.

¹¹⁴ Findlay, Ronald. Ed. *Eli Heckscher, International Trade and Economic History*. Cambridge, Massachusetts: The MIT Press, 2006; Choi, E. Kwan and Harrigan, James. *Handbook of International Trade*. Malden: Blackwell Publishing, 2003; Borjas, George J. “*Economic Theory and International Migration*”. Source: International Migration Review, Vol. 23, No. 3, Special Silver Anniversary Issue: International Migration

“The basic insight of the Heckscher-Ohlin (HO) model is that traded commodities are really bundles of factors (land, labor, and capital). The exchange of commodities internationally is therefore indirect factor arbitrage, transferring the services of otherwise immobile factors of production from locations where these factors are abundant to locations where they are scarce. Under some circumstances, this indirect arbitrage can completely eliminate factor-price differences. Perhaps the most important implication of the HO model is that the option to sell factor services externally (through the exchange of commodities) transforms a local market for factor services into a global market. As a result, the derived demand for inputs becomes much more elastic and also more similar across countries¹¹⁵”.

In other words, free movement of all the factors reallocates all the resources globally. But for many reasons, different countries have different historical backgrounds and different levels of industrialization, and that might be the reason for increasing inequality¹¹⁶.

There are also researchers who question the HO trade theory. As the HO trade model provided, countries like Thailand possess a relatively large endowment of labor and a relatively small endowment of capital. At the same time, America is a country with relatively abundant capital, and a relatively small endowment of labor. Thailand possesses relatively cheap labor and should therefore specialize in the production and export of labor-intensive products. In the meanwhile, America possesses relatively cheap capital and should specialize in the production and export of capital intensive products. However, in the article *Domestic production and foreign trade: The American capital position re-examined* Wassily W. Leontief disagrees. He uses US trade data from 1947, on the contrary to his expectation. He discovered that in the US (seen as a capital-abundant country) import-competing industries used 30 percent more capital per worker than in export industries. This finding has come to be known as the *Leontief paradox*¹¹⁷. There are a lot of arguments and disagreements on this theory. Because of limited extent, this paper will not discuss this further.

an Assessment for the 90's (Autumn, 1989), pp. 457-485. Published by: The Center for Migration Studies of New York, Inc. Available at: <http://www.jstor.org/stable/2546424>. Accessed: 05/09/2013. P459.

¹¹⁵ Leamer, Edward E. *THE HECKSCHER-OHLIN MODEL IN THEORY AND PRACTICE*. 1995: Princeton Studies in International Finance, No. 77, International Finance Section, Department of Economics. Princeton, New Jersey: Princeton University, February 1995.

¹¹⁶ Galbraith, James K. *A Perfect Crime: Inequality in the Age of Globalization*. Source: Daedalus, Vol. 131, No. 1, On Inequality (Winter, 2002), pp. 11-25. Published by: The MIT Press on behalf of American Academy of Arts & Sciences. Available at: <http://www.jstor.org/stable/20027734>. Accessed: 11/09/2013.

¹¹⁷ Choi, E. Kwan and Harrigan, James. *Handbook of International Trade*. Malden: Blackwell Publishing, 2003. P33.

2.4 Institutional Advancement

“When individuals own different goods, have different desires, or both, there is an opportunity for trades that benefit all parties to the trade.¹¹⁸” In the book *The Wealth of Nations*, Smith argues that with the division of labor, workers will be able to concentrate on fewer processes (or maybe just one process) during the manufacturing activity. And the specialization of labor makes the working time shorter by switching from one process to another; it also encourages technological invention and productivity upgrading¹¹⁹. After all the work is being divided, and different products are being produced by different people, it objectively creates the necessity for people to trade their goods and that also creates the necessity for rules of the game.

International trade also leads to necessary institutional changes. International trade not only includes trading of goods and services, but also ideas on market mechanisms. For different countries, the levels of economic development are different. Developing countries are learning to apply market power more efficiently with less intervention from the government in order to increase openness. Especially in bilateral and multilateral trade, participants should fulfill their commitments to international rules and regulations to bridge the gap between developed countries¹²⁰.

Anderson and Marcouiller argue that trade expands dramatically when it gets support by better institutions. They believe that when government economic policies need to be impartial and transparent, the legal system also has to be effective in enforcing commercial contracts. The authors came up with eleven aspects for the composite security index, as follows:

- Government economic policies are impartial and transparent.
- Government regulations are precise and fully enforced.
- Tax evasion is minimal.
- Irregular additional payments are not common in business and official transactions.
- The legal system is effective in enforcing commercial contracts.
- Agreements and contracts with the government are not often modified due to budget cutbacks, changes in government, or changes in government priorities.

¹¹⁸ Stiglitz, Joseph E. *Economics*, 2nd edition. New York and London: Stanford University, 1996. P52

¹¹⁹ West, E. G. *Adam Smith's Two Views on the Division of Labour*, Source: *Economica*, New Series, Vol. 31, No. 121 (Feb., 1964), pp. 23-32, Published by: Wiley on behalf of The London School of Economics and Political Science and The Suntory and Toyota International Centres for Economics and Related Disciplines. Available at: <http://www.jstor.org/stable/2550924>. Accessed: 18/06/2013.

¹²⁰ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010.

- Private businesses can readily file lawsuits at independent and impartial courts if there is a breach of trust on the part of the government.
- New governments honor the commitments and obligations of previous regimes.
- Citizens are willing to adjudicate disputes rather than depending on physical force or illegal means.
- Police are effective in safeguarding personal security so that this is not an important consideration in business activity.
- Organized crime does not impose significant costs on business in the country¹²¹.

Levchenko also discusses the connection between institutional quality and international trade. He argues that the institution refers to contract enforcement, property rights, investor protection, the political system, etc. He believes better institutions in the developed countries have comparative advantages, and in countries with worse institutions contracts are more incomplete¹²². “The central implication of the model is that institutional differences across countries are an important determinant of trade patterns¹²³”.

Anderson, Marcouiller and Levchenko all believe that the high quality of institutions in developed countries was the reason that transactions costs could be reduced. In the current age, trade expands so fast and not only happens among developed countries. Countries all over the world need an international platform for trade activities.

Where there is a society, there is law¹²⁴. Laws, policy and regulations are the most effective tools which the government uses for governing a country, and also for participating the international games. Laws can encourage or discourage economic activities. “Almost every law has distributive consequences, with some groups benefiting, typically at the expense of others. And these distributive consequences are often the most important effects of the policy or program¹²⁵”. At the same time, it has to be noticed that not just laws have large distributive effects, but also policies.

¹²¹ Anderson, James E. and Marcouiller, Douglas. *Insecurity and the Pattern of Trade: An Empirical Investigation*, Source: The Review of Economics and Statistics, Vol. 84, No. 2 (May, 2002), pp. 342-352, Published by: The MIT Press. Available at: <http://www.jstor.org/stable/3211782>. Accessed: 10/09/2013. P342 & 346.

¹²² Levchenko, Andrei A. *Institutional Quality and International Trade*. Source: The Review of Economic Studies, Vol. 74, No. 3 (Jul., 2007), pp. 791-819. Published by: Oxford University Press. Available at: <http://www.jstor.org/stable/4626161>. Accessed: 28/06/2013.

¹²³ Ibid, P793.

¹²⁴ Kim, Chan Jin. *Economic Development and Law in Korea*. Seoul: THE CATHOLIC UNIVERSITY OF KOREA PRESS, 2009. P20.

¹²⁵ Stiglitz, Joseph E. *The Price of Inequality: how today's divided society endangers our future*. New York and London: W.W. Norton & Company, 2012. P57-58.

In modern economies, the roles of the government are not replaceable. The government “[...] redresses market failures, redistributes income, and provides social insurance against risks such as unemployment, health care costs, disability, and retirement¹²⁶”. It plays different roles in different areas, and setting the basic rules of all the economic activities is the most important one.

Without a doubt, economic development and the role of law in the modernization process go hand in hand. Economic modernization requires that laws are created to promote the free flow of resources from developed to underdeveloped countries. More than 160 countries have foreign investment laws that encourage the inflow of foreign capital, technology and managerial skills into the host country¹²⁷.

A “plan” was seen as the symbol for socialist economy. “The intellectual forerunners of the socialist system saw planning as one of socialist’s great advantages¹²⁸”. In most socialist countries, the economic plan is being prepared by the central or national planning office. And this kind of economic plan (usually a five-year plan) is the real operational tool for running the economy. Comparatively, the law of demand and supply does not work as effectively in socialist countries as in other countries. “There was widespread agreement – in developed and developing countries alike – that the state should play a major role in economic activity, not only in affecting aggregate demand, but also in regulating private markets and indeed augmenting or supplanting them with state-owned enterprise production of manufactured and other goods¹²⁹”.

In the modern world, trading activities do not only happen between market economies, but socialist economies are also involved. Competition is seen as the symbol for market economy. It “[Competition] is essential for a market to function efficiently. Competition is what forces firms to look for more efficient ways of producing goods and to meet the desires of consumers more effectively¹³⁰”. With competition, prices decrease and the productivity level is forced to improve. If there is no competition, profits increase rapidly and the firms thus have less pressure to improve their productivity. The government will use laws and regulations, such as fair trade laws and anti-dumping laws to enhance and protect competition.

¹²⁶ Stiglitz, Joseph E. *Economics*. 2nd edition. New York and London: Stanford University, 1996. P168.

¹²⁷ Ibid.

¹²⁸ Kornai, Janos. *The Socialist System: The Political Economy of Communism*. New Jersey: Princeton University Press, 1992. P110.

¹²⁹ Krueger, Anne O. *Policy and Economic Development: How We Learn*. Source: *The American Economic Review*, Vol. 87, No. 1 (Mar., 1997), pp. 1-22. Published by: American Economic Association. Available at: <http://www.jstor.org/stable/2950851>. Accessed: 28/03/2015.

¹³⁰ Stiglitz, Joseph E. *Economics*, 2nd edition. New York and London: Stanford University, 1996. P154.

Before WTO was established in 1995, international regulations regarding international trade were essentially defined in the *General Agreement on Tariffs and Trade* (GATT). “The international economic relations in the twentieth century witnessed developments which led to the evolving of concepts, precept and doctrines completely unique not only to achieve order in global economic and trading relations but also in the establishment of international economic institutions.¹³¹” GATT was initiated by western countries, in order to increase global trade, and to facilitate the reconstruction and development of the global economy. GATT provided a number of benefits¹³²:

- Platform for member countries to negotiate multilateral trade agreements
- Tariff reduction and increased competitiveness of products
- Easier for less-developed countries to export their products
- Access to important trade information and data

Whereas GATT mainly covered the trade of goods, the WTO does not exclusively deal with goods, but also with services, inventions, creations and intellectual property rights¹³³. “WTO accordingly is set to develop an integrated, more viable, and durable trading system encompassing GATT, the results of the past liberalization efforts, and of the results of the Uruguay Round Multilateral Tariff negotiations preserving the basic principles of the earlier negotiations and the objectives underlying a multilateral trading system.¹³⁴” The WTO deals with different problems which relate to trade on a global level. Besides that, it offers a platform for members to communicate and negotiate, “to help trade flow smoothly, freely, fairly and predictably¹³⁵”. The WTO was a direct result of negotiations, and it is currently the host to new negotiations. But liberalizing trade and lowering trade barriers are not the only priorities for the WTO. The WTO is a set of rules and the core spirits are those agreements negotiated and signed by the member governments and the world’s trading nations. Those documents are not laws. They merely provide the legal ground-rules for international commercial activities. They are like contracts: binding member governments to keep their trade policies under limitation within the WTO. At the same time, it needs to be noted that even those agreements were negotiated and signed by governments, but the principle is to help manufacturers of

¹³¹ Koul, Autar Krischen. *Guide to the WTO and GATT: Economics, Law and Politics*. Hague: Kluwer Law International, 2005. P1.

¹³² Kim, Chung-yum. *From Despair to Hope: Economic Policymaking in Korea 1945-1979*. Seoul, Korea Development Institute, 2011. P143-144.

¹³³ World Trade Organization official website. Available at: www.wto.org. Accessed: 03/03/2016.

¹³⁴ Koul, Autar Krischen. *Guide to the WTO and GATT: Economics, Law and Politics*. Hague: Kluwer Law International, 2005. P31.

¹³⁵ World Trade Organization official website. Available at: www.wto.org. Accessed: 05/03/2016.

products and services, exporters and importers to conduct their businesses, while governments meet public objectives.

The WTO's main purpose is to help international trade flow freely, because as many researchers agree, international trade will make positive effects on economic development and well-being. That does not only mean clearing obstacles, but also make sure that individuals, companies and governments all know the global trade rules, and give them the confidence that there will not be sudden changes. Another important aspect to be considered is that international trade often involves interest conflicts. Negotiations based on mutually agreed legal foundations will be the most harmonious way¹³⁶.

The WTO system aims to operate by:

- (1) Setting and enforcing rules for international trade
- (2) Providing a forum for negotiating and monitoring further trade liberalization
- (3) Resolving trade disputes
- (4) Increasing the transparency of decision-making processes
- (5) Cooperation with other major international economic institutions involved in global economic management
- (6) Helping developing countries benefit fully from the global trading system.¹³⁷

The WTO thus is a trade negotiating forum that aims to reduce trade barriers. But the main task for the WTO is to set up a confident, open and non-discriminatory rules-based world trading system¹³⁸. WTO agreements do not only cover goods, services and intellectual property, they also spell out the principles of liberalization and permitted exceptions. All these factors make clear that the WTO has helped East Asian economies increase trade by keeping their domestic markets open and maintain confidence in the international trading system. "A country with high institutional quality is more likely to have better enforcement of the rule of law, thus ensuring a freer, fairer and more competitive market. Improvements in institutional quality help improve the quality of exportable goods and reduce trade costs¹³⁹." WTO agree-

¹³⁶ World Trade Organization official website. Available at: www.wto.org. Accessed: 05/03/2016.

¹³⁷ Martin, Will. Anderson, Kym and Pham, Cong S. *Effects of GATT/WTO on Asia's trade performance*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P51.

¹³⁸ World Trade Organization official website, www.wto.org

¹³⁹ Yu, Miaojie. *China's foreign trade, WTO accession and institutional quality*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P124.

ments provide treatment especially for less developed countries. More importantly, member countries are required to have more transparent trade policies¹⁴⁰.

¹⁴⁰ Armstrong, Shiro. *Overview and issues*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P5-6.

3. Empirical Findings: International Trade and Chinese Economy

After the People's Republic of China was founded in 1949, the Soviet command economy model was installed in China. Before 1964, China had trade connections with other countries (mainly Socialist countries in Eastern Europe, i.e. the Soviet Union). But 1964 was the turning point for trade between China and the Soviet Union. In that year, trade with Japan and Western Europe exceeded the Soviet share and by 1971, Western Europe and Japan together already blocked around half of the Chinese imports¹⁴¹. From those facts it becomes clear that even the focus of the general economic policy was rapid industrialization through self-reliance¹⁴², and thus China was not a completely closed economy around the 1960s¹⁴³.

Even though the Chinese economy was not to a 100 percent a closed economy, it has to be admitted that "Mao years of central planning and socialist experimentation held back economic development¹⁴⁴." After the Great Leap Forward and the Cultural Revolution were over, the Chinese economy was very underdeveloped, especially in the rural area. The agricultural population in China counted over 900 million¹⁴⁵. The living and working conditions in rural areas were serious topics for the Chinese leaders. Deng spent five years in France and one year in the Soviet Union. He acquired a far better understanding of developments in the western world than Mao. Deng had the chance to see industry and commerce in a developed country. And the year in the Soviet Union also gave him the possibility to see how the first socialist country had tackled modernization¹⁴⁶. Deng's special experiences did not only give him a clear picture about the economic development gap between capitalist and socialist countries, but also made clear what the necessary path for Chinese economic development was.

As a reformist leader, Deng concluded that economic development relied on foreign trade. 1978 was the turning point of China's economic development, since a reformist strategy was introduced and confirmed in November at the Third Plenary Session of the 11th Central Committee of the Chinese Communist Party. After China had launched this so-called "Re-

¹⁴¹ Bramall, Chris. *Chinese Economic Development*. London and New York: Routledge, 2009. P362.

¹⁴² Yin, Xiangshuo. "China's trade policy reforms and their impact on industry". Source: *China's Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P95.

¹⁴³ Bramall, Chris. *Chinese Economic Development*. London and New York: Routledge, 2009. P363

¹⁴⁴ Wall, David. *China As a Trade Partner: Threat or Opportunity for the OECD?* Source: International Affairs (Royal Institute of International Affairs 1944-), Vol. 72, No. 2, New Currents in Trade Policy Thinking (Apr., 1996), pp. 329-344. Published by: on behalf of the Wiley Royal Institute of International Affairs. Available at: <http://www.jstor.org/stable/2624359> . Accessed: 10/03/2015. P329.

¹⁴⁵ National Bureau of Statistics of China. Available at: www.stats.gov.cn. Accessed: 29/12/2012.

¹⁴⁶ Vogel, Ezra F. *Deng Xiaoping and the Transformation of China*. Cambridge, Massachusetts, and London. The Belknap Press of Harvard University Press, 2011. P5.

form and Open Door Policy”, Chinese foreign trade developed more rapidly than before. This overall economic reform started in rural areas with the Household/Contract Responsibility System, which will briefly be explained below and after more than 30 years of development, China’s rural economy grew rapidly and attracted worldwide attention. The “Reform and Open Door Policy” introduced two major changes in rural areas: Firstly, the Household/Contract Responsibility System ended up the countryside’s collectivization. It allowed peasants to work for themselves rather than for collective farms. The labor surplus of agriculture got freed and relieved from the limited land. Many people migrated from the poor, underdeveloped areas to the comparatively developed urban areas¹⁴⁷. Secondly, townships and villages were allowed to create small-sized enterprises, the so-called “Township and Village Enterprises” (TVEs)¹⁴⁸.

“The rate of profits is never increased by a better distribution of labour, by the invention of machinery, by the establishment of roads and canals, or by conveyance of goods. These are causes which operate on price, and never fail to be highly beneficial to consumers; since they enable them, with the same labour, or with the value of the produce of the same labour, to obtain in exchange a greater quantity of the commodity to which the improvement is applied; but they have no effect whatever on profit¹⁴⁹.”

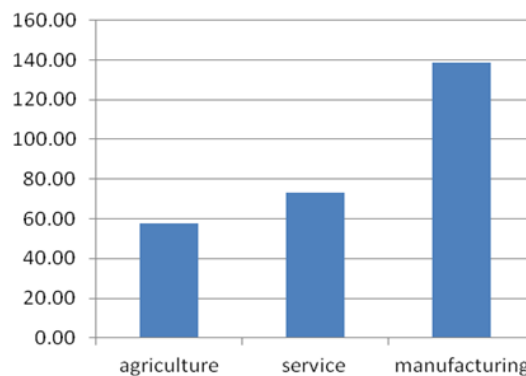
Richardo believes that foreign trade increases the amount and variety of products and an expansion of revenues. As shown in Figure 4, from the end of 1988 to 1995 in China, the gross product value in all three industries (agriculture, services and manufacturing) grew rapidly, especially that in the manufacturing industry.

¹⁴⁷ Further analyze in ZHAO Bo “From the development of township and village enterprises to see the transition of Chinese economic system”.

¹⁴⁸ Gregory, Paul R., and Robert C. Stuart. *Comparative Economic Systems*, Sixth Edition. Boston; Houghton, 1999. P258.

¹⁴⁹ Ricardo, David. *The Principles of Political Economy and Taxation*. Mineola, New York: Dover Publications, Inc., 2004. Originally published: London; New York: J.M. Dent & Sons, 1911. P81.

Figure 4. Growth of Percentage 1988 – 1995 in China ¹⁵⁰



TVEs in China also grew remarkably, with an annual average growth rate of 24.1 per cent during the period from 1985 to 1995. After surplus labor was released from the agricultural industry, TVEs absorbed 28.6 per cent of the total labor force in rural China in 1995. However, the labor shift from a traditional agricultural economy to a manufacturing industry increased the problem of income inequality¹⁵¹.

The development of TVEs in rural areas escalated the reform in urban areas. As one result the Chinese government chose to create Special Economic Zones (SEZs) as experimental areas, instead of modifying the economic policy all at once.

The Chinese Special Economic Zones (SEZs) were to be “laboratories” for experiments in market economics and political economy. “To old guard revolutionaries the market-based reforms, combined with the proposals to allow Chinese enterprises to collaborate with foreign firms, were anathema. The original plan to contain the experiments in the zones made the reforms more acceptable; and the location of the zones demonstrated that the initial intention at least was that the foreign collaboration would be sought among overseas Chinese in Hong Kong (Shenzhen), Macao (Zhuhai), the diaspora in South-East Asia (Shantou) and Taiwan (Xiamen). The initiative proved successful, particularly in Shenzhen¹⁵².”

¹⁵⁰ Li, Shi. Changes in income inequality in China’s transition. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar. 2002. P148

¹⁵¹ Ibid.

¹⁵² Wall, David. *China As a Trade Partner: Threat or Opportunity for the OECD?* Source: *International Affairs* (Royal Institute of International Affairs 1944-), Vol. 72, No. 2, *New Currents in Trade Policy Thinking* (Apr., 1996), pp. 329-344. Published by: on behalf of the Wiley Royal Institute of International Affairs. Available at: <http://www.jstor.org/stable/2624359> . Accessed: 10/03/2015.

Figure 5. China's Special Economic Zones¹⁵³



Under the highly centralized economy, all economic activities were followed according to a certain “Plan”. The law of demand and supply couldn’t be applied in the usual way. Market as the “invisible hand” controls economic activities. At the same time, the high command central economic policy could be seen as the “visible hand”. The role of the government was to establish the rules for the game¹⁵⁴. The development of TVEs could be seen as one of the main forces for the enterprise reform in China. The enterprise reform included the rapid development of non-state owned enterprises (like TVEs) and the reform of State Owned Enterprises (SOEs). And these two made up the core part of the Chinese economic reform. But foreign trade played an increasingly important role in Chinese economy. “Trade policy reforms have not only been an important component of the general economic reforms, but have also exerted a greater impact on China’s economic development, especially on the development of trade and industry¹⁵⁵.” Regarding the situation in China, the government needed to reestablish the rules for all players –including TVEs and SOEs. “The market and the government should complement and coordinate with each other to promote sustained and sound social and economic development¹⁵⁶.”

At the beginning of the reform era, imports and exports in China were still mainly under central administrative control and SOEs and TVEs, were both not given much autonomy.

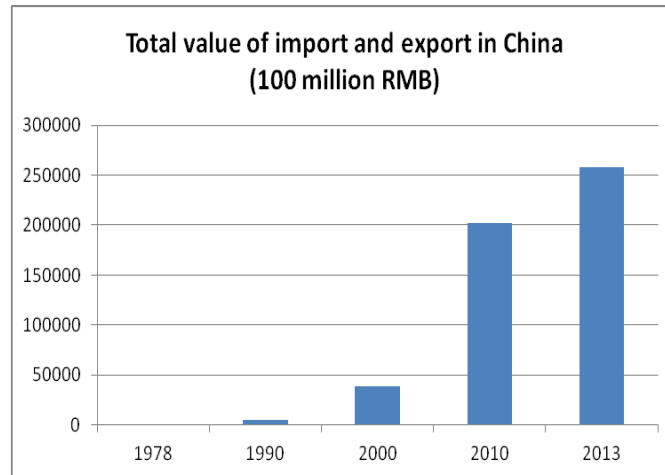
¹⁵³ BBC. *Quick guide: China's economic reform*. Available at: <http://news.bbc.co.uk/1/hi/world/asia-pacific/5237748.stm>. Accessed: 13/09/2015.

¹⁵⁴ Stiglitz, Joseph E. *The Price of Inequality: how today's divided society endangers our future*. New York and London: W.W. Norton & Company, 2012.

¹⁵⁵ Yin, Xiangshuo. “China’s trade policy reforms and their impact on industry”, source: *China’s Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P97

¹⁵⁶ Xi, Jinping. *The “Invisible Hand” and the “Visible Hand”*. Source: *The GOVERNANCE OF CHINA*. Beijing: Foreign Language Press, 2014.

Figure 6. Total value of Import and Export in China (100 million RMB)¹⁵⁷



The Chinese total value of import and export in 1978 was only 35.5 billion RMB. In the late 1980s, the central government decided to extend the reform to the sphere of foreign trade¹⁵⁸. In December 2001, after 15 years of negotiation, China officially became the 143rd member of the WTO¹⁵⁹.

Entering the WTO was the most important and strategic decision made by the Chinese government in terms of Chinese economic development. After that, China became one of the global top traders. At the same time, China started its legalization process to meet the requirements for joining the WTO. Regarding the accession to the WTO, the Chinese government not only played an important role for rule-making internally, but also for rebuilding the regulations for activities outside of China. The government regulated domestic economic activities in order for Chinese enterprises to be more competitive on the global market. By the end of 2001, China had revised more than 2000 laws and regulations.

China's accession to the WTO will help to strengthen and improve the multilateral trading system, promote world economic and trade development, and establish a new, open and just international economic order. Furthermore, WTO accession has largely contributed to reduc-

¹⁵⁷ Chinese Statistical Year Book. Available at: <http://www.stats.gov.cn>. Accessed: 02/05/2015.

¹⁵⁸ Yin, Xiangshuo. "China's trade policy reforms and their impact on industry", source: *China's Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P102

¹⁵⁹ World Trade Organization official website. Available at: www.wto.org. Accessed: 03/05/2016

ing the technological gap between China and developed countries as it provided domestic industries with increasing access to foreign equipment and leading technology¹⁶⁰.

The following part will be divided into three subchapters. First, international trade, technology spillover and the utility of FDI in China will be discussed. Secondly, the regional and income inequality after China had launched the “Reform and Open Door” policy will be presented. At last, institutional advancement in the post-reform era, especially after China’s accession the WTO in 2001 will be examined.

3.1 Technology Spillover and FDI

After the PRC was founded, the development of science and technology was strongly connected with politics. Similar as in the Soviet Union, Chinese science and technology policy focused on the heavy and military industries. Customized industries were underdeveloped for decades. In order to distribute the customized products fairly, all kinds of tickets became the combined or second currency for daily life of purchasing. In the early 1960s, the diplomatic relationship worsened between China and the Soviet Union. China had no alternative partners and very little possibilities of access to new technology, and was forced to face technological autarky till the mid-1970s. Limited improvements were made on the Soviet-legacy technologies. The gap between China and the world was getting wider and wider. “Anxiety over the widening technology gap was a major motivating force for China’s opening¹⁶¹.”

Before 1978, publicly owned enterprises (SOEs or collectively owned enterprises) were the only kind of legal enterprises in China. And according to the socialist system, the bureaucracy is the state, the owner, and the manager of the enterprises all at once. The whole country was seen as “the state syndicate”. Every citizen worked in this huge firm as an employee¹⁶². The *Hukou* system (household registration system) controlled the status and location of a person. Market, free trade, competition – those words were seen as the symbols of capitalism – and were thus not acceptable in China. Maximizing the profit was not the top priority for enterprises, but ensuring everyone’s job was important. Also, with the socialist planned economy, the target for SOEs was to fulfill the economic plan. Since almost everything was done according to the plan, enterprises had nothing to worry about even if they made losses, and they

¹⁶⁰ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010. P6-7.

¹⁶¹ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P355.

¹⁶² Wu, Jinglian. *Understanding and Interpreting China’s Economic Reform*. 当代中国经济改革教程 (In Chinese). Shanghai: Yuandong Press, 2010. P15.

had little incentives to raise efficiency and productivity¹⁶³. Under that situation, there was less demand for technology and productivity updating.

After China had launched the “Reform and Open Door” policy, China has been participating more actively in the world market. Chinese enterprises (including SOEs and TVEs) have taken more responsibility for their own losses and profits¹⁶⁴. “Foreign trade policy in China is regarded as supplementary to industrial policy. One of its major objectives is to stimulate the upgrading of technology and the development of new industries¹⁶⁵.” In order to achieve international quality standards, enterprises now upgrade their technology and thus improve productivity.

In 1999, the former Ministry of Foreign Trade and the Ministry of Science and Technology of China, and other departments in the government proposed the strategy of “Trade Vitalization through Science and Technology”. One of the core strategy was to vigorously promote the utility of high-tech products and high technology to transform traditional industries; that enclosed optimizing the export commodity structure, improving the quality of export commodities, quality and additional value, and enhancing the international competitiveness of Chinese products¹⁶⁶.

The strategy of “Trade Vitalization through Science and Technology” increased in importance from a ministerial program to a national strategy gradually. Through the common efforts made by the government and all sectors of society, the work of “Trade Vitalization through Science and Technology” made remarkable achievements. The government support for high-tech exports and the establishment of a favorable environment for high-tech industries enabled China to achieve a rapid development of technology¹⁶⁷.

According to Jammes technical progress has a dual impact on growth: on one hand it acts directly on the production function by raising the productivity of other inputs. On the other hand, it acts indirectly, by making new capital investment opportunities possible through in-

¹⁶³ Yin, Xiangshuo. “*China’s trade policy reforms and their impact on industry*”, source: *China’s Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P138.

¹⁶⁴ Further analyzed in ZHAO Bo “From the development of township and village enterprises to see the transition of Chinese economic system”.

¹⁶⁵ Yin, Xiangshuo. “*China’s trade policy reforms and their impact on industry*”, source: *China’s Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P124.

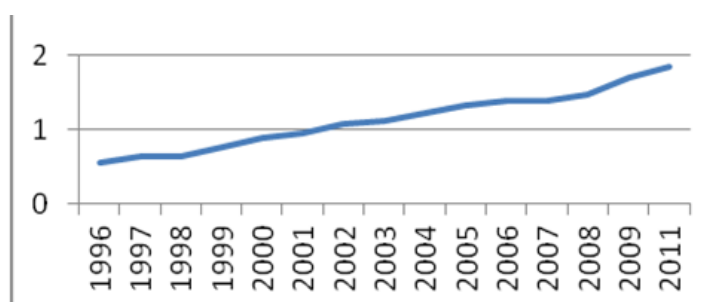
¹⁶⁶ 科技兴贸信息网 “Trade Vitalization through Science and Technology” official website: www.kjxm.org.cn

¹⁶⁷ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010. P6.

creasing marginal productivity¹⁶⁸. New advanced technology requires well-educated labor. Not only the technical engineers must be trained to use new equipment, but also the front line workers who are in charge of production must receive the certain training in order to improve productivity and product quality. At the same time, managerial staff has to learn new management skills and marketing standards. “Types of training range from learning by doing, through seminars, to formal overseas training sessions with the parent company according to the capabilities required¹⁶⁹.”

As this paper has mentioned previously, a country can increase the productivity of its own resources by imports of middle-level products and equipment. The communication channel will also open by trade activities, and then foreign technologies can be introduced to the host countries. At last, the foreign technology expansion will positively affect the host country’s own R&D. Low- and lower-middle-income countries focus more on the identification and adaption of foreign technologies from abroad. Their R&D/GDP ratio is relatively low, typically less than 1 per cent. That number usually rises when the economy develops. The Chinese R&D/GDP ratio was under 1 per cent before 2001, and increased close to 2 per cent in 2011 as can be seen from Figure 7 below.

Figure 7. Research and Development Expenditure in China (Percentage of GDP)¹⁷⁰.



FDI, as a combination of capital and advanced technology, as well as new managerial and updated marketing skills, was quite important and necessary for China¹⁷¹. In 1979, China’s Foreign Joint Venture Law encouraged foreign investment in China; it effectively ended the

¹⁶⁸ Jammes, Olivier. *Foreign direct investment, human capital and catching up: the Chinese case*. Source: China and its Regions: Economic Growth and Reform in Chinese Provinces. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar. 2002. P226-227.229.

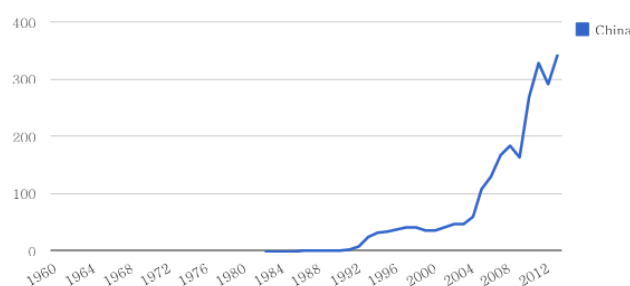
¹⁶⁹ Ibid.

¹⁷⁰ In the year of 2011, data from Chinese Statistical Year Book 2012. From 1996-2009, data from World Bank Data Base: <http://data.worldbank.org>

¹⁷¹ Tong, Sarah Y, and Hu, Youxin. “*Productivity Spillovers from FDI: Detrimental or Beneficial?*”, source: “*Market Development in China: Spillovers, Growth and inequality*”, edited by Fleisher, Belton; Li, Haizheng and Song, Shunfeng. Cheltenham and Northampton: Edward Elgar, 2007. P190.

three decades of being isolated. “The main characteristic of the general trend regarding inflows of FDI to China between 1979 and 1995 is its tremendous rate of growth. This phenomenon is one of the more impressive consequences of the course change decided by the Chinese authorities, from a planned and introverted policy to a market economy open to the rest of the world.¹⁷²” Thus, in less than 20 years, China has become the first destination for FDI among developing countries, and the second largest recipient in the world after the USA.

Figure 8. China Foreign Direct Investment (Billion USD)¹⁷³.



Meanwhile, China has approved a total of over 300 thousand foreign invested projects and actually used an accumulated fund of US\$ 221.9 billion. Foreign funded enterprises (FFE) provided over 17 million jobs, and contributed to 47 per cent of the national total foreign trade¹⁷⁴.

One of the most important tasks for Chinese SEZs is to attract foreign investment to China. Investors from Hong Kong and Taiwan moved in first; investors from developed countries followed close behind. Incoming FDI grew steadily through the 1980s and made important changes in Guangdong and Fujian provinces. At the same time, FDI inflows were also large enough to make a fundamental transformation of the Chinese economy. FDI introduced a bundle of managerial and marketing skills, advanced technology, together with the basic inflow of other resources. After 1992, around sixty percent of the increment to Chinese exports came from foreign-invested enterprises. FDI played an important role in technology transfer, trade expansion, and industrial growth¹⁷⁵.

¹⁷² Jammes, Olivier. *Foreign direct investment, human capital and catching up: the Chinese case*. Source: China and its Regions: Economic Growth and Reform in Chinese Provinces. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P222-223.

¹⁷³ Global Economy. Available at: www.theglobaleconomy.com. Accessed: 21/09/2013.

¹⁷⁴ Yang, Qiumei. *The regional distribution of foreign direct investment in China: the impact of human capital*. Source: China and its Regions: Economic Growth and Reform in Chinese Provinces. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar. 2002. P198.

¹⁷⁵ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P402-406.

Further sectors could also be seen as the reasons that encourage FDI in China. Firstly, the “Reform and Open Door Policy” brought rapid growth in the Chinese economy, and also raised the income level. As the law of demand and supply has been working more effectively, the Chinese market has been showing a growing demand for various kinds of products, especially different products produced by the FFEs. Secondly, as surplus labor was released from the agriculture industry, cheap labor became the comparative advantage for China. That attracted foreign companies who began investing in China. Thirdly, as this paper mentioned previously, “the Chinese Special Economic Zones were to be ‘laboratories’ for experiments in market economics and political economy. To old guard revolutionaries the market-based reforms, combined with the proposals to allow Chinese enterprises to collaborate with foreign firms, were anathema. The original plan to contain the experiments in the zones made the reforms more acceptable¹⁷⁶.” The special locations for the established SEZs attract foreign investors within these regions, referencing the success experiences. Along the south-eastern coast, China opened more cities with a more opened economic policy.

For historic and geographic reasons, the Chinese economy did not develop in an equal manner. Different economic policies create the inequality of income level. And high income attracts well-educated human capital migrating to more developed regions. FDI inflows to a certain region in China are positively related to the level of human capital development, size of market and growth of the private sector. Human capital is the main reason of the development of technology and the development of the economy. In less developed regions, a low level of human capital affects production by reducing the productivity of individual workers internally. “Thus the difference in human capital among regions helps to explain the unbalanced regional pattern of FDI in China¹⁷⁷.”

While the regions on the south-eastern coast have attracted the majority of FDI inflows into China, the inland, which is less populated, was left far behind. In order for the western and central regions to attract foreign investment, to achieve a balance of FDI distribution, to attract a higher level of educated human capital, Chinese local governments need to implement their local economic policies on competitive terms. However, normal workers and well-educated human capital continue to migrate to the regions where they are provided higher payments. Increased FDI has brought highly-paid jobs to better qualified workers¹⁷⁸.

¹⁷⁶ Wall, David. *China As a Trade Partner: Threat or Opportunity for the OECD?* Source: International Affairs (Royal Institute of International Affairs 1944-), Vol. 72, No. 2, New Currents in Trade Policy Thinking (Apr., 1996), pp. 329-344. Published by: on behalf of the Wiley Royal Institute of International Affairs. Available at: <http://www.jstor.org/stable/2624359> . Accessed: 10/03/2015.

¹⁷⁷ Yang, Qiumei. *The regional distribution of foreign direct investment in China: the impact of human capital*. Source: China and its Regions: Economic Growth and Reform in Chinese Provinces. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P198.

¹⁷⁸ Ibid. P218.

However, the majority flowed into the coastal provinces, which are the more developed areas. Generally speaking, over the past three decades, China's "Reform and Open Door Policy" has attracted a huge amount of FDI. The export-oriented FDI spread quickly in the labor-intensive manufacturing industries. And the majority of FDI flowed to the more developed regions on the coast.

3.2 Income Inequality

Income inequality is a common phenomenon all over the world. "Half the world's production fits onto 1.5 per cent of its land. North America, the European Union, and Japan- with fewer than a billion people – account for three-quarters of the world's wealth¹⁷⁹." Not everyone benefits from trade liberalization. Instead, it creates winners and losers at the same time. The ideal scenario is that trade and trade liberalization will be overall beneficial, but in reality, it seldom occurs. International trade together with worldwide competition increasingly lack fairness¹⁸⁰. China is one of the largest countries in the world, but the major part consists of mountains, hills, and high plateaus, divided by river valleys, plains and basins. China historically was a nation of agriculture, but only a small proportion of the land was arable. The inequalities mainly exist between coastal and non-coastal areas, as well as between urban and rural areas. For political and historical reasons, different parts of China developed with great inequality¹⁸¹.

After the PRC was founded in 1949, in order to finance the expansion of industry, the state induced an unequal exchange between the agricultural and industrial sectors. At the same time, it also took up the responsibility of providing jobs, related welfare, and food for all urban residents in the priority urban-industrial sector, while leaving the rest of the population largely outside of state support. The *Hukou* system was an effective mechanism to block free flows of resources between urban and rural areas and between manufacturing and agriculture industries. And also, the highly-centralized economic system blocked free flows of resources, e.g. raw materials. Until the late 1970s, compared to urban areas, rural China maintained this artificial imbalance under the condition of a dual economy¹⁸².

¹⁷⁹ World Bank, World Development Report 2009: Reshaping Economic Geography. Washington D.C., 2009. Pxiii.

¹⁸⁰ Stiglitz, Joseph E. and Charlton, Andrew. *Fair Trade For All: How Trade Can Promote Development*. Oxford, New York: Oxford University Press, 2005.

¹⁸¹ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006.

¹⁸² Kam Wing Chan and Li Zhang. "The Hukou System and Rural- Urban Migration in China: Processes and Changes." *The China Quarterly*, No. 160 (Dec., 1999), pp. 818-855. Available at: <http://www.jstor.org/stable/656045>. Accessed: 09/12/2012. P820.

“The Chinese term shuangguizhi (dual-track system) refers to the coexistence of a traditional plan and a market channel for the allocation of a given good. Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities (in the Chinese case, primarily investment in energy and infrastructure). The dual track implied a two-tier pricing system for most goods: a single commodity had both a (typically low) state-set planned price and a (typically higher) market price¹⁸³.”

The reform policy made two major changes in rural regions: Firstly, the Household Responsibility System (contract responsibility system) ended up the collectivization on the countryside. It allowed peasants to work for themselves rather than for collective farms. The labor surplus of agriculture got freed from the limited land. Many people migrated from the poor, underdeveloped areas to the comparatively developed urban areas¹⁸⁴. Secondly, from the late 1970s till the mid-1980s, townships and villages were allowed to create the so-called “Township and Village Enterprises”¹⁸⁵. The rural household income was growing more rapidly than in urban areas. But after 1984, income growth in rural areas became slower than in the urban areas. The rural-urban income gap began to enlarge again. At the same time, as economic growth in the southeast coastal areas grew more rapidly than in the inland provinces, income inequality among the regions also rose¹⁸⁶.

“This is a hopeful development that has significant policy implications. Policy makers should realize that growth in this region is the most promising in terms of moving large numbers of people out of absolute poverty. The central government can foster some infrastructure creation in this region, even though parts of it are coastal, and they are not the poorest parts of the country. Lacking a major urban center these regions are nonetheless gradually being brought within the orbit of expanding metropolitan economies along the coast. It is most likely that this kind of gradual spread is the spatial process that will bring most of China into the scope of a modern economy¹⁸⁷.”

¹⁸³ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P91-92

¹⁸⁴ Further analyze in ZHAO Bo “From the development of township and village enterprises to see the transition of Chinese economic system”.

¹⁸⁵ Gregory, Paul R., and Robert C. Stuart. *Comparative Economic Systems*, Sixth Edition. Boston; Houghton, 1999. P258.

¹⁸⁶ Zhai, Fan and Li, Shantong. *The impact of WTO accession on income disparity in China*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar. 2002. P121-122.

¹⁸⁷ Naughton, Barry. *Provincial economic growth in China: causes and consequences of regional differentiation*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by: Mary-Francoise Renard. Cheltenham, Northampton. Edward Elgar, 2002. P80, 83.

According to the National Bureau of Statistics of China, Chinese provinces would be divided into four parts based on locations and economic development¹⁸⁸. The eastern region, which refers to the eastern coastal area, comprising 10 provinces, such as Beijing, Shanghai, Guangdong. The central region refers to 6 provinces such as Henan and Anhui. The northeastern region refers to Liaoning, Jilin and Heilongjiang. The western region refers to 12 provinces, including e.g. Xinjiang and Gansu. This region occupies more than 70 percent of the territory, but only has less than 30 percent of the national population¹⁸⁹. Due to the favorable geographical conditions and historic reasons, “[E]conomic transition in China has a very clear regional dimension as reforms were first institutionalized in the coastal provinces¹⁹⁰.” The eastern region is endowed with more developed technology, infrastructure, and a much higher level of educated labor force. It keeps the highest number in both GDP per capita and trade per capita. All of these elements help the coastal provinces to attract a disproportionately large share of foreign investment, which also led to rapid economic growth. Accompanying rapid economic growth, the income level has increased as well. However, the household income gap has widened sharply. “The conflict between economic efficiency and income equality has long been recognized in economics¹⁹¹.”

¹⁸⁸ National Bureau of Statistics China. Available at: http://www.stats.gov.cn/tjzs/t20110613_402731597.htm . Accessed: 11/09/2013. Taiwan, Hong Kong, Macau were not included, see National Bureau of Statistics China.

¹⁸⁹ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010. P10. National Bureau of Statistics China. Available at: http://www.stats.gov.cn/tjzs/t20110613_402731597.htm . Accessed: 11/09/2013.

¹⁹⁰ Li, Shi. *Changes in income inequality in China's transition*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P150.

¹⁹¹ Zhai, Fan and Li, Shantong. *The impact of WTO accession on income disparity in China*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P122.

Figure 9. Political Map of China¹⁹²



As Krugman discusses in his “International Economics”, international trade does not only refer to the movement of goods and services, it also refers to the movements of other factors. Factor movements include three aspects: firstly, labor migration; secondly, international capital transfer; and thirdly, international connection got more involved into the multinational corporations¹⁹³. For many reasons, the level of economic development is unequal in different regions/countries. Some regions have an advanced technology and productivity; some have cheap labor or rich raw materials. International trade activities reallocated all of those factors for manufacturing activities.

“It is far from certain that the temporality and benign implications of any potential growth in regional disparities resulting from changes in trade patterns will materialize. In particular, in cases where increasing polarization takes place during periods of low growth – meaning that not all regions within a country end up better off than before changes in trade patterns took

¹⁹² Political Map of China. Available at: <http://www.mapsofworld.com/china/china-political-map.html>. Accessed: 24/02/2016.

¹⁹³ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy*, seventh edition. Boston, San Francisco: Pearson Addison Wesley, 2006. P147.

place – in cases when trade widens an already wide gap between rich and poor regions, and in cases when new territorial inequalities resulting from trade reinforce pre-existing social, political, cultural, or ethnic divides, the rise in inequalities may not just be a temporary stage, but one that becomes entrenched¹⁹⁴.”

Before 1979, Chinese central government policy had highly influenced the provincial output for around three decades. After 1979 the principle of the reform is unraveling the planned economy, and at the same time formatting the market economy. The northeastern regions used to be the Chinese industrial basements. And this region used to be the most competitive and developed part of China. In the late 1970s, Special Economic Zones got established in southern China. Those zones became a symbol of the government’s commitment to external liberalization. The SEZs “were regions in which foreign investment was encouraged by lower tax rates, fewer and simplified administrative and customs procedures, and, most crucially, duty-free import of components and supplies¹⁹⁵.” Shenzhen SEZ was the early pioneer of both flexible wage systems and tender bidding for construction projects. Especially SEZ governments have unusually high levels of autonomic administrations. Those SEZs are all located in coastal areas, which increased the inequality between eastern regions and the western part of China¹⁹⁶.

After 1979, comparatively the northern together with the western part of China lost competitiveness in the manufacturing industry. As the reform is targeting to set up the socialist market economy mechanisms, northern China had to suffer the collapse of the old planned economic system which was being supported by the state. And at the same time, these regions failed to benefit from the developing opportunities which were created by marketization¹⁹⁷.

“In accordance with the theoretical model, the international openness of China, measured by its exports, increases the specialization of the regions. This leads us to believe that with international openness, the regions were encouraged to exploit economies of scale and are thus incited to specialize. Economic activity, captured by per capita GDP, is linked negatively to specialization. This means that regions with a high per capita GDP will be less likely to specialize. On the other hand, foreign direct investment does not have a significant influence on regional specialization. With regard to this, investment is, for the most part localized in the coastal regions, mainly because of the advantages given to the Special Economic Zones. It is

¹⁹⁴ World Bank, Policy Research Working Paper 5347: Trade and Regional inequality, Washington D. C., 2010. P3.

¹⁹⁵ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. P406.

¹⁹⁶ Ibid. P407.

¹⁹⁷ Naughton, Barry. *Provincial economic growth in China: causes and consequences of regional differentiation*. Source: China and its Regions: Economic Growth and Reform in Chinese Provinces. Edited by: Mary-Francoise Renard. Cheltenham, Northampton. Edward Elgar, 2002. P83.

not the result of the exploitation of economies of scale, but rather the result of deliberate policy from the central government¹⁹⁸.”

As this paper has discussed previously, David Ricardo’s “Comparative Advantages Theory” is the foundation of international trade. Within China, the eastern regions have the comparative advantages of labor, capital and technology; western regions have the comparative advantages of land and resources. As the HO theory and Krugman argued, trade activities are the reallocation of all the factors. So the eastern regions will produce more capital intensive goods, and the western regions will offer more primary products.

By 1995, all the richest provinces were coastal, while the poorest provinces are now all inland regions. Moreover, the process of coastal differentiation is now consolidating and accelerating. Already high income, the coastal provinces now have the highest investment rates and the highest growth rates. In essence, two trends relating to the dissolution of the redistributive system contributed to across the board convergence. The first of these was the end of the redistributive price system, which led to new relative prices that favored agricultural provinces and reduced regional inequality. The second was the reversion of artificial economies that had been sustained by central government investment¹⁹⁹.

From the data of the Chinese Statistical Yearbook, the composition of exports of primary goods blocked 25.6 per cent (1990), 10.2 per cent (2000) and 5.3 per cent (2011) of the total export value. But the manufactured goods blocked 74.4 per cent (1990), 89.8 per cent (2000) and 94.7 per cent (2011). Those data show that Chinese exports are more dependent on manufactured goods. In 2011, the eastern provinces’ GDP just as the percentage of the national total reached 52 percent; the western provinces’ GDP was only at 19.2 percent. Regarding the total value of import and export, the eastern provinces occupied 86.2 percent; that number for western provinces was only at 5 percent²⁰⁰. A comparatively more rapidly rising ratio of manufactured goods in the international market and low exports of primary products²⁰¹ probably is one of the reasons of regional income inequality in China.

¹⁹⁸ Brun, Jean-Francois and Renard, Mary-Francoise. *International trade and regional specialization in China*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by: Mary-Francoise Renard. Cheltenham, Northampton. Edward Elgar, 2002. P96.

¹⁹⁹ Naughton, Barry. *Provincial economic growth in China: causes and consequences of regional differentiation*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by: Mary-Francoise Renard. Cheltenham, Northampton. Edward Elgar, 2002. P80, 83.

²⁰⁰ 中国统计年鉴 Chinese Statistical Year Book 2012

²⁰¹ Primary products definition: Available at: <http://www.economicshelp.org/blog/2599/agriculture/primary-products-2/>. Accessed: 24/02/2016. Primary products are goods that are available from cultivating raw materials without a manufacturing process. Significant primary product industries include agriculture, fishing, mining, and forestry.

Figure 10. Composition of Exports (Primary and Manufactured Products)²⁰²

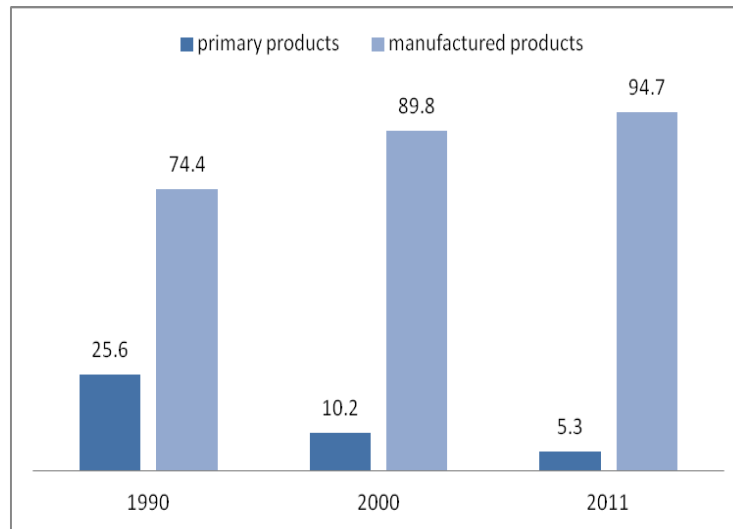
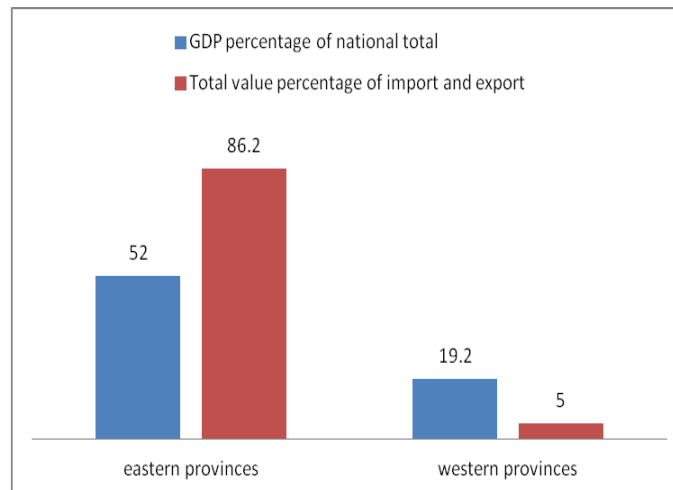


Figure 11. Comparison of Eastern and Western Provinces (Percentage of GDP and Total Value of Import and Export 2011)²⁰³



Since 2000, 17 of the national ETDZs were established in inner China. And at the same time, China had launched the “Grand Western Development Strategy” or “Western Development Program”²⁰⁴. As this paper has discussed previously, international trade has a positive effect on economic growth. This strategy raises state investments, experiences, foreign capital and also international trade more to the western and less-developed regions. The non-coastal areas of China will thus achieve higher openness and will be able to benefit more from the national

²⁰²中国统计年鉴 Chinese Statistical Year Book 2012

²⁰³Ibid.

²⁰⁴ Naughton, Barry. *The Chinese Economy, Transition and Growth*. Cambridge: The MIT Press, 2006. Sun, Peng and Heshmati, Almas. “International Trade and Its Effects on Economic Growth in China”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010.

“Reform and Open Door” policy²⁰⁵. The western regions had achieved certain development rate. But from Figure 11, one can see that in 2012, the GDP percentage together with total value of import and export in the western regions comparatively are quite low.

3.3 Institutional Advancement

Social connection is one of the most important factors for human society. No individual could live without the others. Where there is a society, there is law²⁰⁶. After all the work being divided and different products being produced by different people, it objectively created the necessities for people to trade their goods and that also create the necessities for fairness.

In any society the actions of one person may hurt or benefit others. Economists refer to these effects as externalities. When those who injure others don’t have to bear the full consequences of their actions, they will have inadequate incentives not to injure them, and to take precautions to avoid risks of injury. There are laws to provide incentives for each person to avoid injuring others – their property, their health, and public goods (such as nature) that they enjoy²⁰⁷.

International trade not only facilitates the trading of goods and services, but also ideas on market mechanisms. It leads to robust institutional changes. Developing countries are learning to apply market power more efficiently with less intervention from the government in order to increase openness. Especially in bilateral and multilateral trade, participants should fulfill their commitments to international rules and regulations to bridge the gap between themselves and developed countries²⁰⁸. Anderson and Marcouiller argue that trade expands dramatically when it is supported by better institutions. They believe that when government economic policies need to be impartial and transparent, the legal system also has to be effective in enforcing commercial contracts²⁰⁹. Levchenko also discusses the connection between institutional quality and international trade. He argues that the institution refers to contract enforcement, property rights, investor protection, the political system, etc. He believes better institutions

²⁰⁵ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010. P27.

²⁰⁶ Kim, Chan Jin. *Economic Development and Law in Korea*. Seoul: THE CATHOLIC UNIVERSITY OF KOREA PRESS, 2009.P20.

²⁰⁷ Stiglitz, Joseph E. *The Price of Inequality: how today’s divided society endangers our future*. New York and London: W.W. Norton & Company, 2012.P188.

²⁰⁸ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010.

²⁰⁹ Anderson, James E. and Marcouiller, Douglas. *Insecurity and the Pattern of Trade: An Empirical Investigation*, Source: The Review of Economics and Statistics, Vol. 84, No. 2 (May, 2002), pp. 342-352, Published by: The MIT Press. Available at: <http://www.jstor.org/stable/3211782>. Accessed: 10/09/2013. P342 &346.

indeveloped countries have comparative advantages, and in countries with worse institutions contracts are more incomplete²¹⁰. “A country with high institutional quality is more likely to have better enforcement of the rule of law, thus ensuring a freer, fairer and more competitive market. Improvements in institutional quality help improve the quality of exportable goods and reduce trade costs²¹¹.”

Anderson, Marcouiller and Levchenko all believe that the high quality of institutions in developed countries was the reason that transactions costs could be reduced. In the current age, trade expands so fast and not only happens among developed countries, but underdeveloped countries are also involved. The world needs a global platform for all the international trade activities²¹².

In 1949, mainland China was successfully unified by the Chinese Communist Party, and the PRC was founded as a socialist country. “There was widespread agreement – in developed and developing countries alike – that the state should play a major role in economic activity, not only in affecting aggregate demand, but also in regulating private markets and indeed augmenting or supplanting them with state-owned enterprise production of manufactured and other goods²¹³.” The old economic system was being restructured by the Chinese government into a socialist economic system based on public ownership under a planned economy. In the three decades afterwards, the Chinese communist government tried to safeguard and build the country with orthodox Marxism both economically and politically. During this period, the laws and regulations were reduced only to support the government to govern the country. And Chinese people were deeply suffered by the class struggle. “This period of time was usually labeled as the ‘rule of man’²¹⁴.” After 1978, China transited from a comparatively closed dominantly self-sufficient planned economy to an open, industrialized and commercialized market economy. Firstly, the new economic environment set up the requirements for the insti-

²¹⁰ Levchenko, Andrei A. *Institutional Quality and International Trade*. Source: The Review of Economic Studies, Vol. 74, No. 3 (Jul., 2007), pp. 791-819. Published by: Oxford University Press. Available at: <http://www.jstor.org/stable/4626161>. Accessed: 28/06/2013.

²¹¹ Yu, Miaojie. *China's foreign trade, WTO accession and institutional quality*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P124.

²¹² Anderson, James E. and Marcouiller, Douglas. *Insecurity and the Pattern of Trade: An Empirical Investigation*, Source: The Review of Economics and Statistics, Vol. 84, No. 2 (May, 2002), pp. 342-352, Published by: The MIT Press. Available at: <http://www.jstor.org/stable/3211782>. Accessed: 10/09/2013. P342 & 346; Levchenko, Andrei A. *Institutional Quality and International Trade*. Source: The Review of Economic Studies, Vol. 74, No. 3 (Jul., 2007), pp. 791-819. Published by: Oxford University Press. Available at: <http://www.jstor.org/stable/4626161>. Accessed: 28/06/2013.

²¹³ Krueger, Anne O. *Policy and Economic Development: How We Learn*. Source: The American Economic Review, Vol. 87, No. 1 (Mar., 1997), pp. 1-22. Published by: American Economic Association. Available at: <http://www.jstor.org/stable/2950851>. Accessed: 28/03/2015.

²¹⁴ Liang, Bin. *The Changing Chinese Legal System, 1978-Present: Centralization of Power and Rationalization of the Legal System*. New York. Routledge-Taylor and Francis, 2008. P1.

tutional advancement. As the economic structure worked towards a capitalist model, a more effective legal system was urgently required for enterprises, the government and citizens to adjust their new economic relationships. Secondly, from 1978 until the middle of the 1990s, non-public-owned enterprises developed in a very unhealthy atmosphere. The old planning institutions still existed, but the new market-supporting system has not been successfully built up²¹⁵. In Deng Xiaoping's *Southern Tour* theory, for liberating China's productive forces, market became the key mechanism. And by liberating the productivity forces, it sought to change the political and economic structure in order to reach higher levels of development. But, "liberating the productive forces requires the re-examination of the society's structure of interests, and that would be followed by a new understanding of ownership and distribution²¹⁶." Deng Xiaoping clearly realized how miserable China could be without an effective legal system²¹⁷.

"To ensure democracy for the people, the legal system must be strengthened. Democracy has to be institutionalized and framed into laws, so as to make sure that institutions and laws do not change even if the leadership changes, or whenever the leaders change their views or shift the focus of their attention. An important issue now is that the Chinese legal system is incomplete, with many laws yet to be enacted²¹⁸".

In 1999, "Article 5 of the Chinese constitution was amended to include the principle of governing the country according to law and establishing a socialist, rule of law country²¹⁹." For the market to work well, certain rules are needed for business partners to sign their fair contracts and also abide by them²²⁰. A set of new laws will have to be passed, including bankruptcy laws, accounting laws and banking laws. Following the legislative phase, all these laws should be consistently enforced. The English version of trade law was published in 1994. Ac-

²¹⁵ Potter, Pitman B. "The Legal Implications of China's Accession to the WTO". Source: The China Quarterly, No. 167 (Sep., 2001), pp. 592-609, Published by: Cambridge University Press on behalf of the School of Oriental and African Studies. Available at: <http://www.jstor.org/stable/3451062>. Accessed: 01/09/2013.

²¹⁶ Keith, Ronald C. and Lin, Zhiqiu. *Law and Justice in China's New Marketplace*. New York: Palgrave, 2001.P7.

²¹⁷ Carlos, W. H. Lo. *Deng Xiaoping's Ideas on Law: China on the Threshold of a Legal Order*. Source: Asian Survey, Vol. 32, No. 7 (Jul., 1992), Published by: University of California Press Stable, pp. 649-665. Available at <http://www.jstor.org/stable/2644947>. Accessed: 28/03/2013.

²¹⁸ Deng, Xiaoping. *Emancipate the Mind; Seek Truth from Facts and Unite as One in Looking to the Future (1978), Selected works of Deng Xiaoping, Volume II, 1975-1982*. Available at: <http://english.peopledaily.com.cn/dengxp/vol2/text/b1260.html>. Accessed: 04/04/2013.

²¹⁹ Qian, Yingyi and Wu, Jinglian. *China's Transition to a Market Economy: How Far across the River?* Stanford University Center for Research on Economic Development and Policy Reform, Working Paper No. 69, September 2000. Available at <http://211.71.86.12/uploadfile/teacher/rwlj/teachingplan/200709/1095302320749.pdf>. Accessed: 09/03/2013. P509.

²²⁰ Kornai, Janos. *The Socialist System: The Political Economy of Communism*. New Jersey: Princeton University Press, 1992.

according to former Minister at the Ministry of Foreign Trade and Economic Cooperation, Wu Yi, China was committed to continuing to improve the investment environment and to create conditions to let foreign investors enjoy national treatment²²¹.

Before the WTO was established in 1995, the international regulation of international trade was essentially structured within the GATT. China was one of 23 original signatories to GATT. For political and economic reasons, the Chinese government withdrew from GATT in the 1950s²²². After 1978, the significant economic development required China to participate more in global trade activities. China's accession to WTO was probably the most important strategic decision Beijing made during the reform era. "China's WTO membership signifies China's full integration into the global economy from the position of a previously isolated and planned economy²²³."

"The WTO working party's final report on the accession of China, tabled at the Fourth Session of the WTO Ministerial Conference in Doha in November 2001 and using records from the 14 years since 1987, revealed the extent of the concern over numerous apparent conflicts and inconsistencies between Chinese trade policy and regulatory practice and GATT/WTO standards²²⁴."

"Membership of the WTO serves as an admission ticket for China to the global economic system, into which it can integrate and reap the benefits that come from being a WTO member state²²⁵." It requires Chinese enterprises to join the global market competition with international economic laws²²⁶. Setting up a socialist market economic system has been the target for the Chinese government. The share of public owned enterprises was shrinking in many aspects after 1978. Such as the number of enterprises and employees, gross output values and

²²¹ Yin, Xiangshuo. "China's trade policy reforms and their impact on industry". Source: *China's Opening Door*. Authors: Wall, David; Jiang, Boke and Yin, Xiangshuo. London. The Royal Institute of International Affairs, 1996. P108.

²²² Lardy, Nicholas R. *China in the World Economy*. Washington, DC: Institute for International Economics, 1994. P45.

²²³ Liang, Wei. *Bureaucratic politics, interministerial coordination and China's GATT/WTO accession negotiations*. Source: *China's Foreign Trade Policy: The new constituencies*. Edited by: Ka Zeng. New York: Routledge, 2007. P20.

²²⁴ Potter, Pitman B. *China and the International Legal System: Challenges of Participation*. Source: *The China Quarterly*, No. 191, *China's Legal System: New Developments, New Challenges* (Sep., 2007), pp. 699-715. Published by: on behalf of the Cambridge University Press School of Oriental and African Studies. Available at: <http://www.jstor.org/stable/20192815>. Accessed: 10/03/2015. P703.

²²⁵ Yu, Miaojie. *China's foreign trade, WTO accession and institutional quality*. Source: *International Institutions and Asian Development*. London and New York: Routledge, 2011. P124.

²²⁶ Qian, Yingyi and Wu, Jinglian. *China's Transition to a Market Economy: How Far across the River?* Stanford University Center for Research on Economic Development and Policy Reform, Working Paper No. 69, September 2000. Available at <http://211.71.86.12/uploadfile/teacher/rwlj/teachingplan/200709/1095302320749.pdf>. Accessed: 09/03/2013.

the average wage level. Non-public owned enterprises now became one of the important parts of the national economy. The National Development and Reform Commission partially works as a central planning board. But the central government made clear that such controls will be removed with further reforms, especially after the CCP 18th National Congress. As the non-public owned economic elements are growing, income inequality has increased sharply in different geographical locations, as well as in rural and urban areas. The Chinese society switched the concentration from a political class struggle to economic growth and income distribution. All these factors changed the people's social status in the new economic system, and also appear to indicate that China is working towards a capitalist model²²⁷.

As this paper mentioned previously, the legalization process decentralized the power of the government, restructured the relationship between the central government and the local governments. It gave the local governments more autonomy. The CCP's ideology and one – party control are the symbols of the Chinese political system. China actively began participating in the world trading system by its accession to the WTO. “Accession to the WTO stimulated China to accelerate work to improve its institutional quality, with consequent impacts on the size of its trade boom and integration into the global economy. Membership of the WTO and institutional quality improvement has also favored bilateral trade relationships²²⁸.” But integration into the world trade system in a way is integration into the global capitalist system. On the one hand it provides more opportunities for economic growth, but on the other hand, it also challenges the CCP one-party control. This could be seen as a double – edged sword²²⁹.

Transparency and rule of law are the most important challenges that China had to face regarding its accession to the WTO. The first achievement of the Chinese legal construction is: from market access to market withdrawal, from foreign-invested enterprises to domestic enterprises. According to this scientific path, China gradually builds up its legal system. Second, the reform of the tax system and the structural tax cuts for promoting economic and social development. Third, developing the legal system in order to protect intellectual property rights. Forth, full liberalization of the financial sector, improvement of the financial legal system, and consolidating the separate supervision of the financial system. Fifth, creation of a market friendly environment, and at the same time, safeguarding the socialist market economic order. Sixth, with full respect for the WTO dispute settlement mechanisms, active participation in

²²⁷ Liang, Bin. *The Changing Chinese Legal System, 1978-Present: Centralization of Power and Rationalization of the Legal System*. New York. Routledge-Taylor and Francis, 2008. P180.

²²⁸ Yu, Miaojie. *China's foreign trade, WTO accession and institutional quality*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P124.

²²⁹ Ibid.

trade dispute settlement²³⁰. In other words, the WTO membership itself is not the reason for China to increase its exports. “[The] Problem with transparency continues to recur in areas of public input to lawmaking, access to information on trade policy and regulation, and judicial review²³¹.” The WTO membership helps to increase trade through its influence on Chinese institutional advancement²³².

²³⁰ Chen, Su. *Ten Years after accession of WTO: Review and prospect of Chinese market economy legal construction*, 入世十年中国市场经济法制建设的回顾与展望 (in Chinese). Available at: <http://www.iolaw.org.cn/showarticle.asp?id=3212>. Accessed: 12/09/2013.

²³¹ Potter, Pitman B. *China and the International Legal System: Challenges of Participation*. Source: The China Quarterly, No. 191, China's Legal System: New Developments, New Challenges (Sep., 2007), pp. 699-715. Published by: on behalf of the Cambridge University Press School of Oriental and African Studies. Available at: <http://www.jstor.org/stable/20192815>. Accessed: 10/03/2015. P704.

²³² Yu, Miaojie. *China's foreign trade, WTO accession and institutional quality*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P144.

4. Empirical Findings: International Trade and the Korean Economy

From 1910 to 1945, Korea was under Japan's colonial control. After Japan's surrender in 1945, the Korean peninsula was divided into two parts. In 1948, Syngman Rhee became the first president of the Republic of Korea (South Korea). At that time, almost all the industrial basements were in the northern part of the Korean peninsula, which left the South with almost nothing concerning industry. The national economy of South Korea was almost completely destroyed. Until the early 1960s, Korea was one of the poorest countries in the world and the per capita income was less than 100 USD. Today, Korea has become the world's eighth biggest trading partner, behind the United States, China, Germany, Japan, France, the Netherlands, and Britain. The Korean GDP has reached 1410 trillion USD in 2014, and thus ranked 13th worldwide. The Gross National Income (GNI) per capita achieved 27,090 USD. The Korean economic success was called "the miracle of the Han River," and it became one of the representative success stories regarding a system of market economy²³³.

After the Korean War was over, the government of the United States needed to create a "showcase" to demonstrate the success of capitalism on the Korean peninsula – the very front line of cold war²³⁴. The generous levels of grant in aid were linked to geopolitical considerations. The American government tended to see the strong development of a capitalist economy in Korea as an integral part of their anticommunist strategy. After the end of World War II till the mid-1970s, American aid amounted to almost 80 percent of Korea's fixed capital formation²³⁵. Korea had received more aid from the United States than any other country in the world, except for Israel and Vietnam. At that time, aid was almost the only source for Korea to depend on.

Whatever the reason for the US was to provide aid to Korea, the Korean economy had benefited a lot from it. It helped Korea to increase output and exports, which helped to establish the foundation for a free-market economy. Furthermore, it assisted to reconstruction of the country through investments in the education and health system. And finally, US aid partly financed Korean bills and kept the living standard on a certain level. But, US aid could only help the economic development of Korea, but can hardly be seen as the major source in the

²³³ Cha, Dong-Se. *Korea's Economic Crises*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P451.

²³⁴ Castley, Robert. *Korea's Economic Miracle: The Crucial Role of Japan*. London, New York. St. Martin's Press, INC., 1997. P113-115.

²³⁵ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P303.

process. When US aid was reduced in the 1960s, it forced the Korean government to seek an alternative plan especially for the capital source²³⁶.

In the 1960s, due to the fact that around 70 per cent of the work force depended on agriculture and fishery and only 1.5 per cent on manufacturing, South Korea was basically an agrarian economy. “Bottomless pit”, “nightmare” and “a sick society” were the words used by the Americans to characterize the Republic of Korea until the early 1960s²³⁷.

“A report published by the Japanese government entitled ‘About the Korean Economy’ concluded that, because of the problems embedded in the Korean economy it would be impossible for the Korean government to develop an independent economy. The problems identified by this report included Korea’s: 1) overpopulation, 2) lack of resources, 3) under-developed industries, 4) heavy military expense burden, 5) poor political skills, 6) lack of capital, and 7) lack of administrative ability²³⁸.”

As this paper has mentioned previously, David Ricardo believes that many production elements are not the reason for increasing the rate of profits, however, a country will benefit highly from foreign trade²³⁹. Ricardo used the example of the Portuguese specialization in wine production, which could then be exchanged for English cloth to mutual profit, and then further developed the idea of comparative advantage²⁴⁰. When factors such as labor, capital and other resources are able to move freely between countries and all the factors/resources in each country were fully employed²⁴¹, then “a country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries. Trade between two countries can benefit both countries if each country exports the goods in which it has a *comparative advantage*²⁴².”

Based on Ricardo’s theory, Korea should have specialized their comparative advantages as rice farmers. But Korean leaders clearly knew that even if they successfully increased the

²³⁶ Eckert, Carter J., Ki-baik Lee, Young Ick Lew, Michael Robinson, Edward W. Wagner. *KOREA OLD AND NEW: A History*. Seoul, Cambridge, Massachusetts and London: HARVARD UNIVERSITY PRESS, 1990. P393.

²³⁷ Chaudhuri, Sudip. *Government and Economic Development in South Korea, 1961-79* Source: Social Scientist, Vol. 24, No. 11/12 (Nov. - Dec., 1996), pp. 18-35 Published by: Social Scientis. Available at: <http://www.jstor.org/stable/3520100>. Accessed: 26/03/2015. P18.

²³⁸ O, Won-chol. *The Korean Story: President Park Jung-hee’s Leadership and the Korean Industrial Revolution*. Seoul, WisdomTree, 2009.P68.

²³⁹ Ricardo, David. *The Principles of Political Economy and Taxation*. Mineola, New York: Dover Publications, Inc., 2004. Originally published: London; New York: J.M. Dent & Sons, 1911. Pviii.

²⁴⁰ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011. P196.

²⁴¹ Ibid. P123.

²⁴² Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy, seventh edition*. Boston, San Francisco: Pearson Addison Wesley, 2006.P26.

productivity of rice, Korea would still not become a high-income country. So Korea not only promoted the products in areas in which it had comparative advantages (i.e. agriculture), but also consciously promoted the goods which did not have comparative advantages²⁴³. Korea chose to develop the manufacturing industry and later on science and technology as their new comparative advantage.

From 1961 until 1993, Korea was led in an authoritarian fashion by military men. Park Chung Hee was the president of South Korea from 1961 until his assassination in 1979. Many of South Korea's dramatic economic changes took place during Park's era. In the 1960s South Korea started the export promotion policies when the world capitalist economy was uprising and the world trade expanded fast²⁴⁴. In the meanwhile, Korea's rapid industrialization over the past few decades led to considerable interest in it as a model for developing and transforming economies as well as a major competitor of the developed world in many industries²⁴⁵.

“A country's relative export performance in individual product categories has been taken to reflect its ‘revealed’ comparative advantage within the manufacturing sector. The relative export performance has been used as an indicator of comparative advantage in preference to export-import ratios or net exports, since inter-country differences in the commodity pattern of imports are greatly influenced by the system of protection applied²⁴⁶.”

After Korea switched the trade policy to export promotion, at the beginning, the manufactured goods exported by South Korea were labor intensive and low value added. But when China was still under political movements like the Great Leap Forward and the Cultural Revolution, the Korean government already started an industrialization process, which could be divided into four phases. 1) 1960s – the export drive policy; 2) 1970s – the heavy & chemical industry (HCI) promotion policy; 3) 1980s – the pro-technology oriented policy; 4) 1990s (until today) – the globalization and information technology (IT) industry promotion policy²⁴⁷.

“During the four decades following the Korean War, it evolved from one of the most abject states in the region to one of the most vibrant, a manufacturing powerhouse that has virtually

²⁴³ Chaudhuri, Sudip. *Government and Economic Development in South Korea, 1961-79* Source: Social Scientist, Vol. 24, No. 11/12 (Nov. - Dec., 1996), pp. 18-35 Published by: Social Scientist. Available at: <http://www.jstor.org/stable/3520100>. Accessed: 26/03/2015. P19.

²⁴⁴ Ibid. P20.

²⁴⁵ Ursacki, Terry and Vertinsky, Ilan. *Long-Term Changes in Korea's International Trade and Investment*. Source: Pacific Affairs, Vol. 67, No. 3 (Autumn, 1994), pp. 385-409. Published by: Pacific Affairs, University of British Columbia. Available at: <http://www.jstor.org/stable/2760417>. Accessed: 02/12/2013.

²⁴⁶ Balassa, Bela. *Comparative Advantage Trade Policy and Economic Development*. New York, London, Toronto, Sydney and Tokyo: Harvester Wheatsheaf, 1989. P19.

²⁴⁷ Kim, Chuk Kyo. *Trade and Industrial Policy*. Source: *Development Experience of the Korean Economy*. Edited by: Keuk Je Sung. Seoul: Kyung Hee University Press, 2010.

eradicating poverty, malnutrition, and illiteracy. In a region of fast growth, since the 1960s Korea has increased its per capita GDP more quickly than any of its neighbors²⁴⁸.” Now, Korea is the eighth biggest trading partner in the world and the largest exporter in the world for memory chips, shipbuilding, LCD panels along with many other products. The total export was over 422 billion USD in 2008, per capita income has surpassed 20,000 USD, and Korea’s economic size is approaching 1 trillion USD, which is larger than that of any European country except the UK, France, Germany, Italy and Spain²⁴⁹.

The economic development of South Korea was seen as one of the most successful stories of the post war era. But Korea also had to face unavoidable problems: Firstly, low productivity in the service sector and low investments in services R&D. Secondly, an unbalanced development between large business groups²⁵⁰ (Chaebol) and Small and Medium Sized Enterprises (SME). Thirdly, strong government-led strategies, which may hold or effect the development of a more diffusion-oriented innovation policy. Fourthly, unbalanced international linkages with low levels of international collaboration²⁵¹. This paper will mainly focus on the unbalanced development between Chaebol & SME and the manufacturing and financial (also services) industries in Korea, as these issues are the most difficult problems to solve,

Korea has been a WTO member since 1995 and a member of OECD since 1996. But Korea’s domestic and financial markets are not open compared to other countries. As this paper has mentioned previously, the WTO is a set of rules. Those documents are not laws. But those agreements were negotiated and signed by the member governments and the world’s trading nations. They only provide the legal ground rules for international commercial activities. But all members need to follow. The internal requirement for institutional advancement was forced to be set up when South Korea actively participated in international organizations, i.e. the WTO and the OECD.

²⁴⁸ McKinsey & Company Report: *South Korea: Finding its place on the world stage*. McKinsey Global Institute. April, 2010. Available at: http://www.mckinsey.com/insights/winning_in_emerging_markets/south_korea_finding_its_place_on_the_world_stage . Accessed: 03/05/2015.

²⁴⁹ Sung, Keuk Je. *Was There an Economic Miracle in Korea?* Source: *Development Experience of the Korean Economy*. Edited by: Keuk Je Sung. Seoul: Kyung Hee University Press, 2010. P11.

²⁵⁰ A business group is a corporate structure that consists of legally independent firms, operating in multiple industries and bound together by formal and informal ties. In Korea, family-controlled business groups, called *Chaebol*, have long been contentious, and public attitude toward the Chaebol has been characterized by fundamental ambivalence. Original source: Lim, Wonhyuk. *Business Groups and Fair Trade Policy in Korea*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press. 2010. P351-353.

²⁵¹ OECD Reviews of Innovation Policy – *Industry and Technology Policies in Korea*. OECD publishing, 2014. P16-17.

4.1 Technology Spillover and FDI

After the Republic of Korea was founded in 1948, the Korean economic development heavily relied on US aid. In 1963, as the US government was not sympathetic to the military government; the aid was reduced, which directly forced the Koreans to find an alternative way of capital. Balanced payments and economic growth became the two most important tasks for the government. Korean trade and industrial policy had switched from import substitution toward export promotion. In the early 1970s, the government of the US decided to reduce troops in Korea. This policy forced or promoted Korea to develop its own military industry for national security. That could be seen as one of the most important reasons that transformed Korean trade and industrial policy in a way that promoted industrial development, especially the HCI.

The influx of American capital into South Korea had been accompanied by a corresponding flow of American technology and technical expertise. The aid helped to finance technology transfers from American firms and to create official research and development organizations like the Korea Development Institute (KDI) and the Korea Institute of Science and Technology (KIST). Moreover, the US has since 1945 been the primary training ground for South Korean economic and industrial technocrats, many of whom have been supported by aid funds²⁵².

After Park Chung Hee came into power in 1961, the Koreans launched economic five year plans in order to achieve high economic growth. “President Park though that industrial development should precede agricultural development in the achievement of high economic growth so as to solve not only the poverty problem but also to reduce dependence on foreign aid²⁵³.” Park Chung Hee used to work for the Japanese military during the Second World War²⁵⁴. Japan’s economic success with “enriching the country and strengthening the army” during the Meiji era inspired him. Park was deeply influenced by the Japanese development experience which was based on government-led industrialization²⁵⁵. In order to develop Korea’s national economy, Park and other policy makers believed that promoting the manufacturing industry should be the correct path.

²⁵² Eckert, Carter J., Ki-baik Lee, Young Ick Lew, Michael Robinson, Edward W. Wagner. *KOREA OLD AND NEW: A History*. Seoul, Cambridge, Massachusetts and London: HARVARD UNIVERSITY PRESS, 1990.

²⁵³ Kim, Chuk Kyo. *Heavy and Chemical Industry Promotion Policy in the 1970s*. Source: *Development Experience of the Korean Economy*. Edited by: Keuk Je Sung. Seoul: Kyung Hee University Press, 2010. P144.

²⁵⁴ Holcombe, Charles. *A History of East Asia: From the Origins of Civilization to the Twenty-First Century*. New York: Cambridge University Press, 2011.

²⁵⁵ Kim, Chuk Kyo. *Heavy and Chemical Industry Promotion Policy in the 1970s*. Source: *Development Experience of the Korean Economy*. Edited by: Keuk Je Sung. Seoul: Kyung Hee University Press, 2010. P147.

“As highlighted in many studies, education and human capital formation made an important contribution to economic development in Korea, which achieved near full literacy even before the Korean government launched systematic plans to promote economic development in the early 1960s²⁵⁶.” From the 1960s to the 1990s, as the main focus shifted from Korean industry development to heavy and high-tech industry, the government supported the modernization and technological upgrading of domestic market by promoting “learning” capabilities²⁵⁷. The global competitiveness of low-income economies is natural-resource-based; middle-income economies are investment-based; and advanced or high-income economies are innovation-based. The real, controlling resource and the decisive factor of production is knowledge, and neither capital nor labor anymore²⁵⁸.

“A knowledge economy is one that uses knowledge as the key engine of economic growth. It is an economy in which knowledge is acquired, created, disseminated and used effectively to enhance economic development²⁵⁹.” In order to develop the knowledge and innovation industries to the level of advanced countries, the manpower and technology problem was a critical issue faced by the Korean government because a large number of technical know-how and skilled labor force, including engineers and scientists, were urgently needed. Due to the fact that Korea is lacking natural resources the country had no other choice than promoting the knowledge and innovation industries so as to avoid the mid-income trap.

“There is unmistakable evidence that education contributed to economic growth. The results suggest a few possible channels through which education contributed to economic growth in Korea. (1) The average number of years of schooling or workers contributed to economic growth directly. (2) High literacy and education also contributed to economic growth, though indirectly, by supporting physical capital formation and R&D, both of which contributed to economic growth in Korea Without growing human capital, physical formation capital would have been slower, and the introduction of new technologies would have been more difficult²⁶⁰.”

²⁵⁶ Chu, Ke-young. *Economic Development and Human Capital Formation in Korea*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P381.

²⁵⁷ OECD Reviews of Innovation Policy – *Industry and Technology Policies in Korea*. OECD publishing, 2014.

²⁵⁸ Song, Byung-Nak. *The Rise of The Korean Economy. Third Edition*. New York: Oxford University Press, 2003.

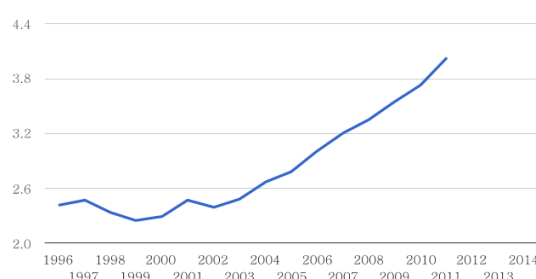
²⁵⁹ Chen, Derek H. C. and Suh, Joonghae. Introduction. Source: Korea as a knowledge economy: evolutionary process and lesson learned. Edited by Chen, Derek H. C. and Suh, Joonghae. Washington: The World Bank Institute, 2007.P3.

²⁶⁰ Chu, Ke-young. *Economic Development and Human Capital Formation in Korea*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P396.

In 1966, the Korea Institute of Science and Technology (KIST) was founded as the first science and technology research institute of Korea. Since then, it has continually played a leading role in national technology development. At the beginning, the KIST brought back a few dozen well-educated scientists and engineers back to Korea with a comparatively high salary, benefit of housing, medical insurance and tuition for their children²⁶¹. But they were still not sufficient enough in number to meet the ever increasing demand for technical manpower in the industrialization sector. In order to change the situation, the Korean government created further research institutes, as for example the Korea Ocean Research and Development Institute or a science park which was established in Daedeok in 1974. Many other government-funded research institutes have been modeled after the KIST and as such, the KIST has set the standards to become the national think tank of science and technology.

The research cluster brought different types of research organizations, i.e. government and public-led, into one location. It created an environment for sharing knowledge and resources. Investment and R&D resources could be maximized. In the meanwhile, it also attracted many private-led research institutes²⁶².

Figure 12. South Korea R&D Expenditure (Percent of GDP)²⁶³



The research institutes played a significant role in the technology and economic development of the country. Although certain number of scientists and engineers working abroad had been continuously brought back to Korea since the 1970s, they were limited in numbers, so the government felt the urgency to produce educated manpower inside Korea. The Korean education system also went through significant reforms for raising the level of labor force to that in advanced countries. New educational institutes were established in order to produce high level engineers and scientists, i.e. Kumoh Technical High School, the Korea Advanced Institute

²⁶¹ Kim, Chung-yum. *From Despair to Hope: Economic Policymaking in Korea 1945-1979*. Seoul, Korea Development Institute, 2011. P447.

²⁶² Ibid. P448.

²⁶³ Global Economy. Available at: www.theglobaleconomy.com. Accessed: 21/09/2013.

of Science (KAIS) in the 1970s. The government provided the necessary support to help the national universities which were located near the industrial complex to specialize in the same area as the nearby complex. At the same time, the government also supported other colleges to improve their educational level and practical skills. “As a result, Korea’s engineering colleges became strong in the education of both theoretical and practical knowledge²⁶⁴.”

As this paper has mentioned previously, the Korean economic development mainly relied on US aid. After the US government changed the policy and the aid was reduced, the Korean decision makers needed to find alternative plans. FDI was a business activity only engaged in by MNCs from industrialized countries. However, as transportation and telecommunications evolved, and world trade and investment were liberalized, FDI came to be recognized as a strategic tool which companies from both industrial and developing countries considered²⁶⁵. Korea had successfully transformed its agricultural economy to a manufacturing and export-oriented economy. Korea is a well-known case of successful catch-up²⁶⁶, but Korea did not create a friendly environment for FDI.

In order to protect the domestic industries until the financial crisis in 1997, Korea had placed heavy regulations and laws on foreign investors. FDI was not allowed in any sector. And in the meanwhile, less transparent and complicated administrative regulations also existed in the areas which were open for FDI.

“On the basis of the World Investment Reports by the UNCTAD (United Nations Conference on trade and Development), Korea has performed quite poorly in attracting FDI, compared to East Asia and the world. Except for a couple of years following the 1997 financial crisis, FDI inflows in Korea have remained sluggish in recent years. As compared to domestic gross investment and GDP, have been significantly less than those of neighboring countries in East Asia and the world. This indicates that Korea has clearly failed to attract FDI to its full potential. Contributions of FDI to domestic value added and employment were relatively low in Korea. Similarly, contributions of FDI to R&D are relatively less in Korea than in China and Japan²⁶⁷.”

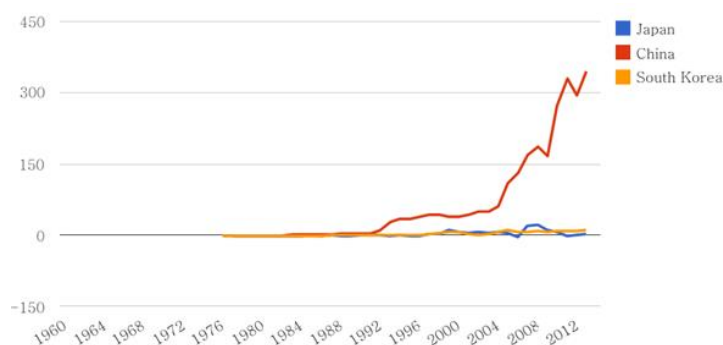
²⁶⁴ Kim, Chung-yum. *From Despair to Hope: Economic Policymaking in Korea 1945-1979*. Seoul, Korea Development Institute, 2011. P428. Also, it is interesting to note that the KAIS placed under the Ministry of Science and Technology, not under the Ministry of Education. In order to receive the special treatment that was not given to the universities.

²⁶⁵ Jun, Yongwook and Kim, Dong-Soon. *Korean Chaebol: Going Global and Over-Expanded FDI*. Source: South Korea: Challenging Globalisation and the Post-Crisis Reforms. Edited by Kim, Young-Chan; Kim, Doo-Jin and Kim, Young-Jun. Oxford: Chandos Publishing, 2008. P25.

²⁶⁶ Kwon, O. Yul. *International Business in Korea: The Evolution of the Market in the Globalization Era*. Cheltenham, UK; Northampton, MA, USA. Edward Elgar, 2008.

²⁶⁷ Ibid.

Figure 13. Foreign Direct Investment (Billion USD)²⁶⁸



During the crisis period in 1997, Korea's foreign exchange reserve fell to 3.9 billion USD. The pre-condition for Korea to receive emergency financial support from the IMF was launching economic reforms and liberalization policies. That increased foreign investors' confidence towards Korea²⁶⁹. In South Korea, *FDI* refers to "a foreigner's acquisition of 10% or more of the equity share of a domestic business through an investment of not less than 100 million won, or a foreign-based business's borrowing of a long-term (5 years or longer) loan from its parent business in a foreign country and the like²⁷⁰."

The situation changed at the end of the 1990s. After the financial crisis in 1997, the Korean government liberalized the FDI policy. In order to achieve the same level as other OECD countries, the Korean FDI policy was switched from "restriction and control" to "promotion and assistance".

The restrictions prohibiting the purchase of stocks and shares exceeding 40% of net assets by foreign investors were also released. And in this context, in 1998, a foreign direct investment stimulation law was enacted, creating a legal environment for foreign investment consistent with international standards. Effective foreign investment stimulation measures such as tax benefits and the simplification of administrative regulations were also undertaken²⁷¹.

The Korean government and the whole society as well as the business community had to improve the Korean investment/business environment. In the year of 2002, almost all (99.8 per

²⁶⁸ Global Economy. Available at: www.theglobaleconomy.com. Accessed: 21/09/2013.

²⁶⁹ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P502.

²⁷⁰ Korea.net, *Korea's Open Market Capitalist Economy*. Available at: <http://www.korea.net/AboutKorea/Economy/Koreas-Open-Market-Capitalist-Economy>. Accessed: 19/07/2015.

²⁷¹ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P502.

cent) of the business sectors were open to foreign investment. Foreigners were also allowed to purchase land with almost no restrictions (size, site, whether for business or privately). The Foreign Investment Zone (FIZ) was established. Foreign investors who brought in specific technology would be able to have the seven-year tax holiday and fifty per cent tax reduction for five years as a special treatment. Foreign investors were also allowed to purchase stock and shares (40 per cent of net assets), after a foreign direct investment stimulation law was enacted in 1998, a more legal and friendly environment for FDI was created with international standards²⁷². As a result, FDI increased remarkably from 1998 to 2004. But at the same time, “Korea has clearly failed to attract FDI to its full potential or to a level comparable internationally in the recent past²⁷³.” As most of the Greenfield investments were in the form of investment of operational facilities (not for new factories), it shows that Korea is no longer a target country for FDI to manufacturing industries. M&A was relatively increased in the recent past together with the relatively low contributions of FDI for economic growth. It might have risen up the discussion of FDI as the controlling of domestic companies and even job losses. All these facts might push the government to start a regulatory reform, in order to get public awareness and understanding of the benefits of FDI and globalization.

4.2 Income Inequality

Compared to China, Korea is a small country with 50 million inhabitants and 223 kilo square meters. It is located in the southern part of the Korean Peninsula. Two thirds of the territory is mountainous, and only 45 per cent can be used for the agriculture industry²⁷⁴. “Although Korea made an impressive return to international competitiveness and sustained growth following the financial crisis of 1997, it has failed to restore the high level of social equality upheld during previous decades²⁷⁵.”

As this paper has mentioned previously, “the conflict between economic efficiency and income equality has long been recognized in economics²⁷⁶.” As Krugman discusses in his “International Economics”, international trade does not only refer to the movement of goods and

²⁷² Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P502.

²⁷³ Kwon, O. Yul. *International Business in Korea: The Evolution of the Market in the Globalization Era*. Cheltenham, UK; Northampton, MA, USA. Edward Elgar, 2008. P114.

²⁷⁴ Korea.net, 了解韩国. Available at: <http://chinese.korea.net/AboutKorea/Korea-at-a-Glance/Facts-about-Korea>. Accessed: 20/07/2015.

²⁷⁵ Yun, Ji-Whan. *Labor Market Polarization in South Korea: The Role of Policy Failures in Growing Inequality*. Source: Asian Survey, Vol. 49, No. 2 (March/April 2009), pp. 268-290 Published by: University of California Press. Available at: <http://www.jstor.org/stable/10.1525/as.2009.49.2.268>. Accessed: 25/07/2015.

²⁷⁶ Zhai, Fan and Li, Shantong. *The impact of WTO accession on income disparity in China*. Source: *China and its Regions: Economic Growth and Reform in Chinese Provinces*. Edited by Renard, Mary-Francoise. Cheltenham, Northampton: Edward Elgar, 2002. P122.

services, it also refers to the movement of all factors. Factor movements include three aspects: firstly, labor migration; secondly, international capital transfer; thirdly, international connection involve into multinational corporations²⁷⁷. For many reasons, the level of economic development is different in different regions/countries. Some regions have advanced technology and productivity. Some have cheap labor or rich raw materials. International trade activities reallocated all of those factors for manufacturing activities.

Before Park Chung Hee became the president of Korea, until the early 1960s, Korea was one of the poorest countries in the world and the per capita income was less than 100 USD. Due to the fact that around 70 per cent of the work force depended their livelihood on agriculture, fishery and only 1.5 per cent on manufacturing, South Korea was basically an agrarian economy around 1960²⁷⁸. During the 1960s and the 1970s, in order to develop the Korean national security and economy, the Korean government launched the “export oriented” trade policy, and also masterminded all the major industrial projects in the country. The economic development of South Korea was seen as one of the most successful stories of the post war era. From the 1960s till 1970s, Korea operated according to the unequal economic policy “efficiency first and equity later”. After the 1980s, “efficiency and equity” both became important for Korea. From the 1960s until the 1990s, even though the Korean annual GNP growth rate was 9 per cent, and GDP per capita was close to the level of western developed countries, the economic and social structures still had distances with these countries. This can be described as “inequality between growth and development”²⁷⁹.

Some unavoidable challenges Korea had to face were the following: 1) low productivity in the service sector, low investment in services R&D; 2) unbalanced development between SMEs and Chaebols; 3) Strong government-led strategies, which may hamper the development of a more diffusion-oriented innovation policy; 4) unbalanced international linkages with low levels of international collaboration, etc.²⁸⁰. After Korea changed the economic policy to an export-oriented one, the Heavy and Chemistry Industries was selected and designed as the major industries for Korean economic development. The development of the HCI industry (iron and steel, non-ferrous metals, ship building, machinery, electronics, fertilizers, oil refining, ce-

²⁷⁷ Krugman, Paul R. and Obstfeld, Maurice. *International Economics: Theory and Policy*, seventh edition. Boston, San Francisco: Pearson Addison Wesley, 2006. P147.

²⁷⁸ Chaudhuri, Sudip. *Government and Economic Development in South Korea, 1961-79* Source: Social Scientist, Vol. 24, No. 11/12 (Nov. - Dec., 1996), pp. 18-35 Published by: Social Scientist. Available at: <http://www.jstor.org/stable/3520100>. Accessed: 26/03/2015. P23.

²⁷⁹ Song, Yu and Yang, Peiqing. *How to Avoid the Middle-income Trap in East Asia: The Korean Experience and Its Enlightenment*. 中等收入陷阱的东亚式规避：韩国经验及其启示 (in Chinese). Beijing: 科学出版社, 2014. P85.

²⁸⁰ OECD Reviews of Innovation Policy – *Industry and Technology Policies in Korea*. OECD publishing, 2014. P16-17.

ment, etc.) in fact became the government's priority²⁸¹. Big enterprise groups (later on Chaebols) were being supported by government policy. After a few decades, Chaebols became the pillar of the Korean national economy, and represented the future direction of development. In 2002, 30 Chaebols blocked 34 per cent of the GDP; the additional value achieved 14.3 per cent of the total national additional value. On the one hand, as the engine of the Korean economic development the Chaebols lifted up the international level of the country. But on the other hand, they have also been accused of abusing their power²⁸², and were seen as the reason for holding the reform of the economic system and the distribution of resources²⁸³.

In the meanwhile, other factors also need to be considered: 1) unbalanced development between agriculture and the manufacturing industries; 2) the domestic saving rate was lower than the investment rate, so the original source of industrialized processes came from outside of Korea (foreign loans), not from within; 3) unbalanced development between financial (and also service) industries and manufacturing industries; 4) the export-oriented trade policy focused on quantity more than on quality, and comparatively the domestic market was less developed; 5) relationship between development and distribution, unbalanced income level in the society²⁸⁴. Because of the limited space and due to the fact that the following two factors are connected closer to the main topic of this thesis, the following part will rather focus on the unbalanced development between Chaebol and SMEs in Korea (1) and the unbalanced development between financial (and also service) industries and manufacturing industries (2).

4.2.1 Chaebol and SME

Park Chung Hee was the president of South Korea from 1961 until his assassination in 1979 and many of South Korea's dramatic economic changes took place during his regime. What transformed South Korea into one of the fastest growing economies of the world was the development of the manufacturing industries. It was in the 1960s that South Korea started export promotion policies when the world capitalist economy was expanding and global trade developed rapidly²⁸⁵. Korea's fast industrialization over the past few decades has led to con-

²⁸¹ OECD Reviews of Innovation Policy – *Industry and Technology Policies in Korea*. OECD publishing, 2014. P23.

²⁸² Lim, Wonhyuk. *Business Groups and Fair Trade Policy in Korea*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.

²⁸³ Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P17.

²⁸⁴ Cui, Zhiying, Piao, Changgen. 崔志英, 朴昌根. 当代韩国经济 (Contemporary Korean Economy- in Chinese), Shanghai, Tongji University Press, 2010. P203-205.

²⁸⁵ Chaudhuri, Sudip. *Government and Economic Development in South Korea, 1961-79* Source: *Social Scientist*, Vol. 24, No. 11/12 (Nov. - Dec., 1996), pp. 18-35 Published by: Social Scientis. Available at: <http://www.jstor.org/stable/3520100>. Accessed: 26/03/2015. P20.

siderable interest as it was regarded as a model for developing and transforming economies as well as a major competitor of the developed world in many industries²⁸⁶.

As this paper mentioned previously, until the early 1960s, Korea was one of the poorest countries in the world. In order to pool the limited resources (i.e. capital, technologies), the Korean government chose to support big business groups (later on *Chaebol*), with specific policies.

As this paper mentioned previously, “a business group is a corporate structure that consists of legally independent firms, operating in multiple industries and bound together by formal and informal ties. In Korea, family-controlled business groups, called the Chaebol, have long been contentious, and public attitude toward the Chaebol has been characterized by fundamental ambivalence²⁸⁷.” At the beginning, it was lack of transparency when the Korean government selected the person who was going to run a big business group/Chaebol. But at that time the Korean government was also short of choices. Firstly, the market did not exist or had an extreme lack of efficiency. Secondly, Korea lacked enough experienced entrepreneurs. Thirdly, the government was quite inexperienced in terms of economic development. Fourthly, information was uneasy to be spread. To sum up, all these reasons, no matter which entrepreneur was being selected, with the support from the government, this business group would get the opportunities to achieve rapid growth²⁸⁸.

After the entrepreneurs were selected, the government started to support these business groups/Chaebols with special licenses for import, a favorable policy for distribution of aid and other capital as well as easier loans from the bank²⁸⁹. In Figure 14 the growth of 30 Chaebols from 1987 to 2002 can be seen.

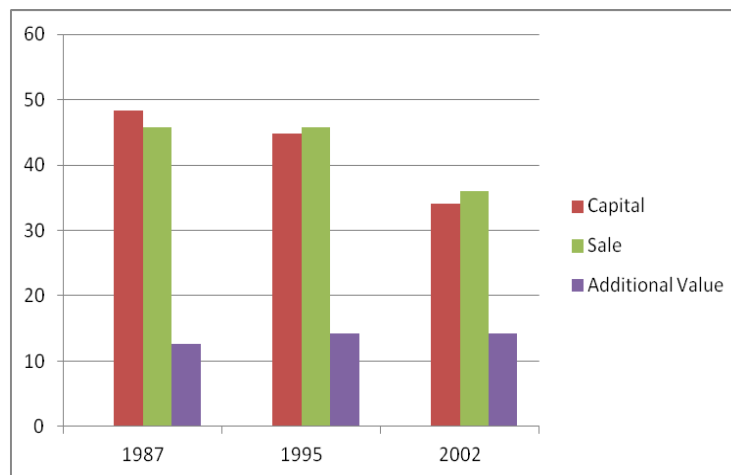
²⁸⁶ Ursacki, Terry and Vertinsky, Ilan. *Long-Term Changes in Korea's International Trade and Investment*. Source: Pacific Affairs, Vol. 67, No. 3 (Autumn, 1994), pp. 385-409. Published by: Pacific Affairs, University of British Columbia. Available at: <http://www.jstor.org/stable/2760417>. Accessed: 02/12/2013.

²⁸⁷ Lim, Wonhyuk. *Business Groups and Fair Trade Policy in Korea*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P351-353.

²⁸⁸ Liu, Hongzhong. *The Chaebol system in South Korea's Catch-up Economy*. 韩国赶超经济中的财阀制度研究 (in Chinese). Beijing: 光明日报出版社, 2009.

²⁸⁹ Ibid.

Figure 14. Percentage of GDP of 30 Chaebols (%)²⁹⁰



The Korean economic policy was promoting the development of Chaebol, export industries and finished products industries. The SMEs, domestic industries and semi-finished products industries were comparatively underdeveloped. The economic policy is actually the root of conflicts between Chaebols and SMEs, especially the inequality between the export and the domestic industries. Especially accessories and spare parts lagged behind also, which held rapid growth of productivity back²⁹¹.

Korea's experience in dealing with the Chaebol problem provides a useful lesson for the whole world. In terms of the policy towards ever dominant business groups, one of the most significant developments was the enactment of the Monopoly Regulation and Fair Trade Act (MRFTA) in the 1980s. This law aimed at encouraging fair and free competition, protecting consumers and promoting a more balanced development of the economy²⁹². It was much more than just a competition law and sought to deal with the Chaebol problem in general²⁹³.

As a result of the Chaebol reforms, part of the institutionalized privileges bestowed on Chaebols and the collusive government-chaebol relations have been eliminated. Corporate governance and the management transparency and accountability of Korean firms have improved. Penetration of foreign capital into the Korean business sector has reduced government

²⁹⁰ Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P17. And the data of financial industry were not included. Original source: KIS -line and Bank of Korea.

²⁹¹ Cui, Zhiying. Piao, Changgen. 崔志英, 朴昌根. 当代韩国经济 (Contemporary Korean Economy- in Chinese), Shanghai, Tongji University Press, 2010.P203.

²⁹² Song, Byung-Nak. *The Rise of The Korean Economy. Third Edition*. New York: Oxford University Press, 2003.

²⁹³ Lim, Wonhyuk. *Business Groups and Fair Trade Policy in Korea*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.

intervention in business operations. Reform of the Korean labor market has substantially improved its flexibility. Management practices have substantially changed toward the Western style²⁹⁴.

At the beginning of 1998, President Kim Dae Jung made an agreement including five principles with the four largest Chaebols. The principles were as follows:

1. Improvement of corporate management transparency
2. Clearance of mutual debt guarantees between the affiliates of the Chaebols
3. Substantial improvement of the financial leverage of firms
4. Concentration of corporate resources on a few core businesses by giving up excessive diversification
5. Improvement of corporate governance²⁹⁵

Among the five principles, improving the transparency in business management could be divided into improvement of measurement accounting and also the decision making processes. After the crisis, the invisible hand of market mechanisms and the visible hand of the government within the market mechanism needed to cooperate better than before. Inefficiency and waste of resources not only existed in the government, but also in other public institutions. Korea thus needs to react faster in the future in order to avoid the reappearance of a similar situation²⁹⁶.

4.2.2 Manufacturing, Financial and Service Industries

Korea started the privatization of commercial banks in 1983. Even though commercial banks were independent from government administration, the government still had the right of naming the managers of the banks. With that, the government was able to control the banks effectively. At the same time, Non-Bank Financial Institutions (NBFI) and local banks were allowed so as to liberalize the financial market. But the side effect was that Chaebols started business in these areas in order to reduce the dependence on government-controlled banks. Until 1988, the top 30 Chaebols blocked around half of the NBFIs in Korea. The limitation which the government had settled for Chaebols was unable to stop them to control the NBFIs. Instead of banks, the NBFIs started to be financial resources to the Chaebols²⁹⁷.

²⁹⁴ Kwon, O. Yul. *International Business in Korea: The Evolution of the Market in the Globalization Era*. Cheltenham, UK; Northampton, MA, USA. Edward Elgar, 2008. P124-125.

²⁹⁵ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P496.

²⁹⁶ Ibid.

²⁹⁷ Liu, Hongzhong. *The Chaebol system in South Korea's Catch-up Economy*. 韩国赶超经济中的财阀制度研究 (in Chinese). Beijing: 光明日报出版社, 2009. P26. P62.

In 1993, after around thirty years, Kim Young Sam became the first president of Korea without a military background. Rooting out widespread corruption, revitalizing the economy, and restoring the national discipline, and finally creating *a new Korea* was Kim Young Sam's promise to the country. But most Koreans treated it more as political rhetoric than a realistic promise to be fulfilled²⁹⁸. In the political sphere Kim Young Sam had to clean the negative influence which had been created by former military registrations. In the economic sphere he delivered the message promising a *new leap toward a new economy*. Kim was a man with a sense for ending corruption and leading the Korean society on to the right path of development. At that time, the society had a strong will of democratization and the domestic market was more open to the global market. All these factors pushed President Kim to make deeper reforms both in political and economic areas²⁹⁹.

Correcting historical mistakes and democratization became the two top priorities for Kim's administration. But economic reforms were not being treated in the same way. Kim wanted to decrease the role of the government and encourage competition and creativity in the economic area³⁰⁰. This target was being achieved, but the necessary function the government should play was ignored at the same time³⁰¹. Centralized national capitalism and a comparatively not opened domestic market could be seen as the structural weakness of Korea.

The growth of the Chaebols expanded their business with a huge amount of capital support. "Foreign capital had been an important source of financing for economic development for Korea like many other developing countries³⁰²." The Korean government provided guarantees to financial institutions, and then these banks were encouraged to take short-term loans in US Dollars from the international financial market and give the loan out in Korean Won domestically for a long-term period. The Korean government only saw the possibility to encourage investments with low costs, but ignored the liquidity risk of the change of the international capital market and the possibility of the exchange rate to decrease sharply³⁰³.

²⁹⁸ Lee, Chong-Sik, and Sohn, Hyuk-Sang. *South Korea in 1993: The Year of the Great Reform*. Source: Asian Survey, Vol. 34, No. 1, A Survey of Asia in 1993: Part I (Jan., 1994), pp. 1-9 Published by: University of California Press. Available at: <http://www.jstor.org/stable/2644951>. Accessed: 24/07/2015.

²⁹⁹ Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P57.

³⁰⁰ Lee, Chong-Sik, and Sohn, Hyuk-Sang. *South Korea in 1993: The Year of the Great Reform*. Source: Asian Survey, Vol. 34, No. 1, A Survey of Asia in 1993: Part I (Jan., 1994), pp. 1-9 Published by: University of California Press. Available at: <http://www.jstor.org/stable/2644951>. Accessed: 24/07/2015.

³⁰¹ Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P57.

³⁰² Cha, Dong-Se. *Korea's Economic Crises*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.P458.

³⁰³ Ibid. P487.

The Korean government, banks and Chaebols created an economic triangle. But as the banks were strongly influenced by government policy, they could not work effectively as normal financial institutions like in other countries. From a certain point of view the banks could be seen as the tool for the government to control the Chaebols. From the 1960s until the crisis, the Korean financial institutions were developing under the government-led financial system. Financial resources were being distributed with no transparency and equality. Low efficiency and bad-debt were increasing and in comparison the monetary institutions were lagging behind. One year after becoming a member of the OECD, namely in 1997, Korea had to face the most serious economic crisis. That was a shock not only for Korea, but also for the whole world. In order to receive the IMF emergency fund and recover from the crisis as soon as possible, the Korean government was forced to balance the inequality between the manufacturing and the financial industries. As a result a structural reform became the top priority for the Korean government. Banks were encouraged to merge and big competitive financial institutions were established. The banks which could not balance the debt were closed. Financial laws were launched instead of government regulations and indirect control³⁰⁴. Consequently, the Korean exchange rate system changed to an “independent floating system”³⁰⁵, which most of the OECD member countries had adopted³⁰⁶.

The direct cause of the financial crisis was: the bankruptcy of the Chaebols ruined the foreign investors’ confidence in the Korean financial stability. Then the reform the Korean government had made was exactly what foreign investors needed. The financial reform was not only the top priority for the structural reform program, but also the most effective reform³⁰⁷. Once the restructuring of the banks was finished, the NBFIs became the next target group. Nearly one thousand small NBFIs that had no prospect of viability were closed³⁰⁸. A more secure safe financial net started to be established in Korea.

³⁰⁴ Cui, Zhiying. Piao, Changgen. 崔志英, 朴昌根. 当代韩国经济 (Contemporary Korean Economy- in Chinese), Shanghai, Tongji University Press, 2010.

³⁰⁵ In 1997, the Bank of Korea was revised and the monetary aggregate targeting system was replaced with this system.

³⁰⁶ Cha, Dong-Se. *Korea’s Economic Crises*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.P458.

³⁰⁷ Cui, Zhiying. Piao, Changgen. 崔志英, 朴昌根. 当代韩国经济 (Contemporary Korean Economy- in Chinese), Shanghai, Tongji University Press, 2010.

³⁰⁸ Cha, Dong-Se. *Korea’s Economic Crises*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P458.

4.3 Institutional Advancement

“When individuals own different goods, have different desires, or both, there is an opportunity for trades that benefit all parties to the trade³⁰⁹.” Smith believes that with the division of labor, workers will be able to concentrate on fewer processes (or maybe just one process) during the manufacturing activity. When different products are being produced by different people, which objectively create the necessary for people to trade their goods and that also create the necessary for rules of the game.

Governments play different roles in different areas. It “redresses market failures, redistributes income, and provides social insurance against risks such as unemployment, health care costs, disability, and retirement³¹⁰.” Setting the basic rules for economic activities is the most important one. International trade not only facilitates the trading of goods and services, but also ideas on market mechanisms. Participating in international trade leads to robust institutional changes. Developing countries are learning to apply market power more efficiently with less intervention from the government to increase openness. Especially in bilateral and multilateral trade, participants should fulfill their commitments to international rules and regulations to bridge the gap between developed countries³¹¹. Scholars like Anderson, Marcouiller³¹² and Levchenko³¹³ all believe that the high quality of institutions in developed countries was the reason that transactions costs could be reduced.

Social connection is one of the most important factors for human society. No individual can be isolated from the others. Social connection is one of the most important factors for human society. Laws, policies and regulations are the most effective tools which governments use for governing the country, and also for becoming part of the international platform, such as the laws to encourage or discourage merger and acquisitions (M&A) or competition laws that can limit the extent of monopoly rents, etc. “Almost every law has distributive consequences, with some groups benefiting, typically at the expense of others. And these distributive consequenc-

³⁰⁹ Stiglitz, Joseph E. *Economics*. 2nd edition. New York and London: Stanford University, 1996.P52.

³¹⁰ Ibid. P168.

³¹¹ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010.

³¹² Anderson, James E. and Marcouiller, Douglas. *Insecurity and the Pattern of Trade: An Empirical Investigation*, Source: The Review of Economics and Statistics, Vol. 84, No. 2 (May, 2002), pp. 342-352, Published by: The MIT Press. Available at: <http://www.jstor.org/stable/3211782>. Accessed: 10/09/2013.

³¹³ Levchenko, Andrei A. *Institutional Quality and International Trade*. Source: The Review of Economic Studies, Vol. 74, No. 3 (Jul., 2007), pp. 791-819. Published by: Oxford University Press. Available at: <http://www.jstor.org/stable/4626161>. Accessed: 28/06/2013.

es are often the most important effects of the policy or program³¹⁴.” At the same time, it has to be noticed that not only laws have large distributive effects, but also policies.

“A country with high institutional quality is more likely to have better enforcement of the rule of law, thus ensuring a freer, fairer and more competitive market. Improvements in institutional quality help improve the quality of exportable goods and reduce trade costs³¹⁵.” From the 1960s to the 1990s, Korean governments all had military background. In the 1960s, President Park Chung Hee tended to regard politicians as being no more than libertines, and at first heavily suppressed political activities. At the beginning, Park was worried about the threat from the northern part of the Korean peninsula. He strongly believed that building a strong and developed country was the only solution for South Korea. For that reason, the government should collect all its resources and focus on economic construction³¹⁶.

Discussions concerning economic affairs were encouraged, however. Park’s philosophy can be found in his often quoted remark that “[...] for such poor people like the Koreans, on the verge of near starvation, economics takes precedence over politics in their daily lives and enforcing democracy is meaningless³¹⁷.” There is no doubt that in an increasingly complex economy such as Korea’s, the *impersonal rule of law* is preferable to the *personal rule of men*. As Gunnar Myrdal and other economic liberals emphasize, a country should rely non-discretionary rather than discretionary measures. The legal system is important to protect property rights, ensure the rule of law, and establish government institutions that allow the free-market system to take root and to function properly. Poor countries have weak institutions, and their legal system is usually no exception³¹⁸.

Administrative support for business also served as an effective supplemental policy instrument. Until the early 1970s, laws and regulations concerning trade and industry had largely been inherited from the Japanese colonial period. Regulations enacted during the Japanese period were mainly intended to control but not to promote economic activities, especially by the native Korean population. Thus, the red tape was deeply involved in arranging exports. As

³¹⁴ Stiglitz, Joseph E. *The Price of Inequality: how today’s divided society endangers our future*. New York and London: W.W. Norton & Company, 2012. P57-58.

³¹⁵ Yu, Miaojie. *China’s foreign trade, WTO accession and institutional quality*. Source: International Institutions and Asian Development. London and New York: Routledge, 2011. P124.

³¹⁶ Liu, Hongzhong. *The Chaebol system in South Korea’s Catch-up Economy*. 韩国赶超经济中的财阀制度研究 (in Chinese). Beijing: 光明日报出版社, 2009. P21.

³¹⁷ Park, Chung Hee. *The Country, the Revolution, and I*. Seoul: Hollym Corporation, 1963. P117.

³¹⁸ Song, Byung-Nak. *The Rise of The Korean Economy. Third Edition*. New York: Oxford University Press, 2003.

mentioned previously in this part, administrative support, as also appropriately emphasized by Yung Whee Rehh and others, was critical for Korea's trade and industrial development³¹⁹.

From the early 1960s, the Korean government clearly noticed the importance of encouraging the introduction of foreign capital and also participating in international market activities. Economic laws have modified frequently in order to catch up with the fast changing economic environments. Foreign trade laws increasingly liberalized the Korean economy³²⁰. In 1969 the government enacted the Regional Industrial Development Law. And in 1975, in order to speed up export expansion, a legal framework for the creation of general trading companies (GTCs) in Korea was established by the Ministry of Trade and Industry (the first case was Samsung). The Korean Commercial law was enacted in 1962. Until 1984, for around two decades, this law was not changed. The legal system was not updated in time in order to keep up with the development of business and industries. For example, in 1972, there were no laws concerning shipyards in Korea, and the only law remotely connected to a shipyard concerned swimming pools. Consequently, the Hyundai group constructed its shipyard with a swimming pool permit. Also, due to the fact that there were no laws concerning airport shuttle buses, Korean Air had operated airport limousine buses between Seoul's Kimpo Airport and major hotels in the city under a village-bus permit. These were just a few of the examples which existed. But from them it was clear to see that Korean government officials were to strictly abide by the laws. It was often the case that the Korean leaders simply ignored the laws and regulations aside because they were not quite effective and realistic³²¹.

"Globalization refers to the way in which national economies are becoming integrated through the free flow of goods and services, capital, technology and other factors of production³²²." The GATT was an initiative started by western democratic countries, to increase global trade, and to facilitate the reconstruction and development of the global economy. Korea became a member of the GATT in 1967. Countries like Korea benefited a lot from it. Firstly, Korea no longer needed to negotiate bilateral trade agreements with other member countries and Korean products could be sold freely without discrimination regarding the international law. Secondly, the import tariffs were reduced among member countries which increased the global competitiveness of Korean products. Thirdly, the GATT made it easier to

³¹⁹ Song, Byung-Nak. *The Rise of The Korean Economy. Third Edition*. New York: Oxford University Press, 2003. P123.

³²⁰ Kim, Chan Jin. *Economic Development and Law in Korea*. Seoul: THE CATHOLIC UNIVERSITY OF KOREA PRESS, 2009. P217.

³²¹ Song, Byung-Nak. *The Rise of The Korean Economy. Third Edition*. New York: Oxford University Press, 2003.

³²² Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.P503.

export products to markets in underdeveloped countries; Korean products could be treated equally in overseas markets in terms of import quotas³²³.

In the 1990s, Korea became a member of the WTO and the OECD. The membership in these international organizations required a more transparent economic policy in Korea. The expanding of Chaebols required a huge amount of capital support. As mentioned previously, the Korean government provided guarantees to international financial institutions. Korean banks received loans in US Dollars from the international financial market for a short term and lent out loans in Korean Won domestically for a long term³²⁴. Two issues need to be noticed: Firstly, the chief manager of the banks was named by the Korean government. Korean banks played the role of an *ATM* machine, which meant that no matter who would apply for a loan and how the financial situation was, as long as the government agreed, the bank would lend the loan out without any risk management or credit checking. Secondly, banks were under government control, at the same time, NBFIs also lived under the shadow of Chaebols. Even though the limitation was being set up by the Korean government – that Chaebols are not allowed to have too much stock sharing in NBFIs – directly or indirectly, the Chaebols could still control over 30 per cent of the NBFIs stock in order to influence these institutions³²⁵.

In order to expand in a short period of time, the Chaebols focused more on the diversification strategy. They ignored the basic principle of innovation and development and simply concentrated on quantity instead of quality growth. They believed that when they grew into a certain size, the government would not allow them to have any problems because they are “too big to fail”. In 1993, Kim Yong Sam became the first Korean president without a military background. He clearly realized the negative influence of the government on politics and economy. Kim was willing to end the corruption and open the domestic market more to the world. But unfortunately, the reforms during his era could be seen as a total failure. On the one hand it denied the positive influence that the government had on the economy from the 1960s. On the other hand it did not create an effective market-led economic mechanism. Especially, without successful reforms both in the political and the economic sphere, Kim reported the Korean GDP per capita was over 10 thousand USD³²⁶ and joined the OECD. As this paper has men-

³²³ Kim, Chung-yum. *From Despair to Hope: Economic Policymaking in Korea 1945-1979*. Seoul, Korea Development Institute, 2011. P143-144.

³²⁴ Cha, Dong-Se. *Korea's Economic Crises*. Source: *Development Experience of the Korean Economy*. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010.P458.

³²⁵ Liu, Hongzhong. *The Chaebol system in South Korea's Catch-up Economy*. 韩国赶超经济中的财阀制度研究 (in Chinese). Beijing: 光明日报出版社, 2009. P119.

³²⁶ This data is official. But as Zheng explains in his book, the actual Korean GDP per capita did not reach 10 000 USD at the time. Original source: Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P17. P58. P84

tioned previously, the WTO and the OECD membership requires more transparent economic policies. Obviously Korea was not ready at that time. The fact that the Chaebols were unable to return the loans strongly decreased the international investors' confidence in the Korean economy. The Korean government also realized the most important reason for that was that the domestic short-term loans relied too much on international monetary institutions³²⁷.

In order to receive the IMF emergency fund, Korea had to reform the financial system thoroughly. After the Korean FDI policy changed from "restriction and control" to "promotion and assistance", laws and regulations were put on the path of matching with international best practice³²⁸. 50 per cent of the complicated administrative regulations were relieved or dismissed. The Korean Investment Service Center worked as one stop in order to provide services for attracting FDI. "The centre offers consultation, advice and assistance to investors, an investment ombudsman, intellectual property rights protection, and best international practice in accounting and corporate governance standards³²⁹." Since 1997 the business environment in Korea has improved remarkably.

"It would not be too much to argue that the Korean crisis was primarily caused by the problems of the public sector. Although the government-led economic development model was clearly faced with a limit, the Korean government never abandoned its intervention both in the allocation of financial and other resources, and in market entry and exit. The decades-long convention of government control led to circumstances where the government could not be free from responsibility even when the fate of the businesses was at stake. The visible hand of the government in the mechanism of the market resulted in a moral hazard for business and overly leveraged financial management of the firms. Moreover, the government failed to perceive the immediate onset of the crisis, and thus, could not implement measures in time to prevent the crisis from assaulting the Korean economy. Hence, inefficiency and waste of resources prevailed not only in the government ministries but also in all other public organizations³³⁰."

In the late 1990s, Koreans had successfully convinced the world that they could overcome the economic crisis and create another *Miracle of the Han River*. The number of regulations in Korea was dramatically reduced. 48.2 per cent (5430) of 11,125 existing regulations were

³²⁷ Zheng, Degui. *Beyond increasing and distribution: Future design of Korean Economy*, 超越增长与分配-韩国经济的未来设计 (in Chinese). Beijing, People's University Press, 2008. P17. P58. P84

³²⁸ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P502. P493.

³²⁹ Kwon, O. Yul. *International Business in Korea: The Evolution of the Market in the Globalization Era*. Cheltenham, UK; Northampton, MA, USA. Edward Elgar, 2008. P124-125.

³³⁰ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P499.

removed and 21.7 per cent (2411) revised. But, even though around 50 per cent of regulations were reduced, the burden on the day-to-day economic affairs still existed. Korea's regulatory reform was thus incomplete and deficient. The reform focused more on quantity rather than quality.

At the same time, the Korean government had to dismantle the Ministry of Economy and Finance. Averagely speaking, around 20 per cent of the manpower and budget for the public sector was laid off³³¹. But simply reducing the number of manpower in the public sector does not guarantee to improve the government's competence and efficiency immediately. "The OECD (2000) points to excessive regulations, lack of transparency in regulations, varying interpretation of domestic regulations, discrimination against foreign competitors, slow implementation and cumbersome administrative procedures as crucial problems in Korea."³³² Deeper reforms, especially in the public sector, were urgently required. In order to increase efficiency, transparency and speedy information flow, an electronic government operation system, a so-called *e-government operation system* was adopted. President Park Geun-Hye promised foreign investors that a safer and more stable economic environment would be provided for further investment. More institutions were created in order to simplify the procedures³³³.

³³¹ Cha, Dong-Se. *The Structural Adjustments of Korea after the Crisis*. Source: Development Experience of the Korean Economy. Edited by Sung, KeukJe. Seoul: Kyung Hee University Press, 2010. P500.

³³² Ibid. P126-127.

³³³ Yoon, Sojung. *President vows to create safer business environment*. Source: Korea.net. Available at: <http://www.korea.net/NewsFocus/Policies/view?articleId=107072>. Accessed: 30/03/2015.

5. Conclusion – Different Routes to the Same Destination

The research question of this paper was: what role did foreign trade play in Chinese and Korean economic development? The research focused on these sectors: technology spillover and FDI; income inequality and institutional advancement.

During the last three and a half decades, foreign trade, especially the export share in GDP has shown a significant positive effect on efficiency, which is also an important factor in industrialization in China. Therefore, China's specialization in processing industries led to the improvement of domestic productivity upgrading, together with the advanced managerial and marketing skills. Because of the favorable historical background and geographical conditions, generally these advantages help to promote economic growth in eastern regions, but the western provinces are still lagging behind³³⁴.

However, aside from regional inequality between eastern and western regions, there are also other problems that China has to face. For example, the SOE reform that has not yet been completed; the legal system still needs to be updated in order to fit a modern market economy, and there is also a low domestic absorptive capability³³⁵. Indeed, after China launched the *Reform and Open Door Policy*, especially after the accession to the WTO, the international trade volume and structure in China have changed significantly. But, international trade could be only seen as a very effective catalyst for Chinese economic growth, whereas the inner reform was the real engine³³⁶.

After the financial crisis in Korea in 1997, there have been significant changes in political, economic, and especially trade policies. Korea now is the thirteenth largest economy in the world. The GDP per capita increased from less than 100 USD in the 1960s to around 28,000 USD in the GDP in 2014 (current USD) was at 1.410 trillion. Research and development expenditure as a percentage of the GDP is at over 2 per cent. Merchandise trade (percentage of GDP) rose from 58.4 in 1980 to 82.4 in 2013³³⁷. Education, health care and other indexes of living standard all increased. Korea successfully avoided the mid-income trap and became a developed country.

During the last half century, Korea changed its foreign policy from import substitution to export orientation. Foreign trade played a significant role in industrialization and modernization

³³⁴ Sun, Peng and Heshmati, Almas. “*International Trade and Its Effects on Economic Growth in China*”, The Institute for the Study of Labor (IZA)-IZA Discussion Paper No. 5151, August 2010. P25.

³³⁵ Ibid.

³³⁶ Bramall, Chris. *Chinese Economic Development*. London and New York: Routledge, 2009.

³³⁷ World Bank Data Base. Available at: <http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS>. Accessed: 17/09/2013.

in Korea. Similar as in China, Korea's specialization in processing industries led to the improvement of domestic productivity upgrading, which was also accompanied by advanced management and marketing skills. At the same time, because of the historical background and economic conditions, the government supported the growth of manufacturing industries and Chaebols in particular. At the same time, small and medium sized enterprises and financial industries did not develop as in other countries. The inequality in Korea is rather an economic structural problem.

However, aside from structural inequality there are other problems that Korea has to face today. The FDI policy is still not friendly to foreign investors; the institutions still need to be improved and become more transparent for the international market economy. Since Korea started an export-oriented economic policy, especially after the crisis in 1997, the country has become more open to the world. But, as in China, international trade could be seen as a very effective catalyst for Korean economic growth, and the internal structural reform was the key.

China is a socialist country under the control of the communist party. Its economic reform is targeting to build a socialist market economy. Korea is a capitalist country, which started its economic development under an authoritarian military government. The initial condition of both countries was rather poor at the beginning of their development, and both had to face serious challenges (China's accession to the WTO in 2001, the Korean economic crisis in 1997). Different routes to the same destination. Open trade policy helped the two countries to narrow the development distance to the international world. But the internal structural reform has been the real engine for economic growth in both cases.

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Kurzzusammenfassung

Diese Arbeit beschäftigt sich mit Technologie-Spillover und dem Nutzen ausländischer Direktinvestitionen, ungleicher Entwicklung und institutionellem Fortschritt in China und Südkorea. Es wird untersucht, ob diese Strukturen in beiden Ländern existieren. Das Ziel dieser Arbeit ist es, herauszufinden, welche Wirkung Außenhandel auf die nationale Wirtschaftsentwicklung in China und Südkorea hatte.

Diese Arbeit diskutiert die Beziehung zwischen Außenhandel und wirtschaftlicher Entwicklung in China nach 1978, und in Südkorea nach 1960. Die Forschungsfrage, die diese Arbeit zu beantworten versucht, ist: Welche Rolle spielt der Außenhandel in der chinesischen und koreanischen Wirtschaftsentwicklung? Diese Fragestellung impliziert weitere Fragen, welche ebenso geklärt werden müssen, und zwar beispielsweise, was der Ausgangszustand der Wirtschaftsreform in Korea und in China war. War internationaler Handel der Grund für Technologie-Spillover und den Nutzen ausländischer Direktinvestitionen in diesen beiden Ländern? Besteht Ungleichheit in Korea und in China? Geschieht institutionelle Weiterentwicklung auch aufgrund von internationalen Handelsaktivitäten? Nach den Forschungsfragen wird eine kurze Literaturübersicht gegeben. Daraufhin wird der theoretische Rahmen für den Analyseteil der Arbeit entwickelt, welcher in den nächsten beiden Abschnitten auf die Fallbeispiele China und Korea angewendet wird. Schließlich wird der Ergebnisteil – verschiedene Wege führen zum gleichen Ziel – die Arbeit abrunden.

Die Resultate dieser Arbeit zeigen, dass die Anfangsbedingungen für beide Länder zu Beginn eher schwierig waren, da beide Länder mit schweren Herausforderungen kämpften. China ist ein sozialistisches Land unter der Kontrolle der Kommunistischen Partei Chinas. Die Wirtschaftsreform zielte darauf, eine sozialistische Marktwirtschaft aufzubauen. Korea ist hingegen ein kapitalistisches Land und begann seinen wirtschaftlichen Aufschwung unter einer autoritären Militärregierung. Die koreanische Wirtschaft wird als "Nationaler Kapitalismus" beschrieben. Verschiedene Routen führten also zum gleichen Ziel. Eine offene Handelspolitik half beiden Ländern, mit globalen Entwicklungen Schritt zu halten. Jedoch ist eine interne Strukturreform der eigentliche Motor für das Wirtschaftswachstum in beiden Ländern.

Abstract

This thesis deals with technology spillover and the utility of foreign direct investment, unequal development and institutional advancement in China and South Korea. It examines whether such structures exist in each country. The aim of this thesis is to investigate and identify the effect foreign trade has had on the national economic development of China and South Korea.

This thesis discusses the relationship between foreign trade and economic development after 1978 in China, and after 1960s in South Korea. The research question this thesis tries to explore is: What role did foreign trade play in the Chinese and Korean economic development? This research question implies that other questions deriving from this one must be addressed as well. For example: what was the initial condition of the economic reform in Korea and in China? Was international trade the reason for technology spillover and the utility of FDI in these two countries? Does inequality exist in Korea and in China? Does institutional advancement happen also because of international trading activities? After the research questions, a brief literature review is provided. Then, the theoretical framework is developed for the analysis. In the following two sections, the theoretical framework is applied to the case of China and Korea. At last, the conclusion – different routes to the same destination – is presented.

The results of this thesis reveal that the initial conditions for both countries at the beginning were quite poor, and both had to face some serious challenges. China is a socialist country under the control of the communist party. The economic reform was targeting to build a socialist market economy. Korea is a capitalist country, which started the economic rising up under an authoritarian military government. The Korean economy was being described as “National Capitalism”. Different routes to the same destination. Open trade policy helped the two countries clarified the development distance to the international world. However, an internal structural reform is the real engine for economic growth in these two countries.