



## Does Korea follow Japan in foreign aid? Relationships between aid and foreign investment<sup>☆</sup>

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### ABSTRACT

Korea, an emerging donor country, largely considers its economic relations to recipients when allocating its aid. Such practices were preceded by Japan before the 1990s. We expect those similar practices between the two countries will make resemblance in aid outcomes. On a macro-level, we show similarities in aid allocations by type, region, income, and sector. The similarities are ascertained also at a micro-level by our statistical analysis on the relationships between aid and FDI. The analysis based on the FDI gravity model and panel dynamic system GMM estimation shows that only aids from Korea and Japan create more inflow of FDI into their respective recipient developing countries. Those are contrasted with other donors' aids, which are not related to FDI or the substitute for FDI.

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### 1. Introduction

In 2010, Korea joined the Development Assistance Committee (DAC) of the OECD, a group of aid donor governments, as its 24th member country. This recent membership is an official recognition from the international community as a considerable donor country. Korea began its contributions to foreign aid in 1987. Korea is now the 2nd recognized Asian donor, following Japan, among a predominately Western list of donor nations. Although Korea has set a target on the size of aid, it has yet to articulate in which direction to develop its aid policy.

Foreign aid intrinsically invokes an altruistic image, but it is far more complex and multi-faceted. For instance, foreign aid aims to help alleviate poverty in developing countries, but at the same time, it is undoubtedly a way for donor countries to advance their national interests. Therefore, most donors face difficulties recon-

ciling these two seemingly conflicting motivations. The combination will be determined by donor nation's internal socio-political factors, international standing, external strategy, geographical calculations, and so forth.

As an emerging donor Korea's foreign aid policy will gradually evolve through its unique internal and external conditions. It is difficult to predict what Korea's foreign aid policy will look like in the future, but it is very interesting to examine whether Korea will follow the path of its Asian predecessor, Japan. Initially, geographical closeness and resemblance in economic structure influenced Korea to use the Japanese experience in foreign aid as a reference. For example, the Japan International Cooperation Agency (JICA) and the Overseas Economic Development Fund (OEDF) were references for the establishment of the Korea International Cooperation Agency (KOICA) and the Economic Development Cooperation Fund (EDCF), respectively.

This study will address whether beyond the institutional resemblances Korea is following its predecessor, Japan in regard to primary direction of aid policy as well. The primary direction of aid policy is what the donor country hopes to ultimately achieve by aid-giving, which is related to how the country reconciles its conflicting motivations of altruism and national interests. We assume that a donor's primary direction in aid policy is best reflected through its allocation of aid fund. That is, if we can find out specific patterns of the donor's aid allocation, then we can also

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answer what the goals of its aid are. Based on this assumption, this study will focus on examining whether there are substantial similarities in aid allocation between Korea and Japan. The similarities will be tested through both macro- and micro-level analyses. Macro-level analysis compares the distribution of aggregate aid between the two countries by type, region, sector, recipients' income level, and so on. On a micro-level, how foreign aid is related to foreign direct investment (FDI) will be tested using bilateral data. In particular we will test whether foreign aid, which is a kind of public resource, has a catalyzing effect on private foreign investment using the FDI gravity model and panel dynamic system GMM estimation. In conclusion we insist that there are strong similarities between Korea and Japan with respect to aid allocation, and this is further highlighted by contrasts with other donors.

## 2. A macro-comparison: aid distributions of Korea and Japan

The total amount of Korea's foreign aid has increased gradually for the last 17 years and reached US\$513 million in 2006, which is shown in Fig. 1. This is larger than aid of Portugal or Greece, and is a little less than aid of Finland. The share of ODA in GNI also was as low as 0.02% in 1990, but increased to hover around 0.06% in the 2000s. This level, however, is still much lower compared with most of the DAC members. The share of DAC members, on average, in 2006 was 0.31%, which was about five times as high as that of Korea.

In 2006 Japan provided foreign aid of \$11.2 billion on a net disbursement basis. This size accounted for 0.25% of its GNI. Japan was the third largest donor in the world following the United States and the United Kingdom. The size of Korea's foreign aid is very tiny in terms of total amount or the share in GNI compared with that of Japan. Its total amount is only about one-twentieth, and its share in GNI is about one-fourth of Japan's aid.

Despite a big difference in their sizes, Korea's aid allocation shows a lot of similarities to Japan's to a surprising extent. In particular, Korea's allocation is closer to that of Japan in the second half of the 1980s than now. Table 1 shows the basic picture of aid fund allocations in Korea and Japan. The recent allocation in Korea is compared to those of two periods in Japan, the second half of 1980s and the latest years. The second half of 1980s is selected because Japan's national income per capita during that period was at a similar level to the present one of Korea in nominal value, approximately US\$20,000. In 1988 Japan's national income per

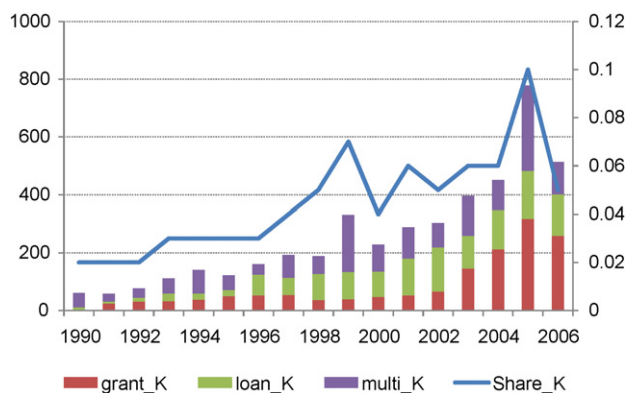


Fig. 1. Evolution of Korea's ODA.

Source: OECD.dat.

Note: grant\_K, loan\_K, multi\_K, and Share\_K denote to be the amount of bilateral grant of Korea's ODA, the amount of bilateral loan of Korea's ODA, the total amount of Korea's multilateral ODA, and the share of Korea's total ODA in Korea's GNI, respectively.

Table 1

Comparisons between Korea and Japan in aid allocations (unit: %).

|                   | Korea                  | Japan     |           | DAC average |
|-------------------|------------------------|-----------|-----------|-------------|
|                   | 2002–2006 <sup>a</sup> | 1985–1986 | 2002–2006 | 2002–2006   |
| <b>Size</b>       |                        |           |           |             |
| Total (US\$ mil.) | 488                    | 7892      | 15,426    | 4294        |
| Share in GNI      | 0.06                   | 0.3       | 0.23      | 0.28        |
| <b>Type</b>       |                        |           |           |             |
| Grants            | 59 (31)                | 37        | 53        | 87          |
| Loans             | 41 (69)                | 63        | 47        | 13          |
| <b>By region</b>  |                        |           |           |             |
| Europe            | 4                      | 2         | 1         | 4           |
| Africa            | 8                      | 16        | 10        | 29          |
| America           | 5                      | 8         | 7         | 9           |
| Asia              | 76                     | 67        | 60        | 33          |
| Unspecified       | 7                      | 7         | 22        | 25          |
| <b>By income</b>  |                        |           |           |             |
| LDCs              | 24                     | 21        | 16        | 26          |
| Other LICs        | 14                     | 12        | 19        | 10          |
| LMIC              | 52                     | 53        | 39        | 30          |
| UMICs             | 3                      | 6         | 4         | 3           |
| Unallocated       | 7                      | 8         | 22        | 30          |
| <b>By sector</b>  |                        |           |           |             |
| Social infra      | 63 (45)                | 23        | 36        | 58          |
| Economic infra    | 29 (46)                | 51        | 45        | 21          |
| Others            | 8 (9)                  | 26        | 19        | 21          |
| <b>Tying</b>      |                        |           |           |             |
| Share of tying    | 97                     | 32        | 8         | 8           |

Source: OECD.stat.

<sup>a</sup> Values in parenthesis indicate the average of the years from 1998 to 2001. These are presented to correct a shock arising from a temporary rise in the aid to Afghanistan and Iraq after 2002.

capita reached more than US\$20,000 for the first time. In order to avoid the problem of annual volatility in aid allocation, we used five-year averages in every case.

We can easily find out some similarities between Korea and Japan in aid fund allocation. First, Japan's aid is characterized by a large share of loans in bilateral aid in the past and now. Korea's aid also shows the same features, which is shown in the share of loans, 41%. Though its share is not as high as the 63% of Japan in the late 1980s, it is much higher than the average of DAC members, 14%. In addition, if we look at the period of 1998–2001 instead of the latest year when a large amount of Korea's aid temporarily went to Afghanistan and Iraq for war recovery, Korea's share of loans goes up to 69%, which is slightly higher than Japan's share in the late 1980s. In the regional distribution, the two countries show similarities in the high concentration in the Asian region. The 76% of Korea's bilateral aid was provided to developing Asian countries, and similarly, 67% of Japan's aid was given to Asia in the late 1980s. Contrastingly, the shares of aid to Africa by Korea and Japan are as low as 8% and 10%, respectively, compared to the DAC average of 29%.

In terms of aid recipients by income we can see a similarity between Korea's and Japan's aid. Korea's aid is characterized by the high ratio of the aid to the middle-income countries. In the period 2002–2006 Korea provided 52% of its bilateral aid to the lower-middle-income countries, which contrasts with 30% of the DAC average. When we reasonably expect that the unallocated income countries are likely to fall into lower income groups, its share of aid to three lower income groups including LDCs, other LICs, and the unallocated income countries is 21% points lower than the DAC average. Therefore, Korea's aid allocation by recipients' income is preceded by that of Japan. The recipient by income in Table 1 shows how close Korea's distribution is to that of Japan in the late 1980s.

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