

# Plans to Activate Investment between Korea and Russia during Putin's Fourth Term – Focusing on High Value-added Industries

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## I. Introduction

The main goal of this study is to identify policy implications for investment cooperation between Korea and Russia in the 4th term of President Putin and to seek ways to increase mutual investment. In particular, case studies were conducted of various investment cooperation projects by Russia with other countries amid the ongoing fourth industrial revolution, aiming to suggest more practical approaches to increase Korean investment in Russia.

Marking the 30 years since establishment of diplomatic relations between Korea and Russia, we need to look back on economic coop-

eration between the two countries and seek ways to develop cooperation one step further. We are seeing fundamental changes in the industrial structure due to reorganization of the international order and digital transformation – such as competition between the United States and China, the establishment of strategic cooperative relations between China and Russia (the so-called fourth industrial revolution), ecosystem disturbances due to climate change and the COVID-19 pandemic, etc. It is necessary to prepare a new type of cooperation strategy in consideration of the fundamental change of paradigm.

## II. Russian Foreign Investment during 2012–18 and after 2018

The analysis was mostly focused on the main characteristics of Russia's investment environment and overseas investment patterns during Putin's 3rd (2012–2018) and 4th (2018–) presidential terms.

The foreign direct investment (FDI) to Russia decreased starting from the Ukraine crisis in 2014 (from 50.5 billion dollars in 2012, 69.2 billion dollars in 2013 to 6.8 billion dollars in 2015). When analyzing the same period by region, European countries still lead investment to Russia, although the size of their investments have decreased year by year. This pattern is similar in other countries outside of Europe as well. While FDI from Europe and the United States is on the decline, FDI from Middle East is showing a slight increase. However, it is necessary to analyze the investment pattern in the long term, as the trends of growth and decline still remain at an insignificant level.

Russia's outward direct investment (ODI) also declined after the Ukraine crisis in 2014 and in 2018, when Putin's 4th presidential period started. As in the case of FDI to Russia discussed above, Russia's ODI has shown a similar pattern, except for Europe. However, ODI to the ASEAN region increased in 2017, as well as that to the Middle East in 2019 (compared to 2012), reflecting one-time investments in Singapore and Turkey. Consider-

ing that more than half of Russia's ODI is concentrated in Europe, the economic sanctions imposed on Russia since 2014 are one of the factors contributing to the decline in Russia's outward investment.

Ultimately, this decrease in the total amount of FDI can be attributed to economic sanctions against Russia, low international raw material prices, and changes in the ruble's value. However, when analyzing the investment trend by country, except for some Europe countries, the investment volume was maintained at a similar level.

## III. Korea's Outward Investment and Korea-Russia Bilateral Investment

The main aim of this study was to examine the recent trends and main characteristics of Korea's ODI, and Korea's direct investment to Russia.

Over the past five years, Korea's FDI has shown a rise in M&As, higher concentration in SMEs and market entry via third countries, sharp reduction in efforts to promote export and low-wage investment by SMEs, and a rapid increase in the proportion of finance and insurance industries. Direct investment to major emerging countries also showed similar trends. The change in the status of emerging countries in the global market is the main reason behind investment targeting the local market of emerging countries. In the past, emerg-

ing countries mostly served as a production base for low-wage-based final goods for developed markets, but now their role has changed.

In the case of Russia, it proved difficult to obtain meaningful results due to the absolute reduction in investment size, but the share of investment aimed at entering the market has clearly expanded. However, considering that the proportion of SMEs has slightly decreased, and the proportion of SMEs remains low among the major emerging countries, it will be necessary to advance the industrial ecosystem of existing manufacturing industries and create new markets in the fields of innovation and domestic distribution, consumer goods and services. SMEs must play a stronger role in this process.

New investment by Korean companies to Russia has decreased in recent years, and is mostly concentrated in the horizontal investment of large companies in the manufacturing field that have already entered the market. These companies are sensitive to changes in the investment environment, such as local import substitution policies. The proportion of direct investment in Russia conducted in the form of M&As has also increased over the past 10 years, which can be interpreted as conservative investment behavior in response to uncertainty in the local investment environment.

As the uncertainty of the local market has

increased due to economic sanctions and Russia's economic recession, psychological and institutional factors such as still high entry barriers (exploration costs) and poor business infrastructure greatly influence Korean companies' investment decisions in Russia.

## IV. Determinants of Korea's FDI to Russia

In this study we conduct an empirical analysis of the determinants of Korea's FDI to Russia, determining why Korea's FDI to Russia has remained relatively low and offering policy suggestions to improve the situation.

First, it is necessary to improve cultural and institutional conditions. In particular, it was found that FDI increases were more sensitive to improvements in cultural and institutional conditions such as the overall investment environment and alleviation of corruption, rather than improvement of economic conditions such as rises in GDP, wage level, exchange rate and inflation.

Second, from a statistical point of view, the negative impact of economic sanctions against Russia on Korea's total Russian FDI was lower than expected. On the other hand, FDI inflows into mid-value-added manufacturing industries that require intermediate technology, such as automobiles, electronic equipment, and chemical products, have significantly decreased due to economic sanctions against Russia.

Third, the determinants of FDI showed clear differences depending on investment motives, investment target industry, and the size of investment companies. First, in terms of investment motivation, it was found that FDI for resource development responds more sensitively to changes in GDP than FDI for market entry. In addition, negative effects on FDI due to corruption in Russia tend to be higher in the area of resource development than FDI for market entry.

Lastly, the determinants of FDI showed different patterns with respect to the size of investment companies. The negative impact of overall investment conditions and cultural and institutional conditions such as corruption on FDI to Russia was more significant in SMEs than in large enterprises. This appears to be due to the relative lack of corporate capacity and investment resource management by small and medium-sized enterprises.

It is necessary to improve cultural and institutional conditions to significantly increase Korea's total FDI to Russia, as well as resource-seeking FDI with relatively high investment sustainability and FDI in the mid/high value-added manufacturing sector. Also as the economic sanctions against Russia are likely to be prolonged, it is important to find ways to cooperate under these conditions. At the same time, it is necessary to identify more fundamental ways to expand FDI to Russia.

## V. Policy Implications and Strategies to Improve Korea-Russia Bilateral Cooperation

In the last chapter we propose policy implications for investment cooperation between Korea and Russia in the 4th term of President Putin, and suggest measures to revitalize investment focusing on high value-added industries. Korean investment in Russia is focused on automobiles, home appliances, and food products (consumer goods). However, the biggest sector within Russia for investment by European and other foreign companies is natural resources such as energy and metals.

Korea and Russia have the potential to increase investment cooperation in the future, and thus we suggest several possible approaches to promote bilateral investment.

First, cooperation should be expanded in investment fields that Russian and foreign companies are traditionally interested in, such as energy, logistics, telecommunications, etc. If energy cooperation between Korea and Russia continues to center on simple arrangements, there is a clear limit to creating synergies. It is necessary to fully consider that investment in the energy sector increases the possibility of investment in related fields and contributes to the expansion of mutual cooperation.

**S**Second, it will be necessary to cooperate in the emerging innovative industries. The recent remarkable changes were made by the government's strategic support for Russia's innovative industries, as well as enhancement of the competitiveness of Russian companies in related fields and expansion of cooperation with foreign companies. This trend is remarkable despite the economic sanctions imposed by the US and Europe on Russia after the annexation of Crimea in 2014. In particular, since 2017, new investments have been remarkably increasing in innovative industries.

**T**Third, active cooperation plans must be formulated in the strategic industries where Russia has global competitiveness. This is a strategy to select fields in which Russia has a comparative advantage and overwhelming competitiveness, and to pioneer a field of active cooperation with related industries.

**F**Fourth, it is necessary to allow management of the Export-Import Bank of Korea investment support program fund by investment rather than loans. In addition, if necessary, it may be possible to consider a method of consolidating and closing the existing obscure Russian and northern-related funds and converting them into support funds that allow new types of investment. One of the practical ways is to expand the annuity payment method to increase investment capacity.

**F**Fifth, joint investment should be considered by Korea and Russia for entry into third-country markets. In this regard, the three-party

fund to be established between Russia, Saudi Arabia and China can be a good model to reference. The sovereign wealth funds of Russia, China and Saudi Arabia have agreed to establish a joint fund to realize Saudi Arabia's Vision 2030. The third-party fund plans to invest mainly in high-tech projects in Russia and Saudi Arabia.

**A**And sixth, it will be necessary to seek ways to bypass Western economic sanctions against Russia. The solution may be different for each individual investment and economic negotiation issue. Therefore, a permanent advisory body for support will be needed. **KIEP**