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Analysis of Economic Cooperation between Kazakhstan and South Korea

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South Korean imports of Caspian Pipeline Consortium (CPC) Blend crude in 2018 increased by four times compared to the previous year. CPC Blend is a light crude oil initially introduced to the market in 2001. The CPC Pipeline links major oil fields in Western Kazakhstan to the Black Sea export terminal. South Korea, a country that consumes 3 percent of the oil produced in the world, halted imports from Iran to comply with US sanctions on Tehran and as a result its refineries are preparing to import CPC Blend crude. According to a report by the Statistical Agency of Kazakhstan, the oil exported from Kazakhstan (CPC Blend Crude) to South Korea exceeded $1.8 billion USD within the first eight months of 2019. As a result South Korea, as it turns out, became the leading oil-importing country in Asia and fourth country in the world. Indeed, according to a Statistics Committee of Republic of Kazakhstan report, total exports from Kazakhstan increased from 0.872 million USD in 2014 to 2.975 billion USD in 2018, indicating that exports had increased by 3.4 times.

Indeed, as shown in Tables 1a and 1b, South Korea is one of the major trade partners of Kazakhstan. It is observed that South Korea has become a major partner country, substantially increasing imported oil from Kazakhstan. In terms of total imports from Kazakhstan, South Korea is ranked as the 6th major country in 2018, which is a significant breakthrough in comparison to 2016, when it was ranked 28th. Oil produced in Kazakhstan is a light, sweet crude with 46.5 API degrees and approximately 0.5 percent sulfur content. The characteristics of this oil positions it roughly at the mid-point between Iranian light crude oil and Iranian condensate in terms of quality. This makes CPC Blend crude oil a suitable replacement for Iranian oil, as experts assert. Traditionally, oil from Kazakhstan has been exported to European markets, where it is usually mixed with other oil grades. However, European refineries often limit imports of oil from Kazakhstan due to the fact that oil produced in Kazakhstan contains a high level of mercaptan, a pungent gas. The modern refineries in South Korea, by contrast to those in European countries, do not face the same problem and this fact makes it possible to import crude oil from the CPC Pipeline.

Table 1a. Kazakhstan major exporting countries

Categories / Countries	Percentage weight					Rank				
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Italy	20.2	17.7	20.4	17.9	19.2	1	1	1	1	1
China	12.3	11.9	11.5	12.0	10.3	2	2	2	2	2
Netherlands	11.0	10.8	8.9	9.8	10.1	3	3	4	3	3
Russia	8.0	9.9	9.4	9.6	8.6	4	4	3	4	4
France	5.9	5.8	4.9	5.9	6.3	5	5	6	6	5
South Korea	1.1	1.7	0.6	2.3	4.9	16	15	28	11	6
Switzerland	5.7	5.8	6.6	6.4	4.7	6	6	5	5	7

Source: Ministry of National Economy Statistics Committee of the Republic of Kazakhstan, Statistical Yearbook 2014-2018

Table 1b. Kazakhstan major importing countries

Categories / Countries	Percentage weight					Rank				
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Russia	33.4	34.4	36.6	39.6	39.3	1	1	1	1	1
China	17.8	16.6	14.5	15.9	16.0	2	2	2	2	2
Germany	5.6	6.5	5.7	5.0	4.9	3	3	3	3	3
Italy	2.5	3.8	3.3	3.2	4.4	8	5	5	5	4
USA	4.8	4.8	5.0	4.2	3.8	4	4	4	4	5
Uzbekistan	2.5	2.4	2.3	2.5	3.4	9	7	8	7	6
South Korea	2.6	2.0	1.8	1.9	2.7	6	10	10	8	7

Source: Ministry of National Economy Statistics Committee of the Republic of Kazakhstan, Statistical Yearbook 2014-2018

South Korea is currently actively importing ferroalloys from Kazakhstan as well. From August to September of 2019, 65.7 thousand tons of ferroalloys were exported to South Korea, amounting to somewhere around 82.4 million USD and exceeding the exports of ferroalloys to CIS countries altogether. The trade pattern between Kazakhstan and South Korea is also turning out to be more reciprocal currently. It is not only exports that have soared recently but also imports from South Korea showed a hike in 2019. Imports from South Korea increased from 393.4 million USD to 2 billion 352.7 million USD in 2019, indicating that imports increased by about six times over the previous year. Interestingly, the trade pattern in 2019 has significantly changed. The items and products imported from South Korea in 2019 were either not observed in the previous years or were not prominent in the trade pattern. For instance, imports of fluid pumps increased from 0.9 million USD in 2018 to 330 million USD in 2019, and air pumps from 0.6 million USD in 2018 to 392.6 million USD in 2019. As a result, Kazakhstan imports from South Korea exceeded exports in 2019, implying improved trade cooperation in 2019.

According to the trade pattern documented in previous years, the main items of Kazakh import are wires and cables, switchboards, panels and consoles, metal products and tools, bodies for vehicles (including cabs), machinery and equipment. Kazakhstan imports largely manufacturing products such as articles of iron and steel, machinery, electrical and electronic equipment. Even at a superficial glance, the Kazakhstan and South Korean economies appear to share complementary ties, the former as an exporter and the latter as a consumer of energy (South Korea imports 84 percent of its energy) with heavy reliance on oil (50 percent). In addition, Kazakhstan relies on high-tech items and products to be imported from South Korea and investments. Thus, the reciprocal economic

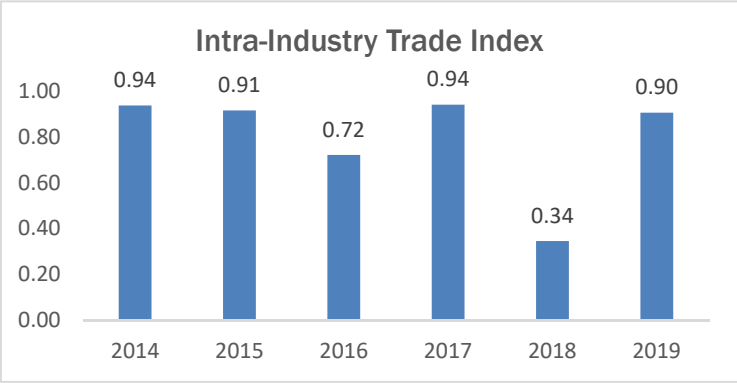
ties constitute the "glue" of the partnership.

In terms of the evaluation of reciprocal trade cooperation between the countries in question, the cooperation indicator could be estimated. Trade cooperation is estimated using the intra-industry trade index method. IIT is measured as follows:

$$IIT = 1 - \frac{|X - M|}{|X + M|}$$

Where X is the amount of exports from Kazakhstan to South Korea and M is imports from Korea to Kazakhstan. Both X and M values are in US dollars. IIT ranges from 0 to 1. When X is close to M, then IIT will be close to one indicating intensive trade cooperation from both sides. Thus, the greater the IIT the greater the economic cooperation between the countries. In Figure 1, it is observed that cooperation index is sufficiently high, implying that the trade cooperation is not one-sided but quite reciprocal.

Figure 1. Measurement of cooperation between Kazakhstan and South Korea



Source: Author's own estimation

The Contribution of Financial Resources in Business Development

Since independence, the government has given initial priority to attracting foreign direct investment (FDI) into the country's mining sector. Given the severity of the post-Soviet economic crisis, and the immaturity of all sectors in generating foreign exchange, the government was eager to secure deals with foreign investors to develop the largest oil fields first. In fact, Kazakhstan was successful in attracting FDI to oil fields and became the largest recipient of FDI among CIS countries. Over the 20 years to 2014, the inward FDI averaged 8% of GDP. According to the FDI Regulatory Restrictiveness Index, Kazakhstan remains more restrictive than most OECD countries, even though it is approaching the OECD average. However, the major concern is not the size of FDI but its destination since Kazakhstan has shifted its policies toward attracting more FDI into sectors other than natural resources extraction, which currently accounts for around three quarters of total FDI. In the last 5-10 years, Kazakhstan opened most other sectors to FDI flow, allowing investors to participate on an equal footing with domestic participants. As a result, Kazakhstan has approached OECD standards, treating enterprises controlled by other nationals as equally favorable as domestic enterprises.

Only a few exceptions are made – to the areas of mass media, fixed-telecommunications, agriculture and forest land and the provision of security service – where equity limits are applied and authorization is required.

Kazakhstan has also implemented crucial reforms toward the protection of foreign investors. For instance, the 2016 Entrepreneurial Code provides more detailed guarantees on the protection of foreign investors' rights and property, in particular, against expropriation and unlawful government conduct. The positions of Investment Ombudsman and Commissioner for the Protection of Entrepreneur's Rights were created to protect investors and firms from bribes or other forms of unfair treatment. In addition, in order to improve the investment climate, the government has recently concentrated on the functioning of the court system. Kazakhstan has created a Specialized Judicial Board under the Supreme Court, where disputes regarding the mutual obligations under investment contracts are settled, thus guaranteeing a more open and transparent environment for foreign investors.

South Korea is one of the largest investors in Kazakhstan. There are over 500 enterprises with the participation of Korean capital in Kazakhstan. Indeed, 1,081 legal bodies and entities, branches and representative offices are registered with South Korean participation (Hyundai, LG Electronics, LG Chem, POSCO, SK Corporation; construction companies Dongil-High Vill and Urim and others) and 516 of these are in operation. South Korean direct investment to Kazakhstan amounted to 5.5 billion, while investments from Kazakhstan to the Korean economy amounted to $2.2 million in the period of 2005 to 2018. The countries have 41 Kazakhstan-South Korean investment projects amounting to $4.6 billion. Among major projects is the construction of the Big Almaty Ring Road, with the participation of the Korean-Turkish consortium, a project of strategic importance for Kazakhstan.

It is important for Kazakhstan to establish economic relations with South Korea to diversify its economy. Kazakhstan's economy is strongly dominated by mineral resources extractive sectors, and the country's rapid economic growth during the period of 2000 to 2007, and afterward due to increased oil prices, was not well translated into substantial growth of non-extractive sectors. The construction and finance sectors contributed half of economic growth, far from a sustainable economic growth pattern. FDI remained concentrated in mineral extractive sectors. The economy is largely dominated by trade and mining sectors accounting for 17.3% and 16.3% of GDP in 2018. The country still remains resource-dependent, with mining industry exports accounting for 74.5% of total exports in 2018. For this reason it can be concluded that the economy is vulnerable to oil price fluctuations. In fact, when the price of oil declined to $40 a barrel in early 2009, the economy was in recession and the currency depreciated.

As a result the government introduced the industrial diversification strategy. In this regard, the government initiated and established ambitious industrial diversification programs such as the Strategy for Innovative-Industrial Development 2013-2015, and Strategy 2020. As a priority the Kazakh National Business Roadmap 2020 program clearly defines the importance of small and medium business development. It identifies the sector as a fundamental factor that boosts production and creates jobs and its policy is oriented toward streamlining regulations, improving business climates, removing barriers and increasing access to finance. The Kazakh National Business Roadmap

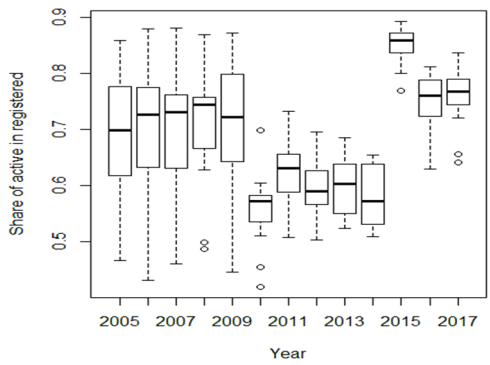
2020 defined the access to finance as an essential factor and tool to stimulate small and medium business enterprise development.

The small and medium business (SME) sector continues to be immature and highly concentrated in a few sectors. The SME sector is primarily concentrated on trade and services and has not kept pace with overall economic development. For instance, 80% of SMEs concentrate in the trade, construction, and service sectors, due to the fact that these sectors are described as low risk and modest start-up capital sectors. The rest of the SMEs are engaged in agriculture (17%) and industry (3%). A high concentration of SMEs in only a few sectors is an indicator of limited support to SMEs in adjacent sectors and limited opportunities for economic diversification. Interestingly, the interest rate set by commercial banks to the trade and service sectors is relatively higher than that in other sectors (17.2% on average in 2018).

On top of this, according to World Bank (2015) statistics the country lags behind the global benchmark in terms of SME contribution to economic development. For example, in 2015 the SME share in GDP accounted for 20%, which is two times lower than the global average. In addition, Kazakhstan is lagging behind most leading countries in terms of SME contribution to employment. As of 2009, the SME share in employment was only about 23.9%. SME development is considered as a key element to reduce the dependence of Kazakhstan on the oil extractive industry and lower exposure to oil price volatility, hence making the economy more resilient to the so-called "curse of natural resources." In the aftermath of the global economic crisis, oil prices declined significantly from $150 per barrel to $35 per barrel, prompting a severe economic impact in Kazakhstan. SME development is crucial to support sustainable economic growth, and thus economic diversification through SMEs is a key priority to the authorities.

The third feature of SME development in Kazakhstan as a primary sector of development is the low share of active operating SMEs in registered number. The number of registered SMEs in Kazakhstan in 2016 was more than 1.1 million, employing more than 3 million of the labor force and producing 27% of GNP. According to the World Bank Data of 2015, approximately 30% of registered SMEs are not actively operating. Figure 4 represents the boxplot of the share of active SMEs in registered. Although the share of active SMEs in registered declined from 2010 to 2014 (only 70% were active), it has improved substantially from 2015 to 2017. In addition to that, the share of active SMEs across the regions (provinces) converged in the period from 2015 to 2017.

Figure 2. The share of active operating SMEs in registered across provinces of Kazakhstan, 2005-2017



The high divergence of SMEs across provinces of Kazakhstan, especially from 2005 to 2009;

The significant decrease of the share of actively operating SMEs from 2010 to 2014;

Increase in the number of SMEs from 2015 to 2017;

The convergence of actively operating SMEs across regions from 2015 to 2017;

Source: Author's own compilation based on Statistical Agency of Republic of Kazakhstan data

The government of Kazakhstan needs a technological development plan to promote diversification of the economy. However, FDI and domestic financing were insufficient to develop the manufacturing industries. Although Kazakhstan moved up four spots to 55th according to the Global Competiveness Index in 2019, its innovation capability index places Kazakhstan 95th among 141 countries. Korea has been very successful in achieving progress in technological innovations, which is reflected in the composition of its exported goods. It is necessary to investigate why Korea was successful in achieving this progress in technological innovation over the recent 50 years in order to derive some important implications for Kazakhstan. The export-driven and heavy industry policies implemented in Korea led to an increase in the demand for technologies. Technological adoption can be separated into different stages in Korea. The major source of technological learning was original equipment manufacturing (OEM), because this form of production provided Korea with an opportunity to work with foreign buyers who arranged everything from product design to materials of quality control. In the 1970s, Korea targeted more capital- and technology-intensive industries, and implemented massive investments to establish machinery and chemical industries. To help industries to adopt new technologies, the government initiated technical training programs and created research institutes. FDI had a restrictive effect on the Korean economy. FDI accounted for only about 3.9% of long-term investment in the period from 1962-1982. In short, Korean industries depended more on informal channels rather than formal in their acquisition of technology, which in turn requires higher technology capability.

The Entrepreneurship Development Fund "Damu" JSC, a government credit guarantee institution (CGS), was created in 1997 through a Decree of the Republic of Kazakhstan Government, to support enterprises providing a wide range of financial instruments and programs. The CGS was created to increase the flow of funds to SMEs since it makes lending more attractive by absorbing the risk associated with it. The CGS reduces the risk of lending as it provides a form of collateral to enterprises, and it can itself assess and monitor the lending process. The major aim of the CGS is to mitigate inefficient credit allocation induced by information asymmetry between borrower and lender. Thus, the government's ultimate goal is to alleviate information asymmetry.

According to the "Damu" Fund, the share of funds provided to enterprises under its program in the total amount of credit averaged 15% in priority sectors and 22% in processing industry in the period from 2014 to 2016. The share of the "Damu" Fund is steadily increasing. For instance, the share of credit extended by the "Damu" Fund in 2016 increased to KZZT574 bln, representing 17% of total credit in economy. Throughout 2015, the "Damu" Fund extended 60% of its loans via a conditional investment fund. The amount of subsidized credit boosted from KZT 90 bln to KZT 235 bln, around 161% increase, in 2016. It has signed 2,597 guarantee agreements for a total amount of KZT 39,844 mln in 2017. The fund signed 60% of guarantee agreements with individual entrepreneurs. KIEP