

# A Study for Improving Trade and Commerce between Korea and Russia

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## Abstract

This paper attempts to provide a way to improvement in trade & commerce between Korea and Russia, analyzing the influence of the circumstances of the Russian economy on economic relations between the two countries. The study briefly reviews the current situation of the Russian economy, and tries to examine the strong points to be considered as leverage for cooperation and the weak points to be overcome. Previous studies have determined that the Russian economy has unlimited potential for growth, because it is endowed with abundant resources, and has a government willing to reform for the opening of the economy, as well as high-quality labor. However, the economic structure is vulnerable to impact of the worldwide financial crisis. It is not possible to overlook its institutional fragility and vulnerability such as a corrupt bureaucracy or a relatively large black market. These undesirable factors may not only undermine the basis of Russia economy but also a hindrance to economic cooperation by increasing economic uncertainty. This paper attempts to analyze comprehensively the socio-economic factors that influence the open-economy of Russia, and to illustrate strategies for improvement in trade and commerce through the viewpoint of Korean firms that are already in business or are trying to enter in the near future. Some measures to improve their economic cooperation are suggested at the end.

Key Words : Trade and Commerce, RTSI , Russian Economy, Russian Ruble, National Capitalism

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## I. Introduction

### 1. Background

The Russian economy has grown at an annual rate of 6.8% since 2000, due to an increase in oil prices and the development policy under the leadership of the Putin regime. Russia has invested oil money in infrastructure and advanced sectors as a foundation for growth, while OPEC countries have consumed or exhausted their oil money. Russia, soon to join the WTO, is trying to make a big economy, escaping the long recession from the transformation of the system in the 1990s.

Korean enterprises were able to get a foothold in the Russian market as a result of aggressive strategies, in spite of a moratorium in 1998, which has been helpful for Korean enterprises in making Russia a dependable market. Taking the circumstances of Russian consumption into consideration, it is expected that Korean firms may be able to make gains in the Russian market through economic cooperation. Making Korean enterprise a faithful partner for economic development is also good for Russia.

The Russian market has recently been more competitive as firms from the EU and Japan that exited or were pessimistic during the moratorium have actively reentered the market. Even though Korean firms have a foothold in the Russian market, their market share is not big enough. Korean firms have experienced failing business in Eastern Europe even though they held a good position, because of a lack of strategy following the opening of markets.<sup>1)</sup> Therefore, it is the time to examine economic cooperation between Russia and Korea thoroughly and to arrange a market strategy for Korean enterprises.

This paper attempts to determine the circumstances of the Russian economy and to examine problems for economic cooperation. Some proposals for improving trade and commerce are suggested in the end. The first section following the introduction surveys previous studies related to economic cooperation between Korea and Russia, and reviews the Russian economy. Several papers that seem to be benchmarks for our study were selected for discussion even though there have been many studies related to the Russian economy and economic cooperation.

### 2. Literature review

There are several works that survey economic cooperation between Russia and Korea. Han, Jong-Man(2006) analyzes the resource potential of Siberia and the far Eastern territories and deduces specific business opportunities

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1) Refer to Cheong, Inkyo and Jungran Cho(2007) pp.223-245.

and methods for cooperation between Korea and Russia on regional development.<sup>2)</sup> His approach is focused on geographical proximity and the ideal complementary economic relationship with Siberia the Russian Far East.<sup>3)</sup>

Another survey looks into the possibility of cooperation between countries based on mutual strengths. Kim, Yong Hwan and Kim, Mi Ja(2005) survey the present status and potential of Russian science and technology in order to examine the possibility of economic cooperation with Korea. The paper provides the insight the technological potential of Russia joined with the commercial technique, capital, and marketing of Korea would contribute beneficial economic growth and mutual prospects. The paper arrives at this conclusion using theoretical approaches towards economic growth, innovation, and policy learning.<sup>4)</sup>

Lee, Sang Joon(2004) mentions some barriers to expanding economic relations such as institutional inconsistencies and regional demographic problems. Using case studies of the OECD(2003) on the interface between central and sub-national governments, laws, regulations, and administrative actions in the region, for example, have potential conflicts with Russian foreign trade commitments. Concerning regional problems, he points out that the region's declining population and low standard of living undermines the basis for regional economic cooperation.<sup>5)</sup>

Eom, Gu Ho and Han, Hong Yul(2003) suggest that it is practical to take a sectoral approach to economic cooperation or integration in Northeast Asia, because it is impossible to integrate the institutional systems among the countries in this area, Russia, Korea, China, and Japan. The paper puts special stress on the role of Russia in implementing such a sectoral approach of regional economic cooperation, such as the idea of a Northeast Asian energy community.<sup>6)</sup>

### 3. Methodology

Since the 1980s, the development of growth theories and of empirically-based theories evolved a model in which policy agencies could consider global ideas concerning objectives and instruments of economic policy. International economic organizations, such as the OECD, the EC, and UNCTAD came to see internationally-based

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2) About the survey for Russian studies, refer to Chang, Duk Joon(2007) pp.155-180.

3) This review is mostly confined to journal articles(Han 2006). Other types of works such as books and reports can be occasionally referred, if necessary.

4) They insist that new growth theory moves away from neoclassical linear perspective to make the knowledge-creation process endogenous, and to relax neoclassical assumptions, such as perfect competition, perfect information, and identical levels of technology.(Kim, Yong Hwan & Kim, Mi Ja(2005) pp.839-874)

5) See, Lee, Sang Joon(2004) pp.733-761.

6) Eom, Gu Ho and Han, Hong Yul(2003) also mention that the Russian Far East has abundant energy resources of interest to the regional economies, and has an efficient transportation and distribution system which connects it to Japan, Korea, and China. It concludes that Russia's deepening political and economic relationship with countries in the region is regarded as a necessary condition for any type of regulatory coordination among the countries.

research and innovation policies as important instruments towards wider-ranging policy objectives. This global innovation system approach leads to an understanding of economic dynamics and socio-economic development among countries that cooperate with each other. For example, OECD(1988) is a policy document that challenges macroeconomic issues. This report interprets technological change as social progress that should be viewed in dynamic terms interacting with the rest of the world. OECD(2001) sets out a vision of devolved economic development policies capable of responding to the challenges of globalization.<sup>7)8)</sup> The report examines how urban and regional governments and development agencies need to use their devolved powers to respond to globalization. Devolution is more than just a transfer of power. It is also a new spirit of cooperation and networking between different levels of government and civil society partners. Brought together at the level of cities and regions, they can apply some promising development tools for strengthening enterprise clusters, promoting training for a knowledge economy, and regenerating distressed areas, for example.<sup>9)</sup>

This paper constructs a model seeking strategies of economic cooperation in view of evolutionary theory to help develop a systematic descriptive argument. The model is used to begin to examine the socio-economic background full of suggestions.

The socio-economic background of Russia is thoroughly examined below to derive implications that influence the market. Based on the implications, the reactionary policies of Russia and neighboring countries are predicted, and the effects on markets are analyzed.<sup>10)</sup> Attention is also paid to the risk factors inherent in the structure of the economy. Finally, comprehensive strategies for economic cooperation between Russia and Korea are deduced.<sup>11)</sup>

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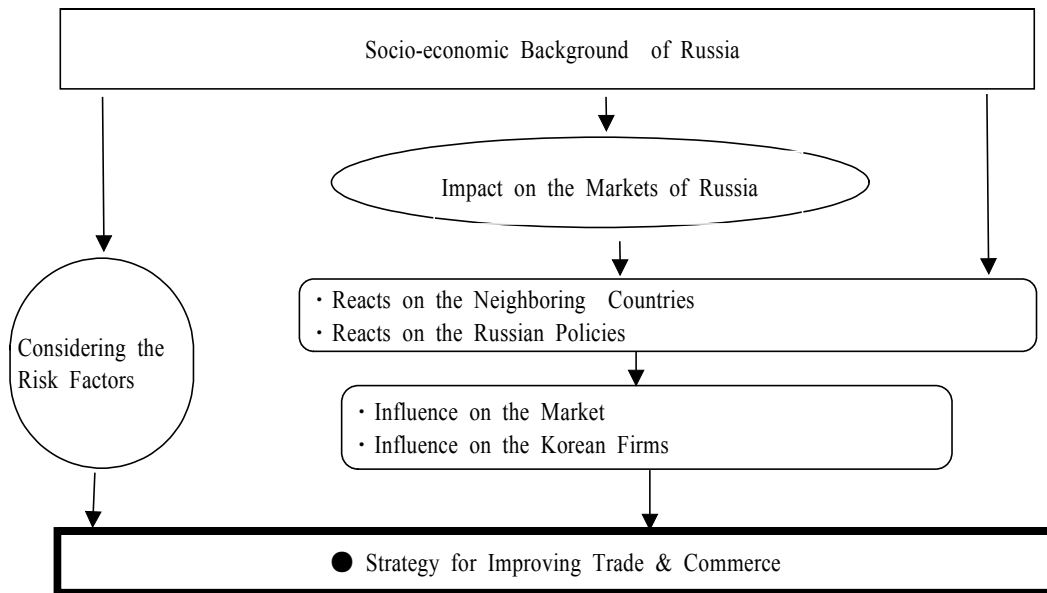
7) Refer to OECD(1988, 1992)

8) See, Gächter, S. et al.(2004) pp.505-531.

9) Cited from OECD(2001) pp.1-275.

10) Park, Chong-Suk and Hwang, Kun-Ha(2007) suggest that free trade groups should examine a draft free trade agreement based on changes in the economic environment and a study the general background of the Free Trade Area of the Americas. Yoon, Kikwan(2003) studied a way of enforcing economic cooperation between Korea and Japan when e-trade prevailed in the East Asian region under the APEC system.

11) Holford, A David, et. al.(2008) pp.424-437.



[Figure 1] Korea–Russia Economic Cooperation Model

## II. General status of the Russian economy

### 1. Review of the economy

The Russian economy has increased to a high growth rate since 2000 even though it had negative growth in the 1990's. Russia experienced a moratorium in 1998, due to expanding industrial strikes, delayed wage payments, declining oil prices, and unstable politics. However, Russia has recently tried to become a major economy following the turnover period of the country's system in the 1990's.<sup>12)</sup>

Economic indicators affirm the state of the Russian economy. The economy recorded 6.9% annual growth from 2000 to 2008 and even though -9.8% in the first quarter of the year 2009 because of the worldwide financial crisis. It is believed, therefore, that Russia has found a stable path towards economic growth. The government budget recorded a surplus equal to 4.1% of GDP in 2008 and the labor market displayed a better condition as the unemployment rate was down to 7.0% in 2008 from 9.8% in 2000.

As an indicator for the openness of the Russian economy, exports and FDI have recently rapidly grown, with

12) See, Dusseault, D., *et al.*(2005) pp.121-30.

a 32.8% increase in exports and a 30.3% increase in imports in 2008.<sup>13)</sup> FDI was \$73.1 billion in 2008, which was more than twice the amount of 2006.<sup>14)</sup> The stock exchange has also reflected the economic boom. The Russian Trading System(RTS) is a stock market established in 1995 in Moscow, consolidating various regional trading floors into one exchange. The RTS was originally modelled on NASDAQ's trading and settlement software. In 1998 the exchange went online with its own in-house system. Russia's stock market surged above 14 times from 1995 through 2009, even though it slowed down recently due to the worldwide financial crisis.

<Table 1> Economic Indicators of the Russian Federation

Indicators	2000	'01	'02	'03	'04	'05	'06	'07	'08	'09 Q1
GDP (real growth, %)	10.0	5.1	4.7	7.3	7.2	6.4	7.7	8.1	5.6	-9.8
Gross Capital Formation ( real growth, %)	75.2	16.7	-2.6	13.2	12.2	9.5	18.6	21.0	11.1	-
Real disp. income (“, %)	12.0	8.7	11.1	15.0	10.4	11.1	10.2	12.1	2.9	-0.6
CPI (rate of inc, %) <sup>15)</sup>	20.2	18.6	15.1	12.0	11.7	10.9	9.7	9.0	14.1	5.4
Trade balance (Bil. \$)	60.1	48.1	46.3	59.9	85.8	118.4	139.3	130.9	179.8	19.1
Urals Oil price (\$/B)	26.6	22.9	23.6	27.3	34.4	50.6	60.9	69.5	93.9	43.2
External Debt(of GDP,%)	50.0	37.0	44.1	43.1	36.1	33.6	31.7	36.4	28.8	-
Budget B. (of GDP,%)	1.4	3.0	1.4	1.7	4.3	8.1	7.4	5.4	4.1	-
Ex. R (ruble/\$, end of)	28.2	30.1	31.8	29.5	27.7	28.8	26.3	24.6	29.4	34.0
Unemployment(%)	9.8	8.7	7.9	8.4	7.1	7.6	7.1	5.7	7.0	9.1
Interest rate(%)*	24.4	17.9	15.7	13.0	11.4	10.7	10.4	10.0	12.2	16.2
S&P Credit Rating	B-	B+	BB	BB+	BBB-	BBB+	A-	A-	BBB+	BBB-

note : \* Ruble credit rate of within 1 year loan offered by non-bank financial institution

source : Росстат ЦБ РФ S&P; Fitch; Moody's ([http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?](http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU)

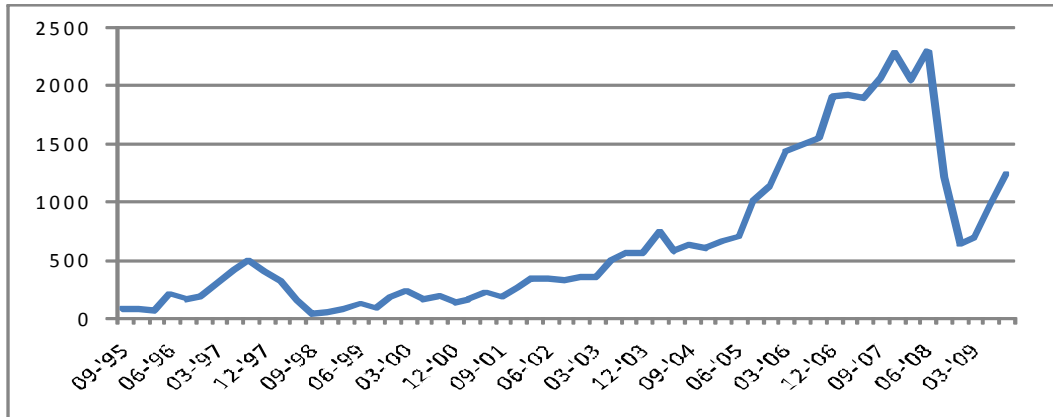
[Language=E&Country=RU](http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=RU))

Bulletin of Banking Statistics., each Nos, Moscow 2009, The central bank of the Russian Federation,

13) See, *Bulletin of Banking Statistics*. No7(194), Moscow 2009, The central bank of the Russian Federation.

14) See, Bank of Russia.(<http://www.cbr.ru/eng/statistics>)

15) CPI is the number of percentage calibrated in December to December of the previous year, Russia Federal State statistics service.(<http://www.gks.ru/wps/portal/!ut/p/cmd/cs/ce>). The average of CPI is geometric average in the period of 2000 to 2006.



Source : <http://www.rts.ru/en/index/stat/monthlyhistory.html?code=RTSI>

[Figure 2] Trend of the RTSI(1995. 9~2009. 9)

The leadership of Putin and the trend of high oil prices have seemed to have acted as a multiplier for the development of the Russian economy, since Russian oil money has been used for the industrial investments whereas the oil money of most of the countries in the Middle East have been consumed in markets for final goods and services. Russia is also restoring its past power as a strong country based on its efficient use of abundant resources. Russia has begun to use its power to influence the world market using mining resources such as oil, gas, iron ore, copper, while Russia's nominal GDP in 2008 was \$1,676.8 billion, which is enough to rank as tenth in the world. Researchers expect, therefore, that Russia will rank fifth in the world economy in 2020, if it continues to grow at the present rate.

<Table 2> Outlook for the Russian Economy in 2020 Compared with 2005

Indicators	2005	2020
Population (of the world, %)	2.2	1.9
GDP (of the world, %)	2.1	3.2
GDP rank in the world	10	5
per capita GDP (\$, PPP 2005 price)	11,000	26,800
World rank of per capita GDP	53	40

source: ИМЭМО<sup>16)</sup>: Мировая экономика: прогноз до 2020 г., М.: Магистр, 2007.

16) ИМЭМО (2007) published a book "Russia in Global Affairs" for the world forecast until 2020.

## 2. Strengths and weaknesses of the Russian economy

### 1) Strengths

The leading strengths of the Russian economy can be summarized as its growth potential, abundant resources, and governmental willingness for reform and for opening the economy.

First of all, Russia is a country endowed with abundant natural resources and relatively high-quality labor. Russia is endowed with energy resources such as oil and natural gas as well as mineral resources such as nickel and iron ore. Oil reserves are estimated at 60 billion barrels(ranked 8th with 6% of the world's) and the amount of production is 9.3 million barrels per day(second in the world). The Commonwealth of Independent States(CIS), which is closely related to Russia, has 10.1% of the world's oil reserves, and 14.3% of oil production. Natural gas reserves amount to 1/3 of the world's and it ranks first in production(20% of the world). There is also iron ore(first, 5.6 billion tons), coal(second, 17.3 billion tons), many minerals, forests, and fisheries.<sup>17)</sup>

Besides the natural resources, there is high-quality labor in all Russian industries. There is particularly highly competitive labor in aerospace, IT, and the defence industry. Workers with high-tech education are spread out nationwide. Novosibirsk, especially, is a center of high-tech institutions. Statistics show that the educational system is well-provided so that Russia illiteracy rate is below 1% and there were 68,000 people with MS degrees in IT as of 2004 while Korea had 10,000 in 2005.<sup>18)</sup>

In the process of lifting the moratorium, the government, under strong leadership, has made a strong drive for development and social reform. In particular, former president Putin gained a position in the country as a strong leader with the Russian people's support and Russia's position in the world has improved since his succession in 2000. The government has centralized power to promote federal administration efficiency, such as by merging local governments with integrated administration across a broader area and introducing a system of appointing the chiefs of local government instead of electing them. During his presidency, Putin played host to the St. Petersburg G8 Meeting in 2006 to show off his leadership of powerful Russia.

In industrial policy, the government has expanding the openness of the economy and carried out policies consistent with a market economy. Reform of the tax and administrative systems is an example of opening the Russian market to the world. The policy of decreasing the corporate and value-added taxes was introduced in order to promote FDI. Privatization and reconstruction of national monopolies has been carried out.

On the other hand, they have reinforced the role of government in the core industrial fields such as energy. A feature of policies adopting multiple industrial structure can be interpreted as reducing intensive use of resources

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17) Refer to "CEO information No. 580", Samsung Economic Research Institute.

18) Refer to KEDI, Center for Education Statistics.(<http://cesi.kedi.re.kr/index.jsp>)



and avoiding resource dependency in a particular industry. Thus, government has carried out multiple industrial policy and local development. Oil money is used to make industry highly sophisticated, in that the structure has a higher economic growth potential and is able to reduce resource dependency at the same time. One example can be found in the IT industry. Government has promoted support for the IT industry in order to improve competitiveness in an information-oriented age. They put the goal in place that the IT industry would increase to contributing 5% of production to GDP in 2010 from 1.5% in 2005, producing 43% of telephones, 40% of computers, and 45% of the internet supplied to the nation. It is reported that they plan one billion dollars of investment in the IT industry in the next five years.

<Table 3> IT Infrastructure in Russia

( Rate of Supply : %)

Fields	2001	2002	2003	2004	2005	2010 goal
Telephone	24.1	25.4	26.6	28.4	30.0	43.0
PC	7.5	8.3	9.0	10.4	12.1	40.0
Internet	2.9	5.6	9.7	12.9	15.1	45.0

source : Ministry of Information and Communication, Russia

It is expected that joining the WTO will influence the proliferation of market mechanisms with a long-term positive effect on Russia. In the experience of economic history, joining the WTO will contribute to improving the physical constitution of the Russian economy, which may lead to continuing economic growth because market competitiveness may lead to market efficiency and promote the economy to become more internationally competitive.<sup>19)</sup>

There are, however, some possibilities of social disturbance due to the radical opening of the economy during the period of adjustment as shown in the period of transition to a free-market system in the 1990's. It is generally expected that the Russian economy will make good progress in high value-added industries, but, industries falling behind will be severely damaged by the opening of the market, including traditional industries and the financial and service industries. The fields suffering tariff reduction after joining the WTO, such as agriculture, communications, and automobiles will accelerate to higher value-added fields if they succeed in reforming through the restructuring of industry.<sup>20)</sup>

19) In details, refer to Cooper, William H.(2006)

20) Rutherford, T. F. and D. G. Tarr, "Poverty effects of Russia's WTO accession: Modeling "real"households with endogenous productivity effects", *Journal of International Economics* 75(2008) pp.131-150.

〈Table 4〉 The Effects on the Russian Economy of Joining the WTO

Fields	Positive	Negative
Reform and Reconstruction	<ul style="list-style-type: none"> <li>• Additional growth due to market opening and deregulation</li> <li>• Improving competitive power.</li> </ul>	<ul style="list-style-type: none"> <li>• Aggravating crisis by severe competition</li> <li>• Social disturbances due to high unemployment</li> </ul>
Trade	<ul style="list-style-type: none"> <li>• Increasing trade</li> <li>• Consumers better off due to declining prices</li> </ul>	<ul style="list-style-type: none"> <li>• Russian market invaded by cheap foreign goods,<sup>21)</sup></li> <li>• Increasing import of costly articles and luxuries.</li> </ul>
Financial Market	<ul style="list-style-type: none"> <li>• Increase in FDI</li> </ul>	<ul style="list-style-type: none"> <li>• Financial disturbance due to possible hot-money and hedge funds</li> </ul>
Industry, Firms	<ul style="list-style-type: none"> <li>• Developing IT and Electronics due to FDI</li> <li>• Highly sophisticated industrial development through M&amp;A and promoting reconstruction</li> </ul>	<ul style="list-style-type: none"> <li>• Crisis in traditional industries</li> <li>• Instability of financial markets.</li> </ul>

Note : Rearranging the contents of the The Economist print edition Nov. 27th 2008 and information by country of KOTRA.

In addition, Russia is rising as a hub of physical distribution based on the Trans-Asian Railway(that will make Russia a land bridge) in that Russia will gain many advantages of trade expansion, increasing the opportunity for international exchange, for human resources, and for increasing FDI. In fact, there was an agreement on the Trans-Asian Railway(TAR) by the UN ESCAP in 2006 for connecting the Trans-Siberian Railway(TSR), the Trans-Chinese Railway (TCR), Trans-Manchurian Railway(TMR), Trans-Mongolian Railway(TMGR) and Trans-Korean Railway(TKR). Of course, there are many problems yet to solve with international agreements for train operation such as standardization of stations and container terminals, simplifying customs procedures, rail fare, and operating conditions.<sup>22)</sup>

## 2) Weaknesses

Even though the Russian economy has long-term potential for economic growth, it has fundamental problems in its industrial structure.<sup>23)</sup> A fast growing economy generally shows a tendency to concentrate on strategic industries so that the economy tends to form an asymmetric industrial structure. The Russian economy is no exception. The economy as a whole is vulnerable to the impacts of inflation or exchange rate fluctuations since

21) Increasing Imports of the chief foreign goods is regarded as highly desirable in theory, though politicians do not agree it due to its negative effects on the domestic labor market.

22) See, Lee, Sang Joon(2004). Also refer to Han, Jong-Man(2006).

23) See, Ickes, B. W. and G. Ofer(2006) pp.409-434.

the growth strategy has concentrated on particular fields, such as energy and heavy industries. In fact, the source of Russian growth mostly consists of funds from exporting natural resources, which are very sensitive to price fluctuations. Analysis shows that there is pressure for appreciation of the Ruble caused by the high government budget surplus and balance of payments.

The CPI and the exchange rate have seemed to be stable so far even though the political and economic situation for continued growth has recently begun to change against Russia. Although it has not been a very serious economic problem, there was an indication that the Ruble had been depreciating due to capital outflows as of the Georgian attack on Russian forces. Thus, it is expected that there is the possibility of a radical increase in inflation and the exchange rate caused by outside impacts. Once an economic crisis happens in Russia, its management is supposed to depend on the government's stabilization funds.

The BOP surplus, paradoxical as it may seem, may be an inflationary factor in Russia. The Russian BOP surplus is caused by the high price of oil and natural gas overseas, which increases the cost of imports. The money supply created by the BOP surplus increases wages, domestic demand, and excess social expenditure, which leads to inflation.<sup>24)</sup>

In addition, the system of fixing exchange rates for the purpose of protecting domestic industry can be also a fundamental problem, because once appreciation happens, it is possible that an industry's competitiveness may radically decline.

Bureaucracy and corruption has been found to undermine the make up of Russia's economy and is the biggest obstacle to expanding investment and economic growth in the country. In the 2008, a corruption index compiled by Transparency International gives Russia 2.1 points out of ten, its worst performance for eight years and on a rank 147 out of 180.<sup>25)</sup> The size of the corruption market is estimated to be close to \$300 billion, equivalent to 20% of Russia's GDP.<sup>26)</sup> There are many examples related to corruption. Some firms engage in black market transactions in order to avoid taxes. Some of the newly rising rich, especially firms that became big after acquisition of national enterprises, are suspected of earning money through underground markets. The black market may also be attributed to income inequality, which has changed for the worse. It is estimated that the income gap between the top 10% and the bottom 10% was 14 times in 2001, but it had increased to 26 times as of 2006.<sup>27)</sup>

Having realized the problems government authorities have recently carried out its crackdown by redressing inefficient bureaucratic and political corruption, and boosting transparency. However, it is supposed that it will take time to clean up corruption, even though the government is attempting to clear out dirty officials.

24) See, Lee, Jong-Min(2007) pp.197-217.

25) Refer to "Transparency International".(<http://www.transparency.org/>)

26) Cited from The Economist print edition Nov. 27, 2008.

27) Control Risk, "Facing Up to Corruption : A Practical Business Guide", 2006.

Finally, economic analysts have expressed concerns over Russia's national capitalism and resource nationalism spreading nationwide. In fact, the trend of enforcing national capitalism is observed in the major infra-industries, such as oil and natural gas, automobiles, aerospace, and military.<sup>28)</sup> In the area of national capitalism, the central government has great influence over the state enterprise M&As with private firms in strategic industries, in which, it is evaluated, the government lacks consistency in its privatization policy since the transition of system. The weight of state or national enterprises expanded to 35% in 2006 from 30% in 2005.<sup>29)</sup> In fact, M&A activity in Russia has been increased up to the 2008 Russian presidential elections.<sup>30)</sup>

<Table 5> Examples of M&A

Acquiring state firm	Acquired private firm	M&A method
Rosneft (oil)	Yuganskneftegaz	Acquisition
Gazprom (gas)	Sibneft (oil company)	Acquisition
UES (electricity)	Power Machine	Acquisition
Aeroflot (aircraft co.)	Major private company	Buying of stocks
Rosoboronexport (arms)	Avtovaz and Kamaz	Acquisition

Source : Acquisitions Monthly October, 2006.

The Putin regime is suspected of having used energy resources as a weapon together with national capitalism. Many experts worry about a natural gas cartel, including North Africa, Middle Asia, and Central Asia under the leadership of Russia. Thus, the US and EU have tried to reinforce diplomatic efforts towards the nations of Central Asia and the Caucasus.

<Table 6> Russia National Energy Industry Enterprises

Domestic Rank	Company	World Rank	Revenues(\$ millions)	City
1	Gazprom*	52	81,115.0	Moscow
2	Lukoil	110	54,539.0	Moscow
3	Rosneft Oil	323	21,959.0	Moscow
4	Surgutneftegas	392	18,413.1	Surgut

28) Puffer, S.M. and D.J. McCarthy, "Can Russia's state-managed, network capitalism be competitive? Institutional pull versus institutional push", *Journal of World Business* 42(2007) pp.1-13.

29) Refer to *Acquisitions Monthly* October, 2006.

30) "Recent trend in Russian M&A", Forum of Association of European Business, 2009. 9. 17. Moscow, ([http://www.aebrus.ru/./MA\\_program\\_eng\\_file\\_2009\\_09\\_09\\_17\\_19\\_29.pdf](http://www.aebrus.ru/./MA_program_eng_file_2009_09_09_17_19_29.pdf))

Source : Fortune 500, July 23, 2007.

Note : Gazprom was ranked 139th in 2005, 102nd in 2006.

### III. The present and future relationship with Korea

#### 1. The present situation

Korean enterprises began doing business in Russia before the Korean government established diplomatic relations with the USSR in 1990. Korean firms actively continued to develop the Russian market from that time, even after the declaration of the moratorium when most Japanese and EU firms tried to exit or were negative towards the Russian market.<sup>31)</sup>

Korean exports to the Russian market grew an average of 44.6% from 2002 ~ 2008.<sup>32)</sup> Samsung and LG Electronics in particular supply ten out of the twenty most popular brands in Russia. This has resulted in an increase in the electronics market share. For examples, the market share has reached 49% for monitors, 48% for appliances, and 28% for mobile phones. In addition to the large firms, medium-sized firms, such as Korea Yogurt(ramen), Orion(chocolate pies), Ottugi(mayonnaise), and Bingre(snacks) have entered the Russian consumer market.

However, Korean business has seemed to reach a critical point in using existing the same methods it has used from the beginning. Many specialists have realized that it is time for them to change their strategies for the Russian market, since the environment has changed since the end of the moratorium.

Firms from Western Europe and Japan, that had left, have tried to re-enter with active market expansion strategies, such as direct investments for building factories and facilities in Russia. Therefore, Korean entrepreneurs need to develop a new strategy for keeping their influence in the Russian market based on analysis of the strengths and weaknesses of the Russian economy.

#### 2. A point to be considered for the future relationship

As we have seen above, the Russian market is attractive to Korean firms on account of market expansion due to long-term economic growth whether as established firms or as new entries. The possibility of infection with

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31) See, Johanson, Martin(2008) pp.46-64.

32) Refer to KOTIS([www.kotis.co.kr](http://www.kotis.co.kr))

the Dutch Disease<sup>33)</sup> is expected to be very low, because the Putin regime has tried to decrease dependency on the energy industry, instead promoting diversification of industry and infrastructure investment in local development.

In the manufacturing field, Russia has strength in science and technology but not in consumer goods, which are dependent on imports. In fact, more than 50 percent of consumer goods are imported. Manufacturing of general consumer goods and durables are vulnerable fields in a way. This is an opportunity for expansion in the Russian market. especially, for Korean firms having a comparative advantage in an opening era. Joining the WTO with an open market will encourage Russia to provide institutional arrangements that contribute to improving the environment for transparent firm management. Furthermore, it is expected that there will be lowered tariffs, removal or appeasement of non-tariff barriers, as well as legal and institutional arrangements in line with international norms.

On the other hand, there is a challenge for the Russian market, that is, increasing competitiveness due to the reentry of firms from developed countries. Many firms from developed countries that left the Russian market in the moratorium period, have recently come back using local production lines.

To make matters worse, Russia joining the WTO will bring about transparency in trade. However, many firms have been engaged in roundabout exports<sup>34)</sup> and will be deprived of gains. In fact, many Korean exporters use roundabout exports. The Russian Minister of Economic Development estimates that 85 percent of the imports of electronics and mobile phones are through roundabout exports.

The rate of sales growth of Samsung and LG Electronics has recently slowed from recording more than 50 percent annually since 2000. Their analysis is that the reason is lowering price competitiveness compared to local producers due to the increased cost of tariffs and distribution.

Russia has a financial system vulnerable financial impacts from abroad. The Russian stock market showed instability even before the grave world financial crisis in September 2008. Both the RTS and MICEX indexes were shut for several days during the world financial crisis due to fluctuation on a scale not seen since Russia's 1998 financial collapse. At that time, MICEX plunged 25 percent in just 2 1/2 days of trading, and fell by more than 55 percent from its May 2008 peak.

Nevertheless, there is an optimistic view of the present Russian economy compared with the economy of the

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33) Dutch disease is a concept that refers to negative consequences arising from large increases to a country's income. It is primarily associated with a natural resource discovery, but it can result from any large increase in foreign currency. When foreign currency inflows cause an increase in the affected country's currency (appreciation) and in wages it leads to two main effects for the country : A decrease in the price competitiveness of its exports and an increase in imports. In the long run both these factors can contribute to manufacturing jobs being moved to lower cost countries. The end result is that non-resource industries are hurt by the increase in wealth generated by the resource-based industries, which leads to undermined growth potential as a whole.

34) A roundabout export to Russia is performed by exporting goods to a nearby country, like Finland, then Russian importers take the goods to clear them through customs. It is similar to bonded warehouse trade.

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1998 financial crisis. This is because foreign reserves in Russia have recorded \$404.9 billion as of September 4, 2009, ranking third in the world<sup>35)</sup> while Russia has adapted well to a market economy since the financial collapse. Above all things, Russia has been politically stable as the new Medvedev-Putin regime has maintained Putin's economic policy since April, 2008.

After analyzing the economic environment for Russia, it is recommended that Korean firms need a comprehensive strategy to keep their market power. Since established firms get the inside track, Korean firms had better seek strategies to expand the market in the face of the reentry of European and Japanese firms who left the market after the Russian moratorium in 1998. In particular, those firms should maintain and reinforce their market influence and try to find ways to expand into new fields in the market by ensuring distribution networks, reinforcing marketing networks, and developing early production operations in Russia.

The case of LG Electronics' Russian production line is a good example. LG Electronics is building a digital electronics factory to produce PDPs, LCD TVs, washing machines, refrigerators, and stereos in Ruza, near Moscow. It has a plan to invest \$100 million by 2010. This can be regarded as a strategy of gaining a foothold where, after ensuring the manufacturing base in Russia is secure with enough domestic demand, they plan to expand the market to CIS countries. This is also a successful case of joint investment with seven small firms that supply parts.

## IV. Proposals for improving trade and commerce

### 1. Expanding the diplomatic base in Russia

In order to expand business in Russia, above all things, it is necessary for Korean firms and the government to maintain systematic relationships to solidify the Russian market and to try to study areas for economic cooperation between Korea and Russia. Keeping abreast of the times, the Korean and Russian governments should try to negotiate an FTA and make efforts for economic cooperation, such as FDI in the energy and consumer goods industries. In fact, in relation to Russia, Korea is falling behind in comparison with its major rivals. For example, Korea is ranked fourth or fifth among major countries in trade, FDI, and diplomatic talks with Russia. There are, however, no political issues or territorial problems between Korea and Russia, except for the issue of North Korea. This means, in some ways, that Korea still has opportunities to improve a relationship with Russia, depending upon the institutions' effort. For example, there are relatively many ethnic Koreans in Russia who can

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35) The Central Bank of the Russian Federation, External and Public Relations Department.( <http://www.cbr.ru>)

be a bridge of cooperation. We could make them the pro-Korean group, providing with a systematic programs to educate them in Korea.

<Table 7> Comparison of Major Countries in Russian Relations

Relations with Russia	EU	US	China	Japan	Korea
Rank in goods trade	1	3	2	4	5
Rank in service trade	1	2	5	3	4
Rank in FDI in Russia	1	2	3	4	5
Rank in Russian FDI	1	2	3	4	5
Rank in territorial disputes	2	4	3	1	5
Rank in ethnic residents in Russia	1	-	3	-	2
Rank in number of summits	1	3	2	4	5

Note : Based on 2008.

Source : Russia Federal State Statistics Services(<http://www.gks.ru/wps/portal/!ut/p/cmd/cs/ce>)

The Central Bank of the Russian Federation(<http://www.cbr.ru/eng/statistics/>)

## 2. Finding a way of cost down by understanding practice and promoting FDI

To improve commercial relations with the Russian, it is important to understand Russian practice in commerce. Though it is trivial to say that human relationship is the first factor in business, there is a common notion that nothing is impossible if he shares a business with Russian. If we take a big black market into consideration, a success of business would be depended upon how a Korean CEO has an affinity with Russian.

FDI in Russia could lead to a close relationship between CEOs of the countries and it affects every deal a business makes. And besides, Korean firms must continue to search for a way to lower costs to expand in the Russian market, because the Russian market is getting more competitive, with EU and Japanese firms. One of the ways is to provide local production that will lead to lower costs by saving on transportation and tariffs. Operating local production in Russia has the effect of showcasing Korea's new inclusive image as a good partner. To achieve the goal, decision makers in firms must perform a thorough analysis of the market situation before carrying out plans that include large direct investments. FDI policy and special economic zones provided by the Russian government usually contain some incentives such as exemptions of income tax and tariffs. Even though some firms have launched into Russian business, the Korean FDI recorded a negligible quantity yet.



〈Table 8〉 Volume of FDI in the Russia in 2008, by main countries

	Mln. USD	Percentage of total(%)
Total investments	103,769	100.0
Cyprus	19,857	19.1
United Kingdom	14,940	14.4
Netherlands	14,542	14.0
Germany	10,715	10.3
Luxembourg	7,073	6.8
France	6,157	5.9
Virginian Islands(UK)	3,529	3.4
Switzerland	3,062	2.9
Ireland	2,903	2.8
USA	2,773	2.7

Source : Russia Federal State Statistics Services (<http://www.gks.ru/wps/portal/!ut/p/cmd/cs/ce>)

### 3. Finding the sectors having comparative advantages

Korean firms have a comparative advantage in the consumer goods industry, thus it is recommended that firms seek business strategies to deal with the growing market for consumer goods. Large enterprises specializing in IT and durables are expected to grow as are small and medium enterprises specializing in general consumer goods, such as foodstuffs, clothing, stationery. Firms that produce parts may also join large enterprises to enter the market.<sup>36)</sup>

Since the market is expected to be very competitive, firms need to develop new products to meet Russian tastes rather than just making existing products. It is advised that the direction for expanding the Russian market is better in provincial cities rather than the big metropolises, because the metropolitan areas are very competitive at present. It has been observed that there is a time lag between the big and small cities in regards of coming into fashion.

### 4. Improving a bargaining power for the government-financed projects

Participation in major government-financed projects is strongly advised. It is desirable to set up a business

36) See information by country KOTRA.(<http://www.globalwindow.org/wps/portal/gw>)

strategy with the aim of following the direction of the Russian government. The Russian government is interested in the fields of local development and IT and communications. “e-Russia” is a project for developing the government system based on internet technology. Korean firms have the experience of making system integration(SI) technology, ADSL technology, and supplying PCs and laptops for Korean e-government.

Besides, there is the possibility of receiving large orders for energy development in the Far East. For example, PoongLim Industry Co. received an order for the construction of Russia Exxon export base(\$112 million) and an order for housing construction in the Tartarstan area for POSCO.

## 5. Systematic risk management

In the wake of the meltdown of the world stock market in September 2008, questions have been raised about the resilience of Russia's economic boom. It has analyzed that, in a matter of grave concern, it will improve the resilience of Russia's financial markets in the long term, although in the near-term the process could be painful, and they indicate that the present situation in Russia is very different from a decade ago. They also point out that Russia currently has enough foreign-currency reserves, a hefty budget surplus with a negligible national debt. The source of the nation's wealth will not be affected by these banking liquidity problems. It is estimated that as long as the price of oil stays above \$70 per barrel, the lucky profits will continue to roll in.<sup>37)</sup>

Even though specialists have an optimistic outlook, the Russian economy has potential problems such as a volatile exchange rate, a rigid fixed-rate exchange system, possible fall in the price of oil, and rising inflation.<sup>38)</sup> Besides, the potential problems of Russia's transition to a free-market system and possible problems concerning institutional changes when joining the WTO cannot be bypassed.

It is advised, therefore, that each enterprise provides a system of risk management against the instability of macroeconomic variables and changes in institutional factors. The Korean government also has to search for ways to diversify the risks that firms still face.

On the other hand, entrepreneurs should find a way to expand areas for possible trade, such as joint research to develop high-end products. Russia has advantages in energy resources, basic science and technology, aerospace, and optics while Korea has advantages in commercializing techniques, capital strength, and the ability to develop markets. These are the industries that are able to yield gains between the two countries. Together with this strategy, the Korean government should examine an FTA in order to maintain competitiveness and expand economic cooperation in Russia. EU countries are considering an FTA with Russia.

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37) “Russia Floods Markets with Cash in Shutdown”, *Times Online*, September 18, 2008.

38) cited, *ibid*, 'Despite this, however, banks and traders remained nervous about the outlook with uncertainty in the global market, falling oil prices and international tensions between Russia and the West over the war in Georgia.'

## V. Conclusion

Economic cooperation is a necessary condition, along with competition, for the creation of wealth, innovation, and knowledge. This paper has briefly summarized and analyzed certain measures in regards to economic cooperation between Korea and Russia. It has also attempted to illustrate a direction for balanced cooperation that will create wealth in both countries.

Because of the limited data, this paper could not yet deal with the concrete fields of economic cooperation between the countries. Policy surveys and a model for building complementary measures of cooperation that will lead to the creation of wealth, innovation, and knowledge in the two countries. Within those limits, strategies for economic cooperation have been advocated. These include an aggressive strategy for keeping market power, expanding local production in Russia and a positive attitude towards growing consumption, taking advantage of Russian government infrastructure projects, and enforcing risk management and the pursuit of long-term effects of economic cooperation.

Even though the recent financial crisis threatens the world economy, it does not mean that either of the countries is facing immediate economic disaster or will abandon its long-held political goals. In particular, since the Russian economy has the potential to grow in the long term, the suggested measures for economic cooperation could be put in effect.

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