REGIONAL ECONOMIES

KAZAKHSTAN: CAPITAL FORMATION PROBLEMS ON THE WAY TO A MARKET ECONOMY

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Difficult Choice at the Start of Reforms

Countries that have taken the road of transition from a planned economy to a market economy encounter roughly similar problems, which have by now been thoroughly studied. Initially, politicians and researchers were concerned about such problems as social stability during the transition crisis, budget execution, the pace of liberalization and advance toward an open economy and, naturally, the character of emerging property relations. One can hardly dispute that at this stage it is extremely difficult to take a systems approach to the creation of market institutions. Naturally, we understand these institutions in the modern sense of the word, as a combination of formal legal framework and effective norms, including rules of conduct of market agents actually observed in practice. In the early 1990s, it was assumed (in most cases tacitly) that the formation of a private (preferably competitive) economy would result in a rapid revival of economic activity. In the countries of Central and Eastern Europe, the turn toward the marketplace took about five years, and growth was first recorded in the mid-1990s. The recession in the former socialist countries has been analyzed time and again, but some of the earliest studies already gave a sufficiently clear explanation of the gener-

al causes of the transition crisis. As regards Russia and Kazakhstan, these causes were justly listed as follows: manufacture of unneeded goods, inefficient production and irrational allocation of resource inputs.[1]

In Kazakhstan, additional problems were created by the "planned" domination of heavy industry, formerly geared to meet the needs of the U.S.S.R., the low development level of many consumer goods and service industries, and territorial isolation. Industries and enterprises under Union jurisdiction accounted for over 90% of total output in the republic. The breakup of the U.S.S.R., the introduction of inconvertible currencies in the newly formed countries, and the abolition of the system of state orders naturally led to the disintegration of existing supply and marketing mechanisms, to the disappearance of sources of productive resources and markets. A high degree of production integration with Union enterprises prevented a quick reorientation of enterprises in Kazakhstan toward new markets. Adjustment at the microlevel proceeded in chaotic macroeconomic conditions. Cessation of the centralized inflow of funds was a typical situation throughout the post-Soviet space. Budget subsidies from the U.S.S.R. and then credits from Russia came to an end, which struck a heavy blow at the republic's chemical and petrochemical industry, engineering, ferrous metallurgy and other basic industries.

The economic recession bottomed out in 1995, when GDP was down by 38.6% (compared with 1990) and industrial output by 52%. GDP growth resumed only in 1996, but was interrupted in 1998 in view of the crisis in world commodity and financial markets (notably in Russia). Despite an average annual GDP growth rate of 9% from 1999 to 2003, Kazakhstan's economy has not yet reached the pre-crisis level of GDP (94.5%). But in 2004 one can expect the republic (in the wake of Poland) to pass the critical point for transition economy countries and reach the 1990 level of GDP.

Moreover, the pattern of annual growth rates in the post-crisis period and the progress made in market and institutional transformations give reason to expect a doubling of GDP (compared with 2000) by 2008, although the target year for this is 2010 (by the time of completion of the first ten-year plan developed under the Strategy-2030 program proclaimed by the country's president in 1997).

Having evaluated the degree of dependence of GDP growth on an increase in capital investment, the state is now planning to achieve a higher rate of accumulation (capital formation),[2] which in 1996-1998 fell sharply (to an average of 15.8%), but then rose to 27% in 2001-2002. This level roughly corresponds to accumulation levels recorded over the past 50 years in countries that have achieved a major breakthrough in their development (given high efficiency of such investment).

Economic trends in transition economy countries show that so-called recovery growth can to a certain extent occur without any new large-scale capital investment. The trivial explanation here is that enterprises (production facilities) that prove to be competitive in the conditions of a new equilibrium at the given level of demand and foreign competition (with due regard for exchange rates) can increase output. Reality has turned out to be more complicated, because the increase in output with an adjustment to the new relative prices and demand structure started from a significantly reduced, crisis level. This means that up to a point there was no tight link between the increase in output and production facilities (capacity underutilization decreased) or labor. The turn toward an increase in consumption was ensured both by an increase in the production of consumer goods and services and by imports.

Needless to say, such growth is limited by its very nature. From a certain point in time, it is necessary to make new investments in the renovation of old and creation of new production facilities. Investments in agriculture, transport, the service industry and trade are partly provided by small businesses. This usually takes place right after a liberalization of economic activity and prices, naturally given the

[1] See: J. Williamson, *The Eastern Transition to a Market Economy: A Global Perspective.* LSE, Occasional Paper #2, 1992.

[2] "In order to maintain a steadily high rate of economic growth, … it is necessary over the next four or five years to bring gross fixed capital formation as a percentage of GDP up to the level of 28%." *Address by the President of the Republic of Kazakhstan to the People of Kazakhstan for 2004*, April 2003.

creation of minimally acceptable conditions, including access to land and real estate, protection of property rights and an appropriate tax regime (or in circumvention thereof). However, development requires investment both in the general infrastructure, in a renovation of large enterprises, and in the construction of new facilities and efforts to enhance the competitiveness of the country's industry as a whole. This implies the need not only for an appropriate macroeconomic climate, but also for adequate behavior of enterprises as regards capital formation, which should be based on the development of institutions, especially financial institutions (with long-term liabilities and instruments), including capital formation incentives for the new property owners.

The transition to a recovery in output goes hand in hand with an increase in economic efficiency, but this does not mean that the goals of transition to the market have been achieved. Economic growth does not as yet amount to modernization. It is much more difficult to bring about a change in economic proportions, both sectoral and territorial, to raise labor productivity and create new competitive enterprises in the conditions of globalization. Unless this is done, there can be no qualitative change in productivity levels, in the country's competitiveness or in the people's living standards.

As a matter of fact, herein lies one of the essential difficulties of the transition period: the problem of combining development and transformation, the need to create market-economy institutions and, at the same time, to resolve major economic problems facing any country. The dilemma here is fairly obvious: either to create conditions for capital accumulation or to opt for more pragmatic attempts to resolve the existing problems with the use of tools at the disposal of the state. In the first case, the state withdraws from the sphere of accumulation on the assumption that its own activities in this sphere are ineffective and that favorable conditions can quickly be created for capital formation by private businesses (investment climate). The main risk here is the time factor: many problems may remain unresolved for long periods and result in higher current costs (for example, expenditures on repairs instead of renovation). The risk of the second approach is long-drawn-out construction of an appropriate "climate," which may lead to an aggravation of a number of problems, for example, to wear and tear of the physical infrastructure, a sharp worsening of regional imbalances in development, and a shortage of private financial resources required to implement large investment projects.

The "poverty trap" can bring development to a halt (as we find in some CIS countries) before market institutions have taken shape, and a lack of positive changes in the economy can have an adverse effect on the formation of the very institutions that are designed to create the prerequisites for a recovery. The two processes—creation of prerequisites for development and solution of economic problems—cannot be isolated from each other, but must run parallel or in stages. In other words, there can be no development or significant increase in capital formation without a sufficiently solid groundwork, just as a transition to more complex and long-term projects in manufacturing or the high-technology sphere requires adequate institutions. Naturally, successes in development, including economic growth and capital investment, help to shape market institutions, creating demand for high-quality institutions. These two processes intertwine, and an end to stagnation as such is important for a transition to economic modernization. In real life we find a contradictory picture reflecting the difficulty of choice and the risks of each approach, including the sequence of stages: the better the climate and the sounder the institutions, the more reason there is to rely on business itself for a solution of national problems. It is important to note that accumulation risks in a private economy are transferred to the level of the firm and often do not coincide with the notions of the state, as represented either by officials or by reformers, about when and how to risk one's funds.

The large package of measures carried out in Kazakhstan in the mid-1990s to achieve macroeconomic stabilization and ensure conditions for development is sufficiently well known. Thus, the economy was privatized and liberalized, a foundation was laid for the operation of a market-based banking system and, during the acute crisis of 1998, the authorities carried out a radical budget audit, reducing the budget deficit to a minimum. The implementation of structural reforms was also promoted by a policy aimed at attracting foreign investment to the oil industry.

Accumulation Dynamics and the Role of Oil Revenue

The sharp drop in GDP and industrial output in 1991-1995 was coupled with a decline in capital investment. In 1996, investment in fixed capital was down to one-tenth of the 1990 figure, with a steady decline in fixed capital formation as a percentage of GDP. Inflation, which in the early 1990s reached four-digit figures, exacerbated the slump in investment activity, which in turn led to a collapse in output. In view of unpredictable price behavior and lower confidence in the advisability of long-term investment in the republic's economy, there was a massive outflow of capital from the country, which limited the possibilities even for its simple reproduction. The problem of capital outflow was aggravated when the state liberalized foreign trade and exchange rate policy while retaining control over domestic prices for the key raw materials. When it became necessary to review the prices of electric power, oil and oil products in order to enable their producers to operate cost-effectively, business entities that were consumers of energy resources were faced with a sharp rise in prices. The "price adjustment" process became continuous and doomed the economy to a higher rate of inflation, a slump in production and an unprecedented decline in investment activity. According to estimates made at the time, the amount of investment required for the economy was 15-20 times higher than the actual level, whereas the amount required for structural transformations in the economy over the following five or six years was close to $20 billion. The situation was in many respects similar to that in Russia: a sharp slump in industrial production, inflation, the transformation of enterprises and the rupture of traditional economic ties, a shortage of credit and capital for new investment, low income levels, growing unemployment and tensions in the regions. The economy was faced with the problem of restoring capital investment as a factor that would enable it to overcome the crisis and continue its development.

In the early 1990s, the republic began to pursue an effective policy aimed at attracting foreign investment, because it was clear that an economic upturn was only possible based on foreign (mostly private) capital investment. It was also clear that economic restructuring with the use of foreign direct investment could only be achieved in competition with other states also seeking to attract capital. For a new country, albeit with abundant mineral and raw material resources but without a "credit history," even a very high expected return could prove to be inadequate to induce investors to put their money into concrete production projects. A key decision here was to reduce the uncertainty factor and provide guarantees for foreign investment. In December 1994, a Law on Foreign Investment was adopted in the republic, and in 1997, a Law on State Support for Direct Investment.[3] These documents established the necessary legal framework for attracting foreign direct investment (providing guarantees against expropriation, nationalization and unlawful acts by government agencies or officials, guarantees for repatriation of profits in convertible currency, etc.).

Apart from that, foreign investors were accorded most favored nation treatment, aimed at protecting their rights and bringing the national legal norms of the contracting parties as close together as possible. In the oil producing industry, the state also resorted to wide use of production sharing agreements (PSAs), which have now reached a peak of cost recovery and will soon begin to generate large profits.

Naturally, at the initial stage Kazakhstan's negotiating positions in its talks with major foreign companies were constrained by the economic crisis. Later on the country could have probably obtained more favorable terms for PSA contracts in the oil industry (just as Russia in Sakhalin). But it could not afford to lose any more time required for development. In addition, had the negotiations lasted one or two years longer, low oil prices (1998) could have hindered the attraction of investment to an even greater extent. In the mid-1990s, foreign investments accounted for only 2% of total fixed capital investment.[4] After that their inflow reached a total amount comparable (when adjusted for population) with the countries of Central and Eastern Europe. In 10 years (1993-2003), foreign direct investment exceeded $25.8 billion, with more

[3] In 2003, these laws were combined into a single Law on Investment.
[4] According to data from the Statistics Agency of the Republic of Kazakhstan.

than half the total attracted in 2001-2003 (the annual average comes to $4 billion, which is almost twice as high as the figure for Russia). In Russia, something similar may be expected in Sakhalin over the next few years in connection with a rapid increase in investment under production sharing agreements concluded in the same period as those in Kazakhstan.[5]

Table 1

Volume of Production
(*% of previous year*)

	1998	1999	2000	2001	2002	2003*
Industry, total	**97.6**	**102.7**	**115.5**	**113.8**	**110.5**	**108.8**
including:						
Mining	**98.5**	**109.6**	**121**	**114**	**115.9**	**108.8**
of which: Production of crude oil and associated gas	**101.8**	**114.4**	**115.8**	**115.1**	**117.4**	**108.2**
Production of natural gas	**95.6**	**135**	**125**	**101.5**	**121.2**	**122.1**
Manufacturing	**96**	**102**	**117.4**	**115**	**108.1**	**108.9**
of which: Food and drink industry	**98.7**	**91.4**	**116.1**	**108.2**	**108.7**	**109.4**
Textile and clothing industry	**89.6**	**103.1**	**121.7**	**125.6**	**115.7**	**98.6**
Oil products	**92.6**	**71.2**	**103.8**	**123.7**	**109.8**	**112.4**
Chemical industry	**61**	**105.9**	**118.6**	**161.3**	**113.4**	**116.3**
Metallurgy	**100.5**	**116.7**	**116.3**	**108.4**	**106.4**	**102.1**
Ferrous metallurgy	**87.5**	**134.9**	**118.9**	**101.8**	**107.9**	**110.5**
Nonferrous metallurgy	**110.6**	**103.7**	**113.9**	**113.6**	**105**	**92.9**
Engineering	**69.5**	**113.6**	**179.9**	**141.2**	**109.6**	**120.7**
Production and distribution of electric power, gas and water	**96.1**	**95.7**	**105.8**	**108.6**	**101.9**	**107.1**
of which: production and distribution of electric powe	**94.5**	**98.5**	**108.1**	**105.9**	**103.4**	**108.9**

Source: Statistics Agency of the Republic of Kazakhstan.
* Estimate.

[5] Today Russia has only three projects (Sakhalin-1, Sakhalin-2 and Kharyaga) being implemented under PSAs signed before the entry into force in 1995 of the Law on PSAs (amendments and addenda to that law were introduced in 1999 and 2001). These three agreements have a "special status:" under the Law on PSAs they are "to be executed in accordance with the terms and conditions specified in these agreements." The PSA pioneer firms have got down to the second stage of development and have announced the second phase of their investment programs (about $20 billion).

Oil production and exports increased in the wake of the boom in real foreign investment in 1998-2001. Kazakhstan proved to be one of the unique countries in the developing world: the Asian crisis of 1997-1999 went hand in hand with a sharp increase in gross investment in the republic. Accordingly, by the time of the rise in oil prices in 2000-2003 the republic had become a significant exporter of oil. Thus, in 2003 it produced 45.3m tons of oil and exported 38.7m tons, or 85% of the total (for comparison, in 1995 the figures were 18.1m and 9.8m tons, respectively). With the development of the Kazakhstan sector of the Caspian Sea, oil production in the country is expected to increase to 61.2m tons (exports, to 51.6m tons) in 2005, 118.6m tons (103.7m tons) in 2010, and 179.2m tons (160.6m tons) by 2015. Investments in this area are projected at $4.4bn in 2003-2005, $8.6bn in 2006-2010, and $13.5bn in 2011-2015.[6]

In relative terms, from 1998 to 2003 production of oil and associated gas increased by 94%, and that of natural gas multiplied 2.5 times, whereas output in manufacturing rose by 62%, and in the food industry, by only 36% (see Table 1).

Growing oil exports naturally boosted oil revenue and helped to resolve de facto the budget crisis typical of transition economy countries in that period (over the past few years, the republic's budget has doubled). The net effect of oil revenue is around 4% of GDP, and in the next few years it is expected to reach 6%. This puts Kazakhstan among the countries in which a huge share of industrial output, exports and budget revenue is traditionally connected with oil production. Estimates show that the share of fuel exports in the republic (around 60%) is moving from the level of Indonesia (25%) to that of Venezuela (80%), while the share of manufacturing exports (20%) is moving in the opposite direction.[7] In fact, over the past eight years mineral resources have accounted for more than 50% of total exports, and over the past four years this figure has averaged about 60%. A point to note here is that the raw material bias in exports has markedly increased not only in connection with external factors (the rise in world oil prices), but also under the impact of domestic factors: growing oil production, development of new fields and commissioning of new infrastructure facilities, such as the Caspian Pipeline Consortium (CPC) system with a throughput capacity of 28m tons per year.[8]

In effect, a two-sector model of the economy has taken shape in the country, where a single industry assimilates most of the industrial investments, turns out most of the export products, is localized in a definite part of the country, and generates huge revenues for the state budget (but revenues dependent on the situation in the world market). The rest of the economy, especially manufacturing and infrastructure industries, remain depressed in terms of investment and unattractive to private capital.

The situation in the mid-1990s (that is, before the Asian crisis) was marked by an increase in foreign investment in the developing countries. In order to gain time, which was of critical importance for the republic's efforts to get development going and for a solution of urgent economic problems, the only way to take advantage of the situation was to offer adequate conditions to foreign firms. Kazakhstan was able to escape from the trap of stagnation during the transition crisis, but its development became heavily dependent on the oil factor.

The newly established two-sector model of development carries considerable risks, and it is extremely important for the state to ensure, first, that progressive development of the oil industry does not entail an increase in current wasteful consumption, given the pressing need for capital formation and for a recovery in other sectors of the economy. Second, it is extremely important to ensure that a reallocation of resources from the oil industry to manufacturing (through more active government investment) does not lead to a loss of private sector incentives to create new and develop traditional lines of production with higher value added.

[6] According to data from the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan.
[7] Estimates by the World Bank and the Ministry of Economics and Budget Planning of the Republic of Kazakhstan.
[8] In the coming years, the CPC system is to be expanded to 67m tons of oil per year.

Economic Structure and Accumulation

A restructuring of the economy in the conditions of reforms naturally engenders the problem of a price revolution, especially after long years of underpricing of raw materials and energy products under the planned economy in the U.S.S.R. (at that time, artificial competitive advantages enabled the manufacturing sector to occupy sufficiently solid positions in the overall production structure).

Table 2

Structure of Industrial Production and Investment by Industry:
1st line—production, 2nd line—investment *(% of total)*

	1991	1995	1997	2001	2003
Electric power industry	4.8	14.7	13.8	8.8	8.1
	10.6	14.4	4.1	5.1	6.7
Oil production	2.2	10	17.5	36.1	40.1
	31.5	35.8	33.2	70.5	72.8
Oil refining	2	5.4	5	3.9	4.4
	n/d*	3.8	1.2	1.8	1.3
Coal industry	3	7.2	3.5	1.7	1.4
	10.4	7.8	6.2	1	1.3
Ferrous metallurgy	5.8	13.6	11.9	6.7	8
	5.1	9.9	5.1	4.4	1.8
Nonferrous metallurgy	9.1	11.5	13.8	11	8.2
	11.8	16.8	6.8	5.4	4.2
Chemical and petrochemical industry	6.3	3.7	2.2	1.5	1.8
	6.2	1.3	0.4	0.8	0.4
Engineering and metalworking	11.6	7.4	5.3	3.4	3.2
	5.4	1.1	0.5	0.9	1.2
Light industry	18.5	2.5	2.1	2.1	1.9
	2.7	0.1	0	0.3	0.1
Food industry	22.3	13	17	12.6	10.2
	7.4	2	3.4	3.9	3

Source: Statistics Agency of the Republic of Kazakhstan.

* n/d—no data.

But a sudden opening up of the economy to the outside world, loss of markets and rupture of ties objectively worsened the problem of a shift in production toward upstream products. To this must be added the weakness of integration initiatives within the CIS framework and the different-vector economic policies of the FSU republics, factors which still hinder effective economic development in the newly independent states. In 12 years, the share of engineering and the light and food industries, i.e., industries facing high import competition, fell from 52.4% to 15.3% (see Table 2). The "lost" percentage points were gained by the oil producing industry. An even more important thing here is that over the past two years the share of the primary industries has continued to grow. Of course, this reflects the specifics of the oil industry, but also the structure and amount of investment. A state of affairs where roughly 73% of total industrial investment goes into oil production poses a serious threat to balanced development in the future.

Investments in recent years have increased unevenly, creating, in particular, regional inequalities. Statistics for 2001-2003 show that more than half (52.6%) of all fixed capital investments go to enterprises in the western part of the republic (Atyrau, Western Kazakhstan, Aktyubinsk and Mangistau regions), where there is a high concentration of large oil and gas fields. It is precisely the implementation of investment projects in these regions that has ensured a huge increase in overall fixed capital investment, which has been growing steadily since 1997 at an average rate of 28.7% a year. But such a one-sided flow of funds into primary (mostly mining) industries raises the question of investment efficiency on the scale of the whole economy. The need to develop the country and to renovate its physical infrastructure (especially roads and water supply system) objectively requires the creation of effective mechanisms for a reallocation of resources.

In addition, such a high level of investment activity in the oil and gas sector entails a significant increase in imports of goods and services. A substantial part of these goods and services is imported for the implementation of large construction projects by enterprises in that sector and is funded out of foreign direct investment. Of course, the development of the oil industry spurs the development of a number of manufacturing industries, but import figures—primarily for producer goods and construction services—are very high (over the past four years, the average annual figure has exceeded $10 billion, rising by about $1.5-2 billion a year).[9] Together with credit payments to direct investors (considering that direct investments mostly flow into the republic in the form of debt capital or so-called intercompany debt transactions between strategic investors and affiliated companies in Kazakhstan), such a situation puts colossal pressure on the current account balance, which has been negative over the past four years (a surplus was recorded only in 2000).

But on the whole the current movement of fixed capital renewal indicators (see Table 3) is fairly optimistic, although in the conditions of rapid changes in the production structure these data are not too reliable. Nevertheless, the depreciation of fixed assets in the republic's economy in recent years has stabilized, and renewal indicators have markedly increased.

However, there is a clear awareness in the country of the need to resolve the main problems in the sphere of investment policy.[10] These include, first, the low level of investment in processing industries and, second, the insignificant amount of private investment in priority sectors, primarily the infrastructure, the agriculture-and-food complex, transport and communications.

Financial Sector and Private Accumulation

The development of the investment process on a private basis depends both on general macroeconomic factors and on the structure of demand and prices, which determine the profitability of investments

[9] Data for total imports of goods and services from the National Bank of the Republic of Kazakhstan and balances of payments for the respective years.

[10] Indicative Plan of Social and Economic Development of the Republic of Kazakhstan for 2004-2006.

Table 3

Renewal of Fixed Capital

Rate of renewal (commissioning of fixed assets as a percentage of their total stock at year-end)						
	1996	1998	1999	2000	2001	2002
All fixed assets, including:	5.8	6.6	8	13.8	13.2	12.6
Agriculture, hunting and services in this sector	1.9	1.3	5.9	4.3	3.9	5.1
Mining	n/d*	n/d*	11.4	22.3	12	13.6
Manufacturing	n/d*	n/d*	8.4	13.1	13.3	13.4
Production and distribution of electric power, gas and water	n/d*	n/d*	5.4	3.6	4.9	4.5
Transportation	3.7	2.5	5	7.4	9.1	10.5
Communications	n/d*	n/d*	13.8	13	22.6	16.4
Depreciation of fixed assets at year-end (%)						
	1995	1998	1999	2000	2001	2002
All fixed assets, including:	n/d*	32	33.1	29.7	33.1	30.1
Industrial enterprises	n/d*	41.7	35.7	32.7	31.3	31.6
Agricultural enterprises	n/d*	49.7	46.8	44.5	42.5	29.1
Construction organizations	n/d*	43.1	38.1	39.5	29.9	30.5
Transportation organizations	n/d*	42.6	41.2	36.6	39.7	36.1

Source: Statistics Agency of the Republic of Kazakhstan.

* n/d—no data.

and projects. Kazakhstan's problem is that rapid development implies the need for a rapid "enlistment" of the necessary institutions and mechanisms in the solution of vital problems. In actual fact, as we saw above, the oil industry and the budget have been growing due to foreign investments and revenue generated by them. Considering the real conditions in the country (particularly the "oil bias"), the need for huge investments in the infrastructure—roads, transportation, communications and water supply—can hardly be met in the immediate future by the private sector, which means this will require considerable government intervention.

At the same time, given the existing biases, it is important that all sectors of the economy which can be cost-effective with private investment should have an opportunity for independent development. Table 4 shows a fairly complicated picture of internal profitability in the various industries. Thus, against the background of naturally high profitability of the export-oriented oil and gas industry and metallurgy all other industries are in the zone of low or negative profitability. With a gradual strengthening of the national currency (as in Russia), the republic's light and food industries are subjected to heavy pressure

from imports, although they are a particularly attractive investment destination for domestic private capital. One of the possible solutions here is to reduce the tax burden on the non-oil sector in order to create incentives or to introduce diverse forms of stimulating priority investments. As it happens, active work is now underway in the republic to develop appropriate instruments in this area.

Table 4

Industry Profitability* (%)

	1991	1993	1995	1997	1999	2000	2001	2002
Electric power industry	11.9	3.7	4.5	–4.2	–12.6	–12.7	–9.2	7.1
Oil production	13	36.3	31.1	2.6	35.1	49.2	48.8	37.4
Oil refining	12.2	28.8	34.4	1.4	19.1	25	11.9	12.3
Coal industry	40.9	46.2	33	–1.7	0.9	–5.6	0.9	n/d**
Ferrous metallurgy	32.3	68.8	24.9	5.5	39.5	40.4	16.4	41.2
Nonferrous metallurgy	29.4	39.5	18.6	24.9	26.4	45.6	37.3	41.3
Chemical and petrochemical industry	20.7	21.2	–4	–16.9	–12.3	–29.6	–29.1	–7.4
Engineering and metalworking	22.8	29.8	11.2	–0.8	n/d**	0.7	2.1	n/d**
Building materials industry	26.1	18.7	6.3	0.3	–12.9	–4.9	6.8	n/d**
Light industry	24.4	32.2	2	–4.6	–6.8	–19.6	–2.9	–3.2
Food industry	19	24.1	9.4	6.2	3.3	...	2.8	0.2

Source: Statistics Agency of the Republic of Kazakhstan.

* Profitability is calculated as the ratio of profit on sales of products (works, services) (since 1998, total pretax income) to production and selling costs.

** n/d—no data.

Yet another imbalance in the development of Kazakhstan's economy is the shortage of reliable and "liquid" projects which could be of interest to investors, especially private investors. This is precisely what limits the role of the financial sector, whose development level in Kazakhstan is estimated to be the best in the post-Soviet space (see Table 5).

The gist of Kazakhstan's economic development problem is that "surplus" oil revenues in Kazakhstan are flowing into the country's budget in conditions where the degree of concentration of private capital and the existing incentive system prevent such capital from engaging in large-scale project funding. For the second time in less than 10 years, the republic is faced with a difficult choice: how to employ its oil wealth, considering the existence of several groups of risks.

- First, there are large uncertainties in the projections of future government revenue and economic growth (given that oil prices could range from $13 to $22 per barrel).[11] The decision

[11] According to the Indicative Plan of Social and Economic Development of the Republic of Kazakhstan, the annual rate of growth in 2004-2006 could be 7.2% if the average world price of oil (Brent crude) is $22 per barrel, and 4.4% if it is $13.3 per barrel.

Table 5

Some Indicators of the Financial System

	1995	1998	2000	2001	2002	2003
Deposits in banking system, $bn	1.06	0.95	2.03	2.96	3.88	5.1
Assets of accumulative pension funds, $bn	—	—	0.79	1.24	1.77	2.6
Deposits in banking system as % of GDP	6.7	4.6	11.3	13.7	16	17
Deposits per capita, $	12.6	24.1	41.1	82.9	108.5	351
Assets of accumulative pension funds as % of GDP	—	—	4.3	5.6	7.2	8.7
Total assets of banking system, $bn	2.55	2.34	3.65	5.44	7.36	11.7
Bank lending to the economy, $bn	0.67	1.11	1.91	3.26	4.32	6.82
Bank lending to the economy as % of GDP	4.2	5.4	10.6	15.1	17.8	22.9
Bank lending as % of gross investment	17	n/d*	58	55	64	78

Source: National Bank of the Republic of Kazakhstan.

* n/d—no data.

has to be made in a situation where prices in the world oil market can change abruptly and significantly.

- Second, the republic has to make a critical choice between investment of new revenue and a rise in personal incomes (social and budget sphere). Most oil producing countries have not resisted the temptation to raise the living standards of their population (which are usually low) out of oil revenue, with the result that external price fluctuations are factored into budget receipts.

Yet another aspect is the distribution of consumption over time, that is, between the present and future generations of citizens. This largely depends on the opportunities for using uncommitted funds in world financial markets. The currently low level of interest rates in the U.S. and the EU hinders effective portfolio investment of public funds abroad in order to "put aside" this money for future productive use without reducing its eventual purchasing power.

Finally, the key problem is how to transfer the available funds to business agents. The list of options is not too long: direct government investment, government development instruments (guarantees, credits, etc.), financial sector and tax measures. In effect, the government is now trying (quite successfully) to make simultaneous use of all these methods in an attempt to accomplish the main task: to create a system of compensatory measures for the solution of a new—and totally different—set of development problems. We are referring to a large package of measures aimed at removing the distortions in the investment structure and paving the way for a diversification of the economy.

One should note that Kazakhstan was the first CIS country to set up a National Stabilization Fund, which at the end of 2003 had a total of around $3.6 billion. That year the republic also developed and adopted a Strategy of Industrial-Innovative Development for 2003-2015, whose main purpose is to achieve sustainable development by diversifying the economy and so to overcome its raw material bias. The main priorities designed to ensure a solution of these problems have been selected as follows: oil and gas refining, use of biotechnology in medicine, agriculture and the food industry; domestic development and manufacture of pharmaceuticals; production of super-pure and high-technology materials; creation of a basis for the state's information infrastructure; and engineering.

The tasks which the state seeks to accomplish in the medium-term perspective are sufficiently ambitious: to raise the average annual rate of growth in manufacturing to 8.4%, to triple labor productivity by 2015 compared with 2000, to reduce the energy intensity of GDP by half, and to raise the productivity of fixed assets. The state also plans to create a business climate and a structure and content of social institutions such as would stimulate the private sector to produce and build up a competitive advantage and to master new elements in the value added chain in concrete lines of production, advancing toward elements with the highest value added; to stimulate the development of science-intensive and high-technology lines of production oriented toward exports; to diversify the country's export potential in favor of high value added goods and services; to go over to world quality standards; and to make more active efforts to integrate into the regional economy and the world economic system with inclusion in international scientific, technological and innovation processes.[12]

With the implementation of this strategy, gross capital formation is projected to reach 25-32% of GDP (final consumption approach), and large amounts of government investment are to go into manufacturing, science and education.[13] The country's leadership is aware that these plans can be carried out only provided there is purposeful training of managerial, engineering, technical and, most importantly, industrial production personnel.

As regards government investment, an important point to note is that in order to accomplish these tasks the republic's authorities have set up specialized state development institutions (Investment Fund, Innovation Fund and Export Insurance Corporation), and have also opened a Marketing Research Center and a Center for Engineering and Technology Transfer. Together with the authorized capital of the Development Bank, established back in 2001, the authorized capital of these organizations is close to $625 million. All these structures are designed to form a system whose stable operation would be based on the principles of decentralization, specialization, internal and external competition and, most important of all, provision of incentives to private sector innovation, because the country's authorities are well aware that the activities of government institutions could dampen private initiative and generate excessive dependence on the state in the use of government funds.

Naturally, one of the main lines of stimulating investment activity by the private sector is a reasonable tax policy. Starting from 2004, the rate of value added tax in Kazakhstan has been reduced by 15%, and the payroll tax burden has markedly decreased as a result of cuts in the rate of individual income tax and the introduction of a regressive scale for the social tax.[14] For enterprises operating in special economic zones, the amounts of assessed corporate income tax have been considerably reduced, and these enterprises are fully exempt from VAT, property tax and land tax. So far the republic has three such zones: Aktau Seaport, Alatau Information Technology Park and Astana-New City, that is, in spheres which have been designated as priority spheres for the development of the country's economy.

In order to promote a renewal of fixed assets, the tax legislation of Kazakhstan (like that of Russia) has repealed the investment allowance, but provides for a double rate of depreciation for new fixed assets

[12] Strategy of Industrial-Innovative Development of the Republic of Kazakhstan for 2003-2015. Decree of the President of the Republic of Kazakhstan of 17 May, 2003.

[13] See: Ye.A. Utembaev, "Promyshlennaia politika i administrativnaia reforma. Dolgosrochnye prioritety," in: *Promyshlennaia politika i administrativnaia reforma*, Presidential Administration, Republic of Kazakhstan, Borovoye, November 2003, p. 215.

[14] The social tax was introduced in 1999, incorporating social payments into extrabudgetary funds. From 1 July, 2001, its rate was reduced from 26% to 21%, and from 1 January, 2004, this tax was switched to a regressive scale (from 20% to 7%).

in the first year of their use. In order to create new and to renovate and expand existing production facilities, the country's legislation envisages a mechanism for investment tax preferences under which taxpayers concluding contracts with an authorized government agency are entitled to deduct the cost of new fixed assets in equal shares, depending on the preference period. In addition, this mechanism provides for a simultaneous exemption from property tax on new fixed assets under investment projects and for an exemption from tax on land parcels acquired and used to implement such projects.

On the whole, provisions on corporate income tax, including depreciation policy, are conducive to a renewal of fixed assets, as indicated above. From 1 January, 2004, maximum rates of depreciation were increased for categories of fixed assets for which a comparative analysis had revealed deviations from the standard rates. In the event, the established procedure for calculating depreciation charges for tax purposes has been retained and higher differentiated limits have been established for deducting repair expenses for fixed asset categories subject to faster wear.

Without going into the details of innovations in the taxation of subsoil users, let us emphasize that Kazakhstan, having introduced (from 1 January, 2004) a new rental tax on exported oil,[15] has retained provisions that prohibit a toughening of legislation as regards taxpayers operating under the PSA model. The tax treatment for such contracts has remained the same over the entire period of implementation of investment projects (naturally, unless the parties have made an agreed decision to change the tax practice). Consequently, there is renewed emphasis on stability guarantees, which helps to enhance the industry's investment attractiveness.

Conclusion

By 1995-1996, the economy of Kazakhstan was confronted with a real threat of stagnation, given the lack of financial possibilities for development and the long-drawn out general crisis in the post-Soviet space. That is why in solving the problems of accumulation and modernization at the first stage the republic addressed a pragmatic task: to create a "locomotive of growth" on the basis of new capital investment. The oil sector became such a locomotive, and today it can be said that the country has made fairly good use of this opportunity.

In the process of fostering a favorable investment climate, creating conditions for modernization and implementing plans for large-scale regeneration of the economy, the republic has passed two turning points. At the first stage, in 1994-1996, active measures were taken to attract foreign investment, which helped to resolve the problems of development and stabilization and to overcome the budget crisis through a privatization of state property and attraction of strategic investors. And in 2001-2003, building on the solution of macrostabilization problems and growing revenue from oil exports, the authorities took steps to increase the rate of accumulation and to implement large-scale development problems of the classical type aimed at creating state development institutions and increasing public investment.

Today the country seeks to make effective use of the new financial opportunities for sustainable development. Kazakhstan with its 15 million population, remote ports and huge resources should make rational use of its oil revenues so as to find the right balance between consumption and capital formation, which will make it possible to modernize the economy and ensure effective development and use of human capital. The laws of globalization are quite harsh. Unless they are offset by reasonable economic policy, the country may be left to cope with the classical problems of the oil and gas "Dutch disease." The growth of GDP after its doubling based on oil revenue will require the development of high value added lines of production and the creation of markets for new products. Today's economic policy is in effect geared to continue market reforms, harmonize legislation with the European Union, liberalize monetary relations, prepare the country for WTO accession and carry out other structural transformations. Their

[15] Under the rental tax on exported crude oil, the object of taxation is the amount of exported crude oil calculated in value terms based on market prices with due regard for the qualitative characteristics of crude oil net of transportation expenses.

purpose is to create an institutional environment for sustainable development based on foreign investment in the field of costly long-term projects in the mining industry and an increase in government funding of infrastructure projects whose profitability and scope of investment make them prohibitive for the private sector and private funding at their current stage of development.

In the process, a special effort should be made to ensure that foreign capital and the state sector do not suppress the investment activity of private businesses, which already produce, as a result of the reforms, over 75% of the country's GDP and which should play the leading role in enhancing the efficiency and competitiveness of national production. Hence the need for new solutions to the problems of upgrading market institutions and the machinery of government so as to remove administrative barriers and reduce the transaction costs of doing business.