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KAZAKHSTAN:
**Economic Transformation and
Autocratic Power**

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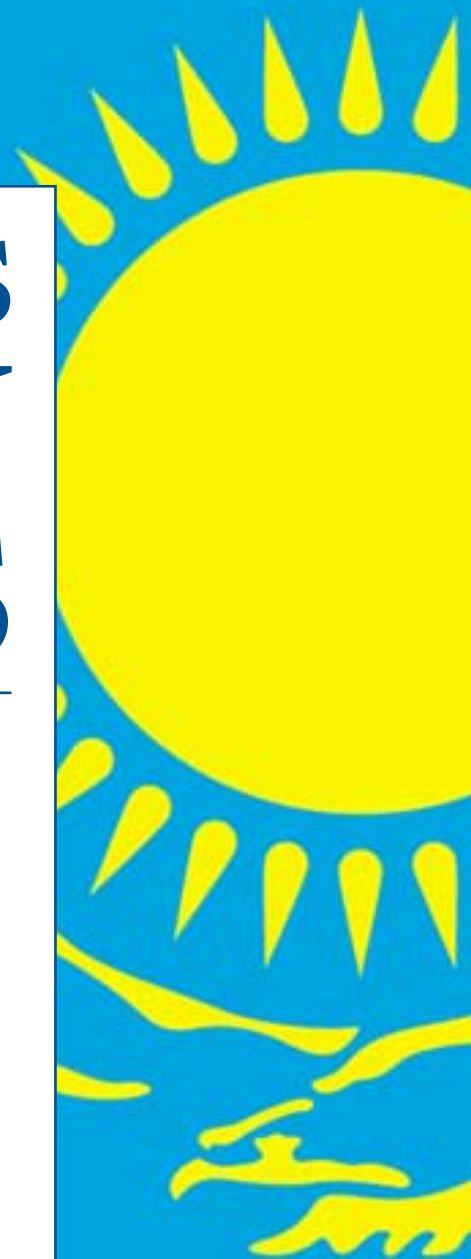
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KAZAKHSTAN: Economic Transformation and Autocratic Power

JÜRGEN WANDEL AND BOTAGOZ KOZBAGAROVA*

EXECUTIVE SUMMARY

Kazakhstan is a major success story in Central Asia, having experienced double-digit growth rates between 2000 and 2007. The country has made significant market-oriented reforms and large amounts of foreign investment. However, following the maxim adopted by many successful countries in Southeast Asia, "First the economy and then politics," political reform in Kazakhstan has lagged.

The key challenge is ensuring broad-based sustainable economic development in order to avoid the "resource curse"—the problem of countries with abundant natural resources paradoxically lagging in development. When the global financial crisis reached Kazakhstan in 2007, additional challenges became managing problems associated with the banking and construction sectors as well as securing macroeconomic stability, in particular lowering inflation.

Inspired by the examples of Malaysia, Singapore, and South Korea and on the advice of Harvard Business School's Michael Porter, the Kazakhstani government tries to promote economic diversification through an active industrial policy based on clustering and supporting companies that the government thinks will succeed. This has led to a mix of liberal and interventionist economic policies.

Much of Kazakhstan's future success will depend upon whether it implements liberal or illiberal economic policies going forward. Given historical and cross-country evidence, additional government involvement in the market process may hamper Kazakhstan's economic potential. With this in mind, this Country Brief recommends the following policy directions:

- Refrain from top-down diversification programs, short-term rescue programs for ailing banks and construction firms, and price controls to fight inflation.
- Tighten monetary policy to curb credit growth.
- Concentrate government spending on infrastructure building and human capital formation.
- Separate the commercial and public functions of national industries and expose them to competition and the accountability rules of private firms.
- Continue to improve business regulations.
- Continue to modernize the political system and establish the rule of law.

If the political decision makers in Kazakhstan recognize entrepreneurship as the market's driving force and focus on the institutional prerequisites to growth, Kazakhstan could unleash great economic potential.

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KAZAKHSTAN:

Autocratic Model of Economic Transformation

I Introduction

AFTER EIGHT YEARS of severe transitional crisis, Kazakhstan experienced an economic boom from 2000 to 2006. With average annual growth rates of 10 percent, the country became a success story not only in Central Asia but also in the Commonwealth of Independent States (CIS).¹ Rising oil prices played a major role in this growth. As the price of oil climbed, the hydrocarbon sector's share of Kazakhstan's GDP also increased, from 11 percent in 1990 to almost 35 percent by 2007. In 2007, the hydrocarbon sector accounted for 57 percent of the country's total industrial output and 70 percent of export revenues;² 27 percent of all foreign direct investments went into the extraction of crude oil and natural gas and 36 percent went into geological exploration and prospecting activities.³

But Kazakhstan's rapid growth in the last seven years did not exclusively depend on favorable world market conditions for these sectors. It is also the result of market-oriented economic reforms, especially rapid price and trade liberalization, privatization, sound macroeconomic policy, and the promotion of entrepreneurship. Moreover, the income and wealth effects resulting from expanded primary production stimulated other sectors, namely financial and general business services and construction/real estate. The country's banking sector has been particularly praised by outside observers as Kazakhstan's major success and the most efficient one in the CIS.⁴

The dominant question in Kazakhstan's economic policy debate is how to make economic growth broad-based and self-sustaining so that the country's oil and natural resources will not be a curse once reserves expire or prices drop. The latter occurred unexpectedly in the second half of 2008 when, after a steady increase since 2001, the world oil price plummeted from a record of nearly \$150 per barrel in July 2008 to under \$40 in December 2008 as world demand declined in the wake of the spreading worldwide financial crisis.⁵

President Nursultan Nazarbayev has set the ambitious goal of Kazakhstan becoming one of the world's 50 most developed and competitive countries by 2015. Diversifying the economy and increasing the competitiveness of the non-oil sectors are considered key to achieving this goal. Inspired by examples of Southeast Asian emerging economies like South Korea, Singapore, and in particular, Malaysia—whose economic success is perceived to be the result of prudent, strategic government planning and intervention—the Kazakhstani government tries to promote diversification with an active industrial policy (instead concentrating solely on the institutional environment that would allow for a market-driven diversification process). This has led to a complex mix of liberal and interventionist economic policies, with the portion of the latter seemingly on the rise. It remains to be seen if this strategy will enable Kazakhstan to sustain its growth and become the first “Asian Snow Leopard” as envisioned in President Nazarbayev's 1997 vision of “Kazakhstan 2030.”⁶

1. The CIS is a confederation that encourages cooperation between its member states: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

2. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007* (Astana, Kazakhstan: Agentstvo Respubliki Kazakhstan po statistike, 2007), 209, 295.

3. National Bank of Kazakhstan, *Statistika*, http://www.nationalbank.kz/cont/publish213203_5371.xls.

4. See Jan Jun, “Central Asia: Are Kazakh Banks Getting In Over Their Heads?” Radio Free Europe/Radio Liberty, February 5, 2007, <http://www.rferl.org/content/article/1074520.html>; Richard Pomfret, “Kazakhstan's Banking Problems,” *CACI Analyst*, February 20, 2008, <http://www.caci-analyst.org/?q=node/4798>.

5. Wikipedia, s.v. “Price of petroleum,” http://en.wikipedia.org/wiki/Price_of_petroleum (accessed December 8, 2008).

6. An English version of “Kazakhstan 2030—Prosperity, Security and Ever Growing Welfare of all Kazakhstanis” can be found at <http://portal.mfa.kz/portal/page/portal/mfa/en/content/reference/strategy2030>. The phrase “Asian Snow Leopard” is a play on the theme of the Asian Tigers, which were a handful of Asian countries that saw impressive growth in the 1990s.

The U.S. mortgage crisis hit Kazakhstan in August 2007, dampening GDP growth and revealing that the country's financial sector was highly integrated with the global economy. Inflation surged and the population felt rising food prices particularly painfully, as food's share in the Kazakhstani consumer basket amounts to 40 percent of average income.⁸ These events have raised the threat of social discontent and created unexpected additional challenges for economic policy in the field of macroeconomic stabilization, financial market reform, and agricultural policy.

Organization of This Country Brief

THIS COUNTRY BRIEF presents an overview of Kazakhstan's economy, explains some of the challenges the country faces, and outlines possible directions for economic policy. This brief's recommendations emphasize the role of competition as a discovery mechanism, entrepreneurship as the economy's driving force, and the importance of the appropriate institutional setting. These institutions include: (1) well-defined and enforced property rights, (2) enforced freedom of contract, and (3) limited government interference with market outcomes.⁹

The Country Brief is organized as follows. The next section provides a brief background on Kazakhstan and the circumstances at the time of its transition to a market economy. Section 3 presents the main economic reforms that have occurred since the country's independence in 1991 as well as their results. Section 4 discusses policy implications for the challenges ahead. The ultimate question is what role the government should play to spur economic development.

Since much has already been written about the transition years in the 1990s,¹⁰ this study will focus on more recent developments. The information used in this Country Brief stems from officially published statistical data by government agencies, newspapers, and journals and a few anecdotes from formal and informal interviews with academics and businessmen, as well as expertise garnered from the authors' own experiences living in the country.¹¹

2 Background

2.1. Land between Russia, China, and Europe

KAZAKHSTAN WAS THE third-largest economy of the Soviet Union and, with 2.7 million square kilometers of territory, is now the ninth-largest country in the world. It is also the world's largest landlocked country, bordering Russia on the north, northeast, and west; China on the southeast; and three other Central Asian republics—Turkmenistan, Uzbekistan, and Kyrgyzstan—on the south. Primarily located in Asia, a small portion of Kazakhstan also extends west of the Urals into Eastern Europe. It is sparsely populated, with only 5.4 persons per square kilometer. The European average is 67 persons per square kilometer.¹²

Kazakhstan is ethnically and culturally diverse. Over 100 nationalities are represented in its population, in part due to mass deportations of many ethnic groups to the country during Stalin's rule. Russians constituted the largest ethnic group in the republic at the beginning of the 1980s, accounting for 40 percent of the total population. By 1990, accord-

7. For evidence that the U.S. mortgage crisis reverberated to Kazakhstan that early, see Olzhas Khudaybergenov, "Vtoroy udar," *National Business* 54, no. 4 (2008): 32–36; Gulnoza Saidazimova, "Kazakhstan: Global Financial Turmoil Hits Credit Rating," October 13, 2007, <http://www.eurasianet.org/departments/business/articles/pp101307a.shtml>; Maria Kielmas, "How Financial Alchemy Engineered a Central Asian Credit Crunch," *China and Eurasia Forum Quarterly* 6, no. 1 (2008): 11–18; Pomfret, "Kazakhstan's Banking Problems."

8. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007*, 64.

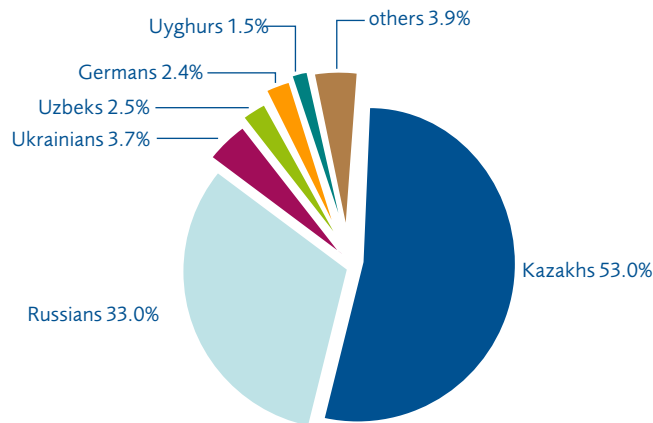
9. Israel M. Kirzner and Frederic Sautet, "The Nature and Role of Entrepreneurship in Markets: Implications for Policy," *Mercatus Policy Series*, Policy Primer no. 4 (Arlington, VA: Mercatus Center at George Mason University, June 2006).

10. See Pomfret, *The Economies of Central Asia* (Princeton: Princeton University Press, 1995); Pomfret, *The Central Asian Economies Since Independence* (Princeton: Princeton University Press, 2006); Yelena Kalyuzhnova, *The Kazakhstani Economy: Independence and Transition* (Basingstoke: Macmillan Press, 1998); Martha Brill Olcott, *Kazakhstan: Unfulfilled Promise* (Washington, DC: Carnegie Endowment for International Peace, 2002).

11. Some names of businesses and persons have been changed to protect their identities.

12. Evraziyskiy dom—informatsionno-analyticheskiy portal: Dosie strany—Kazakhstan, <http://www.eurasianhome.org/xml/t/databases.xml?lang=ru&nic=databases&country=98&pid=31>.

FIGURE 1. ETHNIC COMPOSITION OF KAZAKHSTAN, 2007



Source: *Evraziyskiy dom—informatsionno-analyticheskiy portal: Dosie strany—Kazakhstan*, <http://www.eurasianhome.org/xml/t/databases.xml?lang=ru&nic=databases&country=98&pid=31>.

ing to Kazakhstani data, Kazakhs had become the largest group—40 percent of the total population—and in 2007 they represented 53 percent of the population (figure 1).¹³

The official state language is Kazakh; however, Russian is commonly used for interethnic and everyday communication.¹⁴

Kazakhstan is also a multi-religious state. In 2007, 57 percent of Kazakhstanis were Muslim and 40 percent Christian. Most Muslims in Kazakhstan belong to the Sunni denomination of Islam while most Christians belong to the Russian Orthodox Church. The rest constitute other religions.¹⁵ Religious relations have so far been very peaceful. The highly secularized and Sovietized current ruling elite has been successful in keeping the state secular and in taking a firm position against religious extremism of all kinds, emphasizing that religious belief is a matter of individual conscience. Martha Brill Olcott concludes that “Kazakhstan is the only Central Asian state that can truly call itself secular since it is the

only state in the region that has not accorded Islam a specific role.”¹⁶

Due to its geographical position and ethnic composition—nearly 60 percent Asian and 40 percent European—Kazakhstan views itself as a bridge between Europe and Asia. In his 1997 speech, “Kazakhstan 2030,” President Nazarbayev spoke of “Eurasianism” and restoring the legendary Silk Road as “a broad channel of trade between European and Asian countries.” The Kazakhstani people, located between these big economic regions, should take economic advantage of an expected increase of trade flows through its territory.

Kazakhstan was the last of the Soviet republics to declare independence with the dissolution of the Soviet Union on December 16, 1991. Since then, the newly independent country has pursued a so-called “multi-vectoral” foreign-policy approach, seeking equally good relations with the two large neighbors, Russia and China, as well as with the United States, the European Union, and Turkey.

13. For more details on the issue of ethnicity in Kazakhstan, see Bhavna Dave, *Kazakhstan: Ethnicity, Language and Power*, Central Asia Studies Series 8 (Abingdon: Routledge, 2007).

14. A citizen of Kazakhstan—irrespective of his nationality—is “Kazakhstani,” whereas the adjective “Kazakh” describes only ethnic Kazakhs.

15. The Embassy of the Republic of Kazakhstan in the United Kingdom of Great Britain and Northern Ireland, *Country Profile 2007*, http://www.kazembassy.org.uk/img/Country%20Profile%202007_1.pdf. For more detail on the role of Islam in Kazakhstan and Central Asia, see e.g. Annette Krämer, “Islam in Zentralasien. Blüte, Unterdrückung, Instrumentalisierung,” *Osteuropa* 57, no. 8-9 (2007): 73. Beate Eschment, “Elitenrekrutierung in Kasachstan. Nationalität, Klan, Religion, Generation,” *Osteuropa* 57, no. 8-9 (2007): 175–193; Bahodir Sidikov, “In der Linken der Wodka, in der Rechten der Koran. Zum Phänomen des Volksislam im postsowjetischen Zentralasien,” *Zentralasien-Analysen*, no. 10 (October 10, 2008): 2–5.

16. Olcott, *Kazakhstan: Unfulfilled Promise*, 209.



Peaceful co-existence of Christian and Islamic culture: a Russian-Orthodox cathedral in Almaty's Panfilov Park and a mosque in Turkistan.

This has yielded stable relationships with all of its neighbors. Nevertheless, Kazakhstan still considers Russia its most important international partner, with whom—as President Nazarbayev often points out in official meetings with Russian counterparts—Kazakhstan has no disagreements at all, neither political nor economic. Russian President Dmitri Medvedev made his first international trip to Kazakhstan after taking office in May 2008, indicating that the Russians also value their relationship with this southern neighbor.¹⁷

2.2. The Soviet Economic Legacy

IN ORDER TO understand the challenges of Kazakhstan's economic transition, it is important to first recognize the key features of the country's economy on the eve of independence. Under the Soviet Union's economic system, Kazakhstan mainly produced materials and agricultural products (particularly grain).¹⁸ During Soviet times, minerals were Kazakhstan's most dominant raw materials. In 1989, Kazakhstan produced 19 percent of all coal and 10 percent of all iron ore in the Soviet Union. Interestingly, the country produced only 4 percent of all crude oil.¹⁹ The discovery of new oil and gas fields in the early 1990s made Kazakhstan the 11th-largest holder of proven oil

and natural gas reserves. Nevertheless, minerals are still important. Kazakhstan has the second-largest uranium, chromium, lead, and zinc reserves and the fifth-largest copper reserves of the world.²⁰ In spite of the dominance of primary commodities, Kazakhstan's economy was the most diversified and urbanized country in Central Asia. At the end of the 1980s, only 23 percent of the workforce was employed in agriculture, whereas the respective share in Tajikistan, Turkmenistan, and Uzbekistan was almost 40 percent. More than half of Kazakhstan's labor force worked in industry, construction, trade, transport, and communication.²¹

With interrepublican exchanges accounting for 86 percent of total trade, the Kazakh USSR's economy was tightly integrated into the Soviet division-of-labor system.²² More than half of exports were directed toward Russia. Kazakhstan's transportation infrastructure was also oriented toward Russia, particularly pipeline routes, which ran predominantly to the north but hardly linked western and eastern Kazakhstan.

When the Soviet Union collapsed, these supply and demand links were disrupted, contributing to the decline of GDP. The desire to keep at least some of the old eco-

17. See also Olcott, "Kazakhstan: Will 'BRIC' be spelled with a K?," *China and Eurasia Forum Quarterly* 6, no. 2 (2008): 41–53.

18. Kazakhstan was the third-largest grain producer in the USSR behind the Russian Federation and the Ukraine.

19. Pomfret, *Economies of Central Asia*, 84.

20. Hilmar Rempel, Sandro Schmidt, Ulrich Schwarz-Schampera, Simone Röhling, and Klaus Brinkmann, "Die Rohstoffe Zentralasiens," *Osteuropa* 57, no. 8-9 (Stuttgart, 2007): 442.

21. Pomfret, *Economies of Central Asia*, 34.

22. Lutz Hoffmann, Peter Bofinger, Heiner Flassbeck, and Alfred Steinherr, *Kazakhstan 1993–2000* (Heidelberg, New York: Physica-Verlag, 2001), 6.

A STORY OF POWER

In the early transition years, some young businessmen, educated at prestigious universities in Moscow or the West, managed to penetrate Kazakhstan's old political elite, which mostly consisted of members of the former communist nomenklatura. The modern western know-how of these young businessmen was attractive to government officials working to restructure the economy. The prime minister, Akezhan Kazhegeldin, shifted some of these experts into the government, presidential administration, and state-owned enterprises. The relatively successful implementation of economic reforms in the second half of the 1990s is attributed to these young men's expertise.¹ However, at the end of the 1990s, they increasingly challenged the old political system and establishment, calling for more rule of law. The ensuing conflict culminated in 2001 over the increasing influence certain members of the president's family, especially his son-in-law Rakhat Aliev, exercised in business enterprises. Aliev was married to Nazarbayev's oldest daughter, Dariga, who herself has controlling stakes in major TV channels and in many "independent" newspapers. Aliev was accused of being involved in the kidnapping of two top managers of the NurBank, trying to organize a plot to remove his father-in-law from power, and being involved in the murder of the political opponent Altynbek Sarsenbayev. When the scandal reached international publicity in February 2007, the president withdrew all his protection from Aliev, and in early 2008 a court in Kazakhstan confiscated his property and sentenced him in absentia to 20 years in prison.²

In reaction to the excessive involvement of the upper spheres of the state in business,³ some of the more progressive political and business actors founded the political opposition movement Democratic Choice of Kazakhstan (DVK) in November 2001. They demanded political reforms, including the decentralization of power. Nazarbayev tried to calm the situation and invited them to "cooperate," offering protection of their businesses in exchange for abstention from politics. Those who did not cooperate were removed from office.⁴ Moreover, the government undertook further legal changes aimed at weakening the opposition.⁵ So far, the old cadres have successfully kept young reformers demanding greater political change at bay. Elections to the lower chamber of parliament, the Mazhilis, in September 2004 confirmed the ruling elite when the pro-government Otan (Fatherland) party, headed by President Nazarbayev, won the majority. In the latest parliamentary election to the lower house on August 17, 2007, none of the opposition parties received 7 percent of the popular vote; the president's party, Nur-Otan,⁶ won every seat with 88 percent of the popular vote.⁷

1. For more detail, see Andrea Schmitz, "Elitenwandel und Politische Dynamik in Kasachstan," SWP-Studie 2003/S 39 (Berlin: Stiftung Wissenschaft und Politik, 2003), http://www.swp-berlin.org/common/get_document.php?asset_id=179; Jonathan Murphy, "Illusory Transition? Elite Reconstitution in Kazakhstan, 1989–2002," *Europe-Asia Studies* 58, no. 4 (2006): 523–554.
2. For detail on the Aliev affairs, see "The Downfall of Rakhat Aliev," *Neweurasia*, May 23, 2007, <http://kazakhstan.neweurasia.net/2007/05/23/the-downfall-of-rakhat-aliev/>; "Kazakhstan: President's Former Son-In-Law Sentenced To 20 Years In Jail," *Radio Free Europe/Radio Liberty*, January 16, 2008, <http://www.rferl.org/content/Article/1079360.html>; Nikolay A. Dobronravyn, Boris I. Kolonickiy, Vladimir Ya Gel'man, Andrey P. Zaostrovcev, and Dmitriy Lanko, *SSSR Posle Raspada* (St. Petersburg: Ekonomicheskaya shkola, 2006), 202.
3. Nazarbayev's other daughter's husband, Timur Kulibaev, the son of a former minister of construction, is also heavily involved in business. He was the first vice president of the state-owned petroleum company KazMunayGas and served as the first deputy chairman of the national holding company Samruk. In addition, he has controlling stakes in the newspapers *Panorama* and *Vremya*. Another relative of Nazarbayev, Nurtai Abykayev, is head of the senate, the upper chamber of parliament.
4. In March 2003, the former minister for industry, Mukhtar Ablyasov, and the former akim of Pavlodar, as well as the journalist Sergey Duvanov were sentenced for writing articles about corruption in the upper spheres of state power.
5. For example, in January 2005, the opposition party Democratic Choice of Kazakhstan was forbidden.
6. Before the elections, the Asar party founded by Nazarbayev's daughter Dariga had merged with Otan to form Nur-Otan.
7. Dosym Satpaev, "An Analysis of the Internal Structure of Kazakhstan's Political Elite and an Assessment of Political Risk Levels," in *Empire, Islam, and Politics in Central Eurasia*, Tomohito Uyama, ed. (Sapporo: Slavic Research Center, Hokkaido University, 2007), 284.

conomic links alive may in part be a motivation behind Kazakhstan's close cooperation within the Commonwealth of Independent States. Since independence, the country has sought new trading partners beyond the former Soviet Union and has grappled with the difficulty of developing absent an established processing sector. Besides the challenge of efficiently reforming the economy, the collapse of the Soviet Union has also posed the problem of determining the appropriate political environment for the transition from a centrally planned to a market economy.

2.3. The Political Background: From Communist Dictatorship to Enlightened Authoritarianism

AFTER INDEPENDENCE, KAZAKHSTAN settled on a political constitution similar to that of Russia: a president with wide-ranging powers over the legislature, judiciary, and local government, and a rather weak parliament.²³ Kazakhstan's first—and so far only—president, Nursultan Abisevich Nazarbayev, has reigned for 18 years. After a short period of what Dosym Satpaev, a Kazakhstani political scientist and think-tank director, called "pro-west-

23. The president appoints the prime minister and his cabinet and strongly influences government politics.



President N. Nazarbayev at a forum for holders of the President's "Bolashak" ("Future") scholarship, which enables young, talented Kazakhstanis to obtain high-quality education at foreign universities.

ern democratic romanticism" (approximately until 1995), presidential power gradually strengthened and the influence of state legislative bodies declined.²⁴ In June 2007, a clear authoritarian turning point, Kazakhstan's parliament passed a law granting Nazarbayev lifetime powers and privileges, including immunity from criminal prosecution and the right to call a successor.²⁵ Nazarbayev can act as his successor's advisor, continuing to influence domestic and foreign policy.²⁶

Kazakhstan justifies the expansion of presidential power with its "special way" theory, mimicking the "Asian model," in which political reform takes a back seat to economic growth—"first the economy and then politics."²⁷ Once economic recovery is ensured, political democracy will be introduced. In fact, in his speech to the nation on February 29, 2007, President Nazarbayev committed himself and the government to advancing democratic reforms. These reforms include a more powerful parliament and a greater voice for political parties. Nazarbayev underscored, however, that it will be done

the "Kazakhstani way," which means that the country will remain a presidential republic and such reforms will occur gradually.²⁸

Despite this authoritarian system, President Nazarbayev enjoys widespread popularity. Both Kazakhstani locals and foreign businessmen praise him for achieving political stability by prudently balancing interethnic and international relations, thereby contributing to the economic success of the last seven years. His public speeches are factual and contain credible commitments to economic and political modernization of Kazakhstan's society. Nazarbayev may be called a "benevolent dictator" and Kazakhstan an "enlightened" authoritarian state, compared to Central Asian neighbors Turkmenistan and Uzbekistan, where both political change and economic transformation are slow. Certainly the absence of party and ideological quarrels in Kazakhstan may help push through economic reforms and contribute to political stability, a prerequisite for a favourable investment climate. However, the limited division of power may also

24. Dosym Satpaev, "An Analysis of the Internal Structure of Kazakhstan's Political Elite and an Assessment of Political Risk Levels," *Empire, Islam, and Politics in Central Eurasia*, Tomohito Uyama, ed. (Sapporo: Slavic Research Center, Hokkaido University, 2007): 284.

25. It is speculated that in 2012, Nazarbayev, who will be 72, might name his daughter Dariga Nazarbayeva as his successor. See Nikolay A. Dobronravyn, Boris I. Kolonickiy, Vladimir Ya Gel'man, Andrey P. Zaostrvocev, and Dmitriy Lanko, *SSSR Posle Raspada* (St. Petersburg: Ekonomicheskaya shkola, 2006), 202.

26. Ibid.

27. The evolution of South Korea, Taiwan, and Singapore is often cited as proof of the soundness of such an approach. Satpaev, "An Analysis of the Internal Structure of Kazakhstan's Political Elite and an Assessment of Political Risk Levels," 285.

28. Nursultan Nazarbayev, "The New Kazakhstan in the New World," Almaty, Kazakhstan, Feb. 28, 2007, <http://www.nomad.su/?a=3-200703010020>.

hamper the battle against corruption, which outside observers often see as the major impediment for the proper functioning of formal institutions.²⁹

3

Economic Reforms Since Independence

BECAUSE OF ITS strong economic integration with Russia, Kazakhstan's government initially pursued a similar course of reform.

3.1. Price Liberalization and Macroeconomic Stabilization

FOLLOWING RUSSIA'S EXAMPLE, Kazakhstan lifted price controls from about 80 percent of all goods in January 1995.³⁰ However, continuing high rates of inflation wrought havoc on prices. The monetary inflation rate reached 1,381 percent per annum at the end of 1992 and peaked in early 1994 at 1,892 percent (see figure 2).

Until the introduction of the national currency—the tenge—on November 15, 1993, Kazakhstan was a member of the ruble zone (in which Russia determined the money supply).³¹ After monetary independence, Kazakhstan pursued tight fiscal and monetary policy, decreasing the growth of the M1 and M2 money supply—effectively currency, checkable deposits, and savings deposits—from 106 percent and 108 percent, respectively, in 1995 to 28 percent and 34 percent in 1997, holding inflation to 17 percent.³² From May to December 1997, the currency was fixed at KZT 75.55 to US \$1.³³ This combination of tight money and a stable exchange rate gradually caused a real appreciation of the tenge and decreased price competitiveness of the real sector of the economy.

In August 1998, Kazakhstan was hit by the Russian Crisis, which buffeted the country's fledgling economic recovery.³⁴ The Russian financial collapse led to a crisis of confidence in CIS economies, deterring investment in the region. However, Kazakhstan coped quite well, thanks to the government's relatively low share of short-term liabilities and careful financial management.³⁵ Between August 1998 and February 1999, the tenge depreciated

29. See "Kazakhstan: Going off the rails," *The Economist*, April 10, 2008, http://www.economist.com/world/asia/displaystory.cfm?story_id=11019786.

30. By January 2002, Kazakhstan had liberalized the remaining regulated prices for transportation and communication services, bread, baby food, and some energy products. Zhaksybek A. Kulekeev, *Ekonomicheskaya ponorama Kazakhstana za gody nezavisimosti* (Astana: TOO "Klassika," 2003), 12.

31. One reason why Kazakhstan and the other neighboring Central Asian republics were firm adherents to the ruble zone was Russia's willingness to continue extending credits to them through the monetary system. Yet, it was only a fraction of the aid they had received before independence (Pomfret, *Economies of Central Asia*, 48).

32. The National Bank of Kazakhstan, Statistics: Monetary Aggregates, <http://www.nationalbank.kz/index.cfm?uid=6B03E0EA-802C-E8F0-EE5A12BFFF9478F9&docid=184>; Kulekeev, *Ekonomicheskaya*, 29.

33. *Ibid.*, 30.

34. In August 1998, after recording its first year of positive economic growth since the collapse of the Soviet Union, Russia was forced to default on its sovereign debt and devalue the ruble from six to twenty four rubles per dollar. The following triggered the crisis: (1) a rising budget deficit (9 percent of GDP in 1997). Due to the inability of the Russian government to collect sufficient tax revenue, international credits and short-term domestic bonds financed the deficit; (2) a deterioration of the current account caused by the declining demand—and thus declining prices—for raw materials following the East Asian crisis of 1997. This hit Russia severely since raw materials accounted for 40 percent of its total exports; (3) the inability of the Russian government to implement a coherent set of economic reforms, among them a comprehensive liberal tax regime; and (4) a political crisis that peaked in March 1998 when President Boris Yeltsin unexpectedly sacked his long-time prime minister Viktor Chernomyrdin for not reacting adequately to the nascent crisis. However, it took a month for parliament to approve the new prime minister and another month to form a government. This led to severe erosion in investor confidence. Investors fled the market by selling rubles and Russian securities. The Central Bank spent its foreign reserves to defend the ruble, which in turn further eroded investor confidence. On August 17, 1998, the Russian government let the exchange rate float downward, defaulted on its domestic bonds, and declared a moratorium on foreign debt payment for 90 days. For more detail, see Anders Aslund, *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed* (Washington, DC: Peterson Institute for International Economics, 2007), 173; Aslund, *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia* (Cambridge: Cambridge University Press, 2007), 133.

35. Kazakhstan had favored long-term indebtedness to international organizations (particularly the World Bank) and foreign governments over short-term indebtedness to private foreign investors. Short-term liabilities represented only 17.2 percent of total government liabilities, whereas in Russia the share was 23 percent. See Marcel Stremme, "Avoiding the Pitfalls: Kazakhstan Joins the World Economy," (working paper no. 20, Internationale Projekt Consult, 1998).

only by 10 percent and interest rates—at 25 percent—remained low compared to Russia, though still too high to significantly stimulate demand in Kazakhstan.³⁶ Nevertheless, this depreciation of the tenge benefited exporters and attracted foreign investment, helping kickstart the economy in 1999 and ending a decade of poor macroeconomic performance. Since May 1999, the central bank has pursued a “dirty” float—a managed float with occasional intervention by Kazakhstan’s central bank—against the U.S. dollar. (Despite pressures for appreciation of the tenge, the exchange rate in February 2006 was KZT 130 to US \$1, the same as at the end of May 1999.³⁷)

Coinciding with these developments was the upturn in oil prices, allowing Kazakhstan to further boost its exports.³⁸ Since 2000, Kazakhstan has experienced double-digit economic growth. In 2007, per-capita incomes were about five times the 1999 level (measured in U.S. dollars) and the unemployment rate had declined to 7.3 percent. Deft macroeconomic management has certainly favorably affected GDP growth, but the oil boom has also been a key factor.³⁹ However, as the data provided by the Asian Development Bank in figure 3 shows, rapid development of the country’s non-oil economy has become another main engine of growth since 2005, especially construction and services. Data from the International Monetary Fund support this development (see figure 4).

36. Hoffmann et al., *Kazakhstan 1993–2000*, 234.

37. Pomfret, “Has Kazakhstan Used its Energy Resources to Promote Diversification through Support for Agriculture?” (paper presented at the International Conference *Institution Building and Economic Development in Central Asia* at the International School of Economics and Social Science at the Kazakh-British University, Almaty, June 5–6, 2008).

38. Pomfret, *The Central Asian Economies Since Independence*, 44; Aslund, *How Capitalism Was Built*, 77.

39. Non-oil output has increased as well, particularly in financial services, construction (by 40 percent in real terms), business services, and the food industry. The food industry grew an average of 9 percent each year from 2001–2004 and 13.2 percent in 2005. See Asian Development Bank, *Asian Development Outlook 2006: Kazakhstan*, <http://www.adb.org/documents/books/ado/2006/documents/kaz.pdf>, 95; Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*, <http://www.adb.org/documents/books/ado/2008/KAZ.pdf>.

FIGURE 2: SELECTED MACROECONOMIC INDICATORS, 1994–2008

	1994	1997	1998	2000	2001	2004	2005	2006	2007	QUARTER 1 2008
GDP (mil US\$) ¹	16,665	22,165	22,136	18,294	22,152	43,150	57,124	81,000	101,700	118,700 ²
GDP per capita (US\$) ¹	1,052	1,446	1,469	1,229	1,491	2,874	3,771	5,292	6,548	7,574 ²
GDP growth (percent)	-12.6	1.7	-1.9	9.8	13.5	9.6	9.7	10.7	8.7	6.1
Inflation	1,892	17	8	13	8	6.7	7.5	8.4	11	17
Unemployment (percent)	7.5	13	13.1	12.8	10.4	8.4	8.1	7.8	7.3	6.9
External Debt (mil US\$)	n.a	7,750	9,932	12,685	15,158	32,713	43,429	73,996	96,369	98,709
Budget Deficit (percent of GDP)	-6.5	-5.2	-8.0	-1.0	-0.9	-0.3	+0.6	+1.4	-1.4	-2.1 ²
Balance of payments (mil US\$)	130	480	-443	585	384	3,999	-1,944	11,134	-3,051	1,384
Trade balance (mil US\$)	-1,389	-276	-800	2,440	1,320	6,785	10,322	14,642	15,100	5,700
Export (mil US\$)	3,542	6,899	5,871	9,288	8,927	20,603	28,300	38,762	47,800	10,300
Import (mil US\$)	-4,931	-7,175	-6,671	-6,848	-7,607	-13,818	-17,978	-24,120	-32,800	-4,600
Balance of services (mil US\$)	-90	-183	-251	-872	-1,524	-3,099	-5,268	-5,912	-7,970	-1,348
Export (mil US\$)	451	761	903	1,132	1,301	2,009	2,228	2,807	3,552	925
Import (mil US\$)	-541	-944	-1,154	-2,004	-2,825	-5,108	-7,496	-8,719	-11,522	-2,273
Contribution to growth:										
Industry (percent)	n.a	21.4	23.8	33.2	30.7	29.3	29.8	29.5	28.3	34.7
Agriculture (percent)	n.a	11.5	8.6	8.1	8.7	7.1	6.4	5.5	5.7	2.1
Construction (percent)	n.a	4.2	4.9	5.2	5.5	6.1	7.8	9.8	9.4	5.6
Services (percent)	n.a	58.9	56.7	48.4	49.3	53.3	52.0	51.7	54.3	57.4
Foreign Direct Investment (mil \$)	n.a	50	123	10,078	12,917	22,376	25,607	32,689	43,381	45,354

1. By official exchange rate
2. Estimates for the whole year

Source: Agency of Statistics of the Republic of Kazakhstan: Statistical Yearbook of Kazakhstan (Astana: Agency of Statistics of the Republic of Kazakhstan, 2006); Kazakhstan za gody nezavisimosti, Almaty, National Bank of Kazakhstan (www.nationalbank.kz), Ministry of Finance (www.minfin.kz).

FIGURE 3: CONTRIBUTION OF ECONOMIC SECTORS TO GDP GROWTH (%), 2003–2007

	2003	2004	2005	2006	2007
GDP	9.3	9.6	9.7	10.7	8.5
Agriculture	0.2	0.0	0.5	0.4	0.5
Industry (excluding construction)	2.7	3.1	1.4	2.2	1.3
Construction	0.6	0.9	2.4	2.8	1.6
Services	5.8	5.6	5.4	5.3	5.1

Source: Asian Development Bank, Asian Development Outlook 2008: Kazakhstan, <http://www.adb.org/documents/books/ado/2008/KAZ.pdf>, 112.

FIGURE 4: REAL OIL AND NON-OIL GDP CHANGE (%), 2003–2007

	2003	2004	2005	2006	2007 ¹
GDP	9.3	9.6	9.7	10.7	8.9
Real oil	11.6	15.4	1.7	5.0	7.3
Real non-oil	8.9	8.4	11.5	11.9	9.2

1. Projection

Source: International Monetary Fund, Republic of Kazakhstan: Staff Report for the 2007 Article IV Consultation (Washington, DC: International Monetary Fund, 2007), 19, <http://www.imf.org/external/pubs/ft/scr/2007/cr07235.pdf>; International Monetary Fund, Republic of Kazakhstan: Staff Report for the 2008 Article IV Consultation (Washington, DC: International Monetary Fund, 2008), 24, <http://www.imf.org/external/pubs/ft/scr/2008/cr08288.pdf>.

Figure 5 shows that services account for more than half of GDP, while real-estate activities account for 15.5 percent and financial activities for 6.2 percent in 2007. Construction's share of GDP has risen from 6 percent in 2003 to 10 percent in 2007.

FIGURE 5: STRUCTURE OF GDP (% OF TOTAL), 2003–2007

	2003	2004	2005	2006	2007
GDP total	100	100	100	100	100
Production of goods	42.9	42.5	44.0	44.8	43.8
Agriculture	7.8	7.1	6.4	5.5	5.7
Industry	29.1	29.3	29.8	29.5	28.1
Construction	6.0	6.1	7.8	9.8	10.0
Production of services	51.8	53.4	52.0	51.7	54.4
Trade, repair of motor vehicles, personal and household goods	11.6	12.5	11.8	11.4	12.3
Hotels and restaurants	0.8	0.9	0.9	0.8	0.8
Transport	10.8	10.1	9.8	9.3	8.7
Communications	1.6	1.7	2.0	2.2	2.4
Financial activities	3.2	2.9	3.2	4.7	6.2
Real-estate activities, lease and services rendered to consumers	14.4	15.3	15.1	14.9	15.5
Government administration	1.9	2.2	2.1	1.9	2.0
Education	3.5	3.7	3.5	3.1	3.1
Healthcare and social services	1.8	1.9	1.7	1.6	1.6
Community, social, and personal services	2.1	2.0	1.8	1.7	1.7
Activities of households as employers of domestic staff and producing goods and services for own use	0.1	0.2	0.1	0.1	0.1
FISIM ¹	-1.5	-1.3	-2.2	-3.0	-4.8
Net Taxes	6.8	5.4	6.2	6.5	6.6

1. FISIM stands for Financial Intermediation Services Indirectly Measured. In the System of National Accounts, it is an estimate of the value of the services provided by financial intermediaries, such as banks, for which no explicit charges are made; instead these services are paid for as part of the margin between rates applied to savers and borrowers.

Source: Agency of Statistics of the Republic of Kazakhstan, *Kratkiy statisticheskiy ezhegodnik Kazakhstana: Predvaritel'nye dannye za 2007 god, 2008*, 120.

Figure 6 demonstrates the overwhelming importance of mining within the industry sector. Since 2004, it has accounted for more than half of Kazakhstan's total industrial production, followed by the metallurgy industry and the food industry.

FIGURE 6: STRUCTURE OF INDUSTRIAL PRODUCTION BY BRANCHES, 2003–2007 (% OF TOTAL)

	2003	2004	2005	2006	2007
Industry total	100	100	100	100	100
Mining	48.4	53.4	59.4	57.8	56.7
Mining of fuel and energy-producing minerals	44.1	48.6	54.9	53.6	51.9
Mining industry, excluding mining of fuel and energy-producing minerals	4.3	4.8	4.5	4.2	4.8
Manufacturing	42.9	39.7	35.2	37.0	37.9
Food processing	11.8	10.5	8.8	8.0	8.1
Textile and sewing industry	1.3	1.0	0.8	0.6	0.5
Manufacture of coke, refined petroleum products, and nuclear materials	4.4	3.5	3.2	2.8	2.5
Chemical industry	1.4	1.1	1.0	0.8	0.9
Metallurgy industry and manufacture of fabricated metal products	17.0	16.3	14.0	16.8	16.9
Machine-building	3.3	3.3	3.4	3.5	3.6
Others	3.7	4.0	4.0	4.5	5.4
Production and distribution of electricity, gas, and water	8.7	6.9	5.4	5.2	5.4

Source: Agency of Statistics of the Republic of Kazakhstan, *Kratkiy statisticheskiy ezhegodnik Kazakhstana: Predvaritel'nye dannye za 2007 god, 2008*, 147.

In May 2000, the government paid off its debts to the IMF ahead of schedule and the state enjoyed a budget surplus in 2005 and 2006.⁴⁰ However, mid-2007 brought new macroeconomic difficulties to Kazakhstan. Inflation returned to double digits (11 percent) for the first time in seven years, despite the National Bank's (the official name for the Central Bank of Kazakhstan) attempts to tighten liquidity. National and international observers⁴¹

40. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007*, 341.

41. See e.g. Asian Development Bank, *Asian Development Outlook 2006: Kazakhstan*, <http://www.adb.org/documents/books/ado/2006/documents/kaz.pdf>, 96; Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*, 113; European Bank for Reconstruction and Development, *Transition Report 2008: Growth in Transition London (2008)*, 137; Bodo Lochmann, "Inflationsrate wird zur Nagelprobe," in *Deutsche Allgemeine Zeitung*, (June 15, 2007), 3; Olzhas Khudaybergenov, "Boyazn' inflyatsii," *National Business* 54, no. 4 (2008): 18–22; Petr Svoik, interview by Yaroslav Razumov, "Who is responsible for the inflation in Kazakhstan?" *Silk Road Intelligencer*, November 26, 2007, <http://silkroadintelligencer.com/2007/11/26/who-is-responsible-for-the-inflation-in-kazakhstan/>.

42. Money supply M1 and M2 growth in 2006 was 60 percent, resp. 86 percent against 18 percent, resp. 29 percent in 2005 (The National Bank of Kazakhstan, Statistics: Monetary Aggregates).

43. For more detail, see International Monetary Fund, *Republic of Kazakhstan: Staff Report for the 2006 Article IV Consultation* (Washington, DC: International Monetary Fund, 2006), <http://www.imf.org/external/pubs/ft/scr/2006/cr06244.pdf>; International Monetary Fund, *Republic of Kazakhstan: Staff Report for the 2007 Article IV Consultation* (Washington, DC, International Monetary Fund, 2007), <http://www.imf.org/external/pubs/ft/scr/2007/cr07235.pdf>; Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*.

44. See also Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*.

45. Constitution of the Republic of Kazakhstan, <http://www.constcouncil.kz/rus/norpb/constrk/>.

hold monetary, but also non-monetary factors responsible for the rising prices, including the effect of high money growth,⁴² the strong growth in real wages (particularly in the public sector), greater domestic demand fueled by high oil-related incomes, increases in utility and transport tariffs, and an overall credit boom. Both external borrowings and a buoyant growth in domestic deposits funded the credit boom (see also section 4.2.2 of the appendix). All these, plus the impact of the world financial crisis, served to slow GDP growth to 8.7 percent in 2007 and an estimated 5–6 percent in 2008.⁴³ Curbing inflation is again an economic policy priority. The National Bank has announced a two-year monetary program to hold average inflation to 16–18 percent in 2008. For 2009, the average inflation target is 8.5–10.5 percent. To achieve these targets, the National Bank will restrict credit expansion to the economy to 9.5 percent. The government has considered price controls for basic consumer items and used "moral suasion" on producers and traders not to raise prices; but such measures encourage black markets to develop and discourage domestic production.⁴⁴

3.2. Privatization

KAZAKHSTAN HAS PROGRESSED quickly with the introduction of private property rights. In fact, the Constitution of the Republic of Kazakhstan explicitly guarantees them.⁴⁵

3.2.1. Privatization Method

SMALL-SCALE ENTERPRISES (THOSE employing 200 or fewer workers) were privatized by cash sale. Kazakhstan privatized its medium-scale enterprises through a voucher scheme similar to methods implemented in Czechoslovakia and Russia. Very large firms were privatized on a case-by-case basis through direct asset sale.⁴⁶

By 1992, most small-scale enterprises were privatized and many new private firms emerged, predominantly in the trading business. Voucher privatization of medium-sized firms entailed conversion into joint stock companies and subsequent sale of shares. Employees had the right to receive up to 25 percent of the shares. Czech-style Investment Privatization Funds (IPFs) could bid on the remainder. Each resident of Kazakhstan received vouchers that could be exchanged for shares in IPFs. From 1995–1997, the voucher scheme was dropped and medium-sized enterprises were privatized by direct asset sales under individually negotiated agreements. According to Martha Brill Olcott, an expert on political and economic transition issues in Central Asia and the Caucasus, this was the most corrupt stage of privatization in Kazakhstan.⁴⁷ There was little transparency and many of the deals were concluded rapidly.⁴⁸ By the end of 1997, most medium-scale enterprises were privatized.

Agricultural privatization began in 1993 and at first involved only non-land assets. Collective farms were privatized by selling shares. In addition, family (peasant) farms have been allowed to exist.⁴⁹ The 1995 Law on Land confirmed the principle of state land ownership, but guaranteed private use rights under long-term leases (99 years).⁵⁰ The target for recognizing full private property rights on agricultural land was 2001, but there were serious objections by some parliamentarians and older Kazakhstani, who viewed it as violating the traditions of their former nomadic culture. A new land code finally passed in 2003,⁵¹ allowing private ownership of

agricultural land with all property rights, including the free sale and purchase of land plots. The most important economic consequence of recognizing full private property rights on farm land is that smaller family farms now have valuable collateral, easing access to credit.

Privatization in Kazakhstan has proceeded faster and has gone further than in any other Central Asian country to date, except for Kyrgyzstan (figure 7).⁵² By 2007, the private sector employed approximately three-quarters of the population and accounted for 70 percent of GDP.⁵³ However, completely or partially state-owned companies continue to operate in the energy, transportation, and communication sectors.⁵⁴

46. Vladislav Ermakovich, Petr Kozarzhevskiy, and Yulian Pan'kuv, "Privatizatsiya v Respublike Kazakhstan," (working paper no. 85, Issledovaniya i analizi, Nauchno-issledovatel'skiy fond CASE, 1996), http://www.case.com.pl/upload/publikacja_plik/4886209_085r.pdf.

47. Olcott, *Unfulfilled Promise*, 139.

48. According to Sander Thoenes, "Speed differentiates Kazakhstan's privatization more than anything. One company asked a consultancy to submit a proposal for a three-week legal and commercial investigation for a bid. Two days later, the consultancy found that the company had already won the bid." ("Kazakhstan's sale of the century," *Financial Times*, October 25, 1996, quoted in Kalyuzhnova, *The Kazakhstani Economy*, 78).

49. Tohtar A. Esirkepov, *Privatizatsiya gosudarstvennoy sobstvennosti v Respublike Kazakhstan v usloviyakh perekhoda k rynku* (Almaty: Universitet Turan, 1999).

50. Gul'nara K. Kurmanova, "Osnovnye napravleniya i rezul'taty zemel'noy reformy v Respublike Kazakhstan na sovremennom etape," in *Vestnik sel'skokhozyaystvennoy nauki Kazakhstana* no. 9 (2007): 5–7.

51. See Government of the Republic of Kazakhstan, "Zemel'nyy kodeks RK" no. 442-II, June 20, 2003, *Jurist online*, <http://www.pavlodar.com/zakon/?dok=02847&ogl=all>. For a detailed discussion of the new land code, see also Centr sistemnykh issledovaniy Administratsii Prezidenta Respubliki Kazakhstan and Gesellschaft für Technische Zusammenarbeit (GTZ), "Zemel'nyy kodeks RK—to, chto Vy khoteli by znat' (Informacionnaya podderzhka sela)."

52. Pomfret, *The Central Asian Economies Since Independence*, 76 and 87; Martin C. Spechler, "The Economies of Central Asia: A Survey", *Comparative Economic Studies* 50, no. 1 (2008), 33.

53. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007*, 36.

54. According to data published by the Financial Supervisory Agency, as of August, 2008 there were 11 joint-stock companies of which the state was the single owner. See <http://www.afn.kz/index.cfm?uid=4604E0BB-A709-737D-5F148B4EC09E43C5&docid=602>. The respective state-owned companies are as follows: in energy, KazMunayGaz; transportation, Dostyk Eenergo; also in transportation, Temir Zhol, and communications, Kazpochta.

FIGURE 7: PRIVATE SECTOR SHARE IN GDP AND EMPLOYMENT IN CENTRAL ASIA AND RUSSIA (IN %)

	1992		1995		1998		2000		2003		2006		2007 ¹	
	Share in GDP	Share in employment	Share in GDP	Share in employment	Share in GDP	Share in employment	Share in GDP	Share in employment	Share in GDP	Share in employment	Share in GDP	Share in employment	Share in GDP	Share in employment
Kazakhstan	10.0	n.a.	25.0	n.a.	55.0	73.0	60.0	78.8	65.0	75.4	65.0	77.0	70.0	78.0
Kyrgyzstan	20.0	12.8	40.0	68.5	60.0	76.3	60.0	78.2	65.0	80.2	75.0	n.a.	75.0	n.a.
Tajikistan	10.0	21.1	25.0	33.8	30.0	34.1	40.0	44.3	50.0	45.8	55.0	51.9	55.0	52.1
Turkmenistan	10.0	n.a.	15.0	n.a.	25.0	n.a.	25.0	n.a.	25.0	n.a.	25.0	n.a.	25.0	n.a.
Uzbekistan	10.0	n.a.	30.0	n.a.	45.0	n.a.	45.0	n.a.	45.0	n.a.	45.0	n.a.	45.0	n.a.
Russia	25.0	n.a.	55.0	n.a.	70.0	n.a.	70.0	n.a.	70.0	n.a.	70.0	n.a.	70.0	n.a.

1. Estimate

Source: European Bank for Reconstruction and Development (EBRD), Transition Report 2008: Growth in Transition, (London: EBRD, 2008), <http://www.ebrd.com/country/sector/econo/stats/index.htm>.

3.2.2. Business Groups

OUT OF THE privatization process, big business groups emerged, mostly as holding companies. These groups tend to be vertically integrated conglomerates and control multiple phases of the production process, such as financing, capital, and manufacturing. They also often have close links to political power.⁵⁵ According to Richard Pomfret, professor of economics at the University of Adelaide in Australia, ten megagroups together control more than four-fifths of the economy.⁵⁶

Business groups are particularly widespread in the banking sector. This is an outcome of the early transition years when many manufacturing and trading enterprises had founded their own pocket banks. As of September 1, 2008, 15 major banks were part of business groups. Seven

belong to diversified business groups where the mother company is either an investment or manufacturing company (such as in energy or metallurgy). The remaining eight are purely financial services holding companies.⁵⁷

Business groups appeared even in the agro-food sector, mostly in its most lucrative subsector, the grain sector. Galia Akimbekova, an economist with the Almaty-based Research Institute of Economics for the Agro-Industrial Complex,⁵⁸ estimates that about 40 so-called “agroholding companies” operate in the grain sector, controlling nearly one-third of grain farmland and providing about two-thirds of all grain sold domestically and exported.⁵⁹ Financial analysts Arystan Ibraev and Sergey Frangulidi consider approximately 15 of these to be *big* grain holdings, often controlling several thousand hectares of farm-

55. The ten biggest groups are the following joint stock companies: KazMunayGaz, Kharrikeyn (Hurricane) Kukmol' Munay, Shymkentnefteorgsintez, KEGOK, Temirtau Mitall Stil, Korporaciya Kazakhmys, Kaztsink, Alyuminiy Kazakhstan, KazKhrom, Ust'Kamenogorskiy titano-magnievnyy kombinat. The Agency of Social Technologies “Epicenter”—Eurasian Center for Political Research (in Russian: Agenstvo social'nykh tekhnologiy “Epicentr”—Evrazijskiy centr politicheskikh issledovaniy) ranks in addition the Eurasian Natural Resources Corporation (ENRC) (formerly Eurasian Industrial Association—EIA) among the top groups. Like most of the biggest conglomerates, ENRC operates in the natural resources sector and has integrated mining, processing, energy, logistical, and marketing operations. It is the world's largest producer of ferrochrome, the world's sixth-largest iron ore exporter and the world's fifth-largest supplier of traded alumina. ENRC contributes around 4 percent of Kazakhstan's GDP. See Rashid M. Ruzanov, “Vektory integracii finansovogo i promyshlennogo kapitala,” *Kazakhstan-Spektr* no. 2 (2007): 68; Agenstvo social'nykh tekhnologiy “Epicentr”—Evrazijskiy centr politicheskikh issledovaniy (transl. Agency for social technologies “Epicentre”—Eurasian Centre for Political Research), *Finansovo-promyshlennye gruppy Kazakhstana za kulisami superpresidentskoy respubliky*, (International Eurasian Institute for Economic and Political Research), http://www.iicas.org/2005/2_12_05_ks.htm.

56. Pomfret, *The Central Asian Economies Since Independence*, 7.

57. Information published by the Agency of the Republic of Kazakhstan on regulation and supervision of financial market and financial organizations, available at <http://www.afn.kz/index.cfm?uid=45F2B250-DA17-7E59-6C6C57622EB18D9B&docid=184> and <http://www.afn.kz/index.cfm?uid=45F2B250-DA17-7E59-6C6C57622EB18D9B&docid=185>.

58. “Agro-Industrial Complex” denotes what in Western countries is called the agro-food sector.

59. Galia U. Akimbekova, *Formirovanie effektivnoy sistemy proizvodstva, pererabotki i sbyta sel'skokhozyaystvennoy produkcii* (Almaty, 2006), 108.

land.⁶⁰ “Ivolga-Holding,” for example, farms one million hectares in northern Kazakhstan and another 140,000 in Russia. Most of these big players originated in grain trading and gradually expanded into primary grain production. Some are themselves part of diversified conglomerates.

Such business groups are not unique to Kazakhstan. They can be found in East Asia (Japanese keiretsus, South Korean chaebols), India, Latin America, and even in western economies like Italy. In fact, the diffuse corporate ownership characteristic in the United States and the United Kingdom is actually the exception.⁶¹ Business groups may result from entrepreneurial discovery under certain economic and institutional conditions or reflect cultural peculiarities. Anders Aslund, a supporter of this view who has studied business groups in Russia and the Ukraine, argues convincingly that they are in fact “nothing but normal” for this stage of economic development. He compares the emergence of conglomerates in the three largest CIS countries with the 19th-century industrial empires of the so-called “robber barons” in the United States. He found similar economic, legal, and political conditions for their rise, namely vast economies, large economies of scale in certain industries (especially oil, metals, and grain), rapid structural change, the prevalence of natural rents (in oils and metals), and poor legal institutions.⁶²

During Kazakhstan’s transition period, when formal institutions signalling trustworthiness were lacking, the emergence of business groups seemed to be a rational entrepreneurial method to secure supply and marketing links as well as access to capital through risk diversification. For example, analysis shows Kazakhstani agroholdings have evolved in response to principal-agency

problems with suppliers and downward processing and marketing stages.⁶³ They also react to changing profit opportunities, demonstrated by the sale of unprofitable segments.⁶⁴

However, large business groups might work to the detriment of the market process if close links to political power lead to preferential tax breaks or if businesses receive subsidies or exemptions from burdensome regulations. This is not to say that developed western market economies with a more diffuse ownership structure are free from political rent-seeking. They are not. But, because lobbying is legalized and regulated, it may be more transparent. In addition, political rent-seeking power may not be as concentrated in the hands of a tiny elite.⁶⁵ Some observers stress that the relationships are particularly tight between the government and business groups that operate in fields with high profit margins like natural resources, financial services, and grain.⁶⁶ This might be either because the state has stakes in the holding company,⁶⁷ or, as critical observers argue, the owners of the conglomerates depend on powerful officials’ protection and renegotiate opaque privatization deals using scare tactics. However, there is not enough information publicly available to back up the latter assertion.

3.3. Foreign-Trade Policy

ANOTHER INSTITUTIONAL PREREQUISITE for functioning market processes is a national economy open to foreign competition. Kazakhstan has made considerable progress in this area; however, protectionistic tendencies seem to be on the rise.

60. Arystan Ibraev and Sergy Frangulidi, “Zerno: Chto poseesh’, to pozhnesh’,” *National Business* 37, no. 11 (November–December, 2006): 14.

61. Randall Morck, Daniel Wolfenzon, and Bernard Yeung, “Corporate Governance, Economic Entrenchment, and Growth,” *Journal of Economic Literature* XLIII (September 2005): 693. See also Aslund, *How Capitalism Was Built*, 256. He confirms that “rather than considering oligarchs an exception, as most of the Anglo-American literature about Russia does, we must accept them as the international standard.”

62. John Steel Gordon, *An Empire of Wealth: The Epic History of American Economic Power* (New York: Harper Collins, 2004), 207, quoted in Aslund, *How Capitalism Was Built*, 260. Gordon observes that the state of law in the United States in the 1860s after the civil war was often not much different than in transition countries: “Nothing characterized American politics and thus the American economy so much as corruption. There were, in effect, no cops on the beat, and the result, for a few years, was capitalism red in tooth and claw.”

63. For example, processors (e.g. dairies) encountered problems with farmers who supplied the necessary agricultural raw materials (milk). The farmers neither followed the contractually fixed quality requirements nor delivered it on time. Also, wholesale traders (e.g. of flour) often did not pay the upstream processing enterprise (flour mill). See Jürgen Wandel, “Agroholdings or Clusters in Kazakhstan’s Agri-Food Sector?” paper presented at the IAMO Forum 2008, *Agri-Food Business: Global Challenges—Innovative Solutions*, June 25–27, 2008, Halle, Germany, <http://www.iamo.de/forum0/forum2008/program-highlights/poster-sessions/session-on-agroholdings/agroholdings-versus-clusters-in-the-kazakh-agri-food-sector.html>.

64. Some large agroholdings like Bogvi, Agrocentr Astana, Alibi-Agro, and BATT Grain are leaving agricultural production.

65. See Morck et al., *Corporate Governance, Economic Entrenchment, and Growth*, 697.

66. See Heidi Kjærnet, Dosym Satpaev, and Stina Torjesen, “Big Business and High-Level Politics in Kazakhstan: An Everlasting Symbiosis?” *China and Eurasia Forum Quarterly* 6, no. 1 (2008): 97.

67. Such an example is the ENRC, where the state holds 19.31 percent of its shares.

Until the end of 1995, most quotas had been abolished and the need for import licenses reduced to only eight product categories. From 1996 on, tariffs following WTO requirements mainly regulated foreign trade. Until 2002, the average weighted tariff was further lowered to 8 percent (from 12 percent in 1997).⁶⁸ Restrictions on currency convertibility have been continually removed, too. The Law on Currency Regulation and Currency Control (Amendments) of December 17, 2005 finally abolished almost all the restrictions that had so far existed. The only exceptions are currency operations, for which a license system has been retained. However, the law also leaves a loophole for discretionary intervention as it permits government to reintroduce controls on currency operations in case of “sudden severe economic shocks.”

World Bank trade restrictiveness indicators underscore the openness of the Kazakhstani economy. The Most Favored Nation (MFN) Trade Tariff Restrictiveness Index (TTRI) indicated Kazakhstan’s uniform equivalent tariff was 2.1 percent in 2006 compared to 9.9 percent in 2001.⁶⁹ This is 8th out of 125 countries for which the TTRI has been calculated and much lower than the average for the categories “Europe and Central Asia” and “upper-middle-

income countries” (4.2 percent and 5.3 percent, respectively). However, since the mid-2000s, the government has turned to a more protectionist foreign-trade policy, promoting import substitution in order to safeguard its active industrial policy for so-called strategic sectors of the economy. The increase of the specific tariff frequency ratio and MFN-applied simple average tariff reflect this trend.⁷⁰ The MFN-applied simple average tariff rose to 7.8 percent from 2.8 percent in the early 2000s.⁷¹

Even before the increased protectionism, there were ad-hoc impositions of import restrictions that made trade policy less predictable. For example, following the August 1998 Russian Crisis, Kazakhstan introduced a 20 percent value-added tax on all personal imports from Russia, Kyrgyzstan, and Uzbekistan. In December 1998, the Law on Measures to Protect the Domestic Market from Imported Goods was passed and then followed by a temporary import tariff of 200 percent on goods from Kyrgyzstan and Uzbekistan. And in 2007, the government temporarily licensed the export of grain only to temporarily ban its export from April to September 2008, both in an attempt to fight rising bread prices and out of fear of a food shortage.

68. Diana M. Madiyarova, “Strategiya formirovaniya vneshneekonomicheskoy politiki,” (Almaty: Ekonomika, 1999), 76; Kulekeev, *Ekonomicheskaya*, 21; Gul’nar Smailova, “Razvitie vneshney torgovli Kazakhstan,” *Analytic no. 5* (2005): 24.

69. The Most Favored Nation Trade Tariff Restrictiveness Index (MFNTTRI) is calculated by the World Bank Development Economics Research Group (DECRG) using United Nations Conference on Trade and Development (UNCTAD) Trade Analysis and Information System (TRAINS) and United Nations Commodity Trade (COMTRADE) Statistics Database. The index summarizes the trade restrictiveness of the MFN tariff schedule of a country. It is equivalent to and expressed as the uniform tariff rate that would be needed to generate the country’s aggregate import volume at its current level (given heterogeneous tariffs). The MFN TTRI considers only ad valorem and specific tariffs and does not take into account domestic subsidies or export taxes. It is calculated as a weighted sum of ad valorem tariffs and ad valorem equivalents of specific duties, where weights are import volumes and estimated import demand elasticities. Since the TTRI does not cover non-tariff barriers it can be seen as providing a lower-bound estimate of the extent of protection prevailing in a country. The problem with calculating measures that do include non-tariff barriers, like the World Bank Development Economics Research Group’s Overall Trade Restrictiveness Index (OTRI), is that not all non-tariff barriers, such as bans, are motivated by protectionist objectives but to safeguard human health. To distinguish between these objectives is, however, difficult. The TTRIs and OTRIs by country and the data used to calculate them are posted on the DECRG Trade Research Web site at <http://go.worldbank.org/CSVQJIV3H0>. For more detail on the DECRG’s trade restrictiveness indicators, see Roumeen Islam and Gianni Zanini, *World Trade Indicators 2008: Benchmarking Policy and Performance* (Washington, DC: The World Bank, 2008). For more on methodological issues to measure trade restrictiveness, see Hiau Looi Kee, Alessandro Nicita, and Marcelo Olarreaga, “Estimating Trade Restrictiveness Indices,” (World Bank Policy Working Paper no. 3840, 2006), http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2006/01/31/000016406_20060131161106/Rendered/PDF/wps3840.pdf.

70. The specific tariff frequency ratio reflects the number of product categories with at least one specific tariff as a percentage share of the total number of so-called Harmonized Schedule (HS) tariff lines. A specific tariff is a tariff that does not vary with price, but is based on quantity. A tariff line is a single item (product category) in a country’s tariff schedule. The tariff schedule is the list of all of a country’s tariffs, organized by product categories. The Harmonized Schedule is the list of tariffs charged for all products imported to a country. By international agreement, most countries use 6-digit codes to classify products for customs purposes. The MFN-applied simple average tariff is calculated as the simple average of the Most Favored Nation ad valorem tariff rates that a country applies to its trading partners available at HS 6-digit product level in a country’s customs schedule. Ad valorem equivalents of specific tariffs are excluded. Simple average means that tariff lines are included even where there are no trade flows. See Islam and Zanini, *World Trade Indicators*. The specific tariff frequency ratio rose from zero in the late 1990s and an average of 1.65 percent in 2000–2004 to 11.8 percent in 2007, a level higher than the averages not only in the “Europe and Central Asia” category (6.7 percent) but also in upper-middle-income countries (3.9 percent).

71. World Bank, *Kazakhstan: Trade Brief* (2008), <http://info.worldbank.org/etools/wti2008/docs/brief97.pdf>.

Interestingly, entrepreneurs complain more about informal, non-tariff barriers to trade. Customs officials have considerable discretionary power in applying opaque health, safety, and technical requirements, all of which impose substantial costs.⁷² One owner of a small coffee roastery and café, who depends on the import of coffee beans, named these circumstances as the greatest obstacle to keeping the business running. Inputs must be imported far in advance of when they are needed to allow for processing. Often only paying bribes or hiring a specialized broker helps to smooth the process. Taking into account these non-tariff obstacles, Kazakhstan ranked 178th—dead last in the rankings in the World Bank Doing Business “Trading Across Borders” subcategory.⁷³ However, Bodo Lochmann, a senior lecturer of economics with ten years’ experience working and living in Kazakhstan, notes that while these informal obstacles surely do hamper foreign trading, they do not make it extremely difficult. Compared to a decade ago, both formal and informal obstacles have been drastically reduced.

Repeated statements by the president and the 1996 application for WTO accession indicate that, at least in principle, the Kazakhstani government is committed to freer trade and integration into the global economy. The accession process appears to be fairly advanced; however, it is believed that because of Kazakhstan’s close links with Russia, the country will not enter the WTO before Russia.⁷⁴ However, the accession of the Ukraine in February 2008 makes prediction difficult.⁷⁵ Still, conversing with Kazakhstani business representatives, administrators, and academics reveals a mixed attitude to the WTO. While most are aware of the advantages of increased access to foreign markets and dispute settlement that a WTO accession will bring, fears remain about the short-term social costs due to the necessary structural adjustments and even the loss of whole sectors, particularly agriculture (with the exception of grain).⁷⁶

FIGURE 8: CURRENT ACCOUNT COMPONENTS (IN BILLION US\$)

Year	Current account balance	Goods	Services	Income	Transfers
2003	-0.3	3.7	-2.0	-1.7	-0.2
2004	0.3	6.8	-3.1	-2.9	-0.5
2005	-1.1	10.3	-5.3	-5.7	-0.4
2006	-1.8	14.6	-5.9	-9.3	-1.2
2007	-7.0	15.2	-7.9	-12.0	-2.2

Source: Asian Development Bank, Asian Development Outlook 2008.

3.4. Business Regulation

FOR ENTREPRENEURS TO exercise their creativity in the market process, it is important to have not only well-defined property rights, but also the freedom of contract, a limited tax burden, and few government interferences of other sorts.

3.4.1. Freedom of Contract

ARTICLE 4 OF the Constitution of the Republic of Kazakhstan,⁷⁷ as well as the country’s Civil Code, guarantees freedom of contract, freedom from arbitrary interference in a person’s private affairs, and defense of violated rights in court. Corporate law regulations modeled on western laws govern the commercial activity of various legal business forms (joint stock companies, limited liability partnerships, etc.). A competition law passed in 1991 (revised in 2001 and 2006) prohibits any form of monopolistic activity or any other activity directed at limiting or removing competition.⁷⁸ The law covers all types of economic entities, irrespective of their nature, structure and ownership; thus it includes state agencies and state-owned entities. The competition law also identifies certain “natural monopolies” for which various subsidiary regulations have been passed. In 1998,

72. See also Aslan Sarinzhapov, “Neformal'nye i finansovye bar'ery—prepyatstvie k polucheniyu vygod ot regional'noy integracii,” *Karzhly Karazhat—Finansy Kasachstana* (K.K.–F.K.), no. 4 (2005), 56.

73. World Bank, *Doing Business 2008: Kazakhstan* (Washington, DC: World Bank, 2008), 2, <http://info.worldbank.org/etools/wti2008/docs/brief97.pdf>.

74. See also Pomfret, *The Central Asian Economies Since Independence*, 175. For more details on the WTO accession of CIS countries, including Kazakhstan, see also Aslund, *Transformation of Central and Eastern Europe, Russia, and Central Asia*, 278.

75. See the assessment of Bodo Lochmann, “Wann tritt Kasachstan der Welthandelsorganisation bei?” *Deutsche Allgemeine Zeitung*, February 8, 2008, 3.

76. See e.g. Natal'ya Buleshova, “Problema ugrozy v ekonomike Kazakhstane,” *Kazakhstan v global'nikh processakh*, no.1 (2005): 132–139. This journal is issued by the Institut mirovoy ekonomiki i politiki (IMEP) pri Fonde Pervogo Prezidenta Respubliki Kazakhstan.

77. <http://www.constcouncil.kz/rus/norpb/constrk/>.

78. The law in its 2006 version is accessible at <http://www.zakon.kz/our/news/news.asp?id=30062668>.

competition legislation was complemented by the Law On Unfair Competition.⁷⁹ Bankruptcy legislation regulates market exit.

Both laws were enforced. However, some reports indicate that the competition law has not always been applied to promote competition.⁸⁰ In particular, the law's provision that allows the antimonopoly agency to interfere with the price fixing of firms with "market power"⁸¹ has in fact been used to regulate prices by setting price ceilings and floors. As Aydyn Bakibaev, director of the Institute of Private Law and expert on antitrust policy, reports, any company having a market share of more than 15 percent, measured by a company's share of a sector's total sales,⁸² can be regarded as a "dominant" firm. He continues, "If such a firm tries to increase profitability through cutting costs, it risks being accused of demanding a monopolistic high price. The accusation is usually based on the fact that its profit exceeds the average profit made in the industry. This means antitrust authorities still apply the 'absurd' idea of a 'justified price,' which, in fact, only hinders firms from growing and increasing profitability through innovation and cutting costs."⁸³ In addition, there are reports of non-transparent investigation procedures and lawsuits alleging corruption and arbitrary decisions.⁸⁴

A fourth revision of the competition law was passed in December 2008 and came into effect in January 2009.⁸⁵ It unites the 1998 and 2006 competition laws and tries to overcome some of the shortcomings of the previous legislation. This holds in particular for the antitrust investigation and lawsuit procedures. The new law requires

more transparency for court procedures and more evidence to be collected to back accusations of market power abuse. In addition, the law tries to define more precisely the vague notions of a dominant firm, unfair competition,⁸⁶ horizontal agreements, and collusion, as well as monopolistic high and low prices. Nevertheless, it fails to do so,⁸⁷ leaving much room for discretionary government intervention. This is because there is neither an objective definition of what is "dominant" or "fair," nor is there a convincing theoretical foundation that may help to unequivocally detect market power and its abuse or draw a deterministic relationship between market structure, the conduct of firms, and economic performance. For example, when a firm lowers its price, is that competition or an attempt to monopolize? Or, when a firm gains market share, is that evidence of efficiency or a threat to competition? Or is a large profit due to a successful innovation or the "abuse of market power?"

3.4.2. Taxation

ON JULY 1, 1995, Kazakhstan adopted the most transparent tax code of any member of the Commonwealth of Independent States and set the stage for subsequent reforms that would provide favorable incentives for entrepreneurial activities. The 1995 Tax Code reduced the number of taxes from 43 to 11. Primary taxes were the value-added tax (VAT), corporate tax, and the individual income tax. In 1999, a unified social tax of 26 percent was introduced, replacing various payments for pension, health care, unemployment, and social security.⁸⁸ While foreign investors held up this new tax code as a good model for other countries, local managers of enter-

79. The law is accessible at <http://e.gov.kz/wps/portal/download?page=antimonopoly&fileID=92142>. Article 5 lists the practices deemed to be unfair. Among them are patent and copyright violation, advertising using false information, collusion, and dumping.

80. See e.g. Lochmann, "Kasachstan: Grüne Gurken werden zu Gold," *Deutsche Allgemeine Zeitung* (2008), 3; Aydyn Bikebaev, "Kak nam zashchit' konkurenciyu," *Ekspert Kazakhstan* 59, no. 11 (2008), http://www.expert.ru/printissues/kazakhstan/2008/11/zaschita_konkurencii/; Svetlana Gribanova, "Monopolistov prosyat pobespokoits'sya," *Ekspert Kazakhstan* 182, no. 35 (2008), http://www.expert.ru/printissues/kazakhstan/2008/35/zakon_o_konkurencii.

81. Chapter 8, Article 30 of the 2006 Competition Law

82. Chapter 3, Article 9 of the 2006 Competition Law.

83. Bikebaev, "Kak nam zashchit' konkurenciyu."

84. *Ibid.*

85. See for more detail Zakon "O konkurencii," http://ru.government.kz/docs/zakon_o_konkurentzii_2008_goda.doc.

86. The new law forbids any tying agreements, exclusionary practises, boycotts, or discrimination. However, it does not specify the business practices that fall under these categories (see chapter 3, Zakon "O konkurencii").

87. In order to identify monopoly pricing two methods shall be applied, which are, however, rather vague. The first is an "as if competition concept." Thus, a price is considered monopolistically high "if it exceeds the price that would be established by a non-dominant firm in a competitive market." According to the second method a price is monopolistic "if it exceeds the sum of costs and of an appropriate profit necessary to compensate the producer for its production and marketing activities." Yet it is not précised what costs and profit are regarded to be appropriate. See for more detail chapters 2 and 3 of the 2008 Competition Law.

88. The latter includes such cases as loss of working ability and loss of the provider of the family.

prises still considered the total tax rate very high.⁸⁹ To reduce incentives to participate in the shadow economy and provide more favorable conditions for entrepreneurship, further improvements to the tax system came into effect in January 2002. The number of taxes decreased to 10 and tax rates were cut further (see figure 9).⁹⁰ Further amendments to the tax code in January 2006 improved taxation for small-sized enterprises. One year later, in 2007, a revised tax code was adopted that again reduced and facilitated taxation. The VAT rate was reduced from 15 percent in 2002 to 14 percent in 2007, and it was stipulated that the VAT rate shall be reduced every year until 2009 by another percentage point. Corporate income tax remains at 30 percent for all legal entities.⁹¹

FIGURE 9: DEVELOPMENT OF TAX RATES, 1995–2009

	1995	2002	2007	2009 (planned)
Corporate income tax	30% (10% for agriculture)	30%	30%	20%
Individual income tax	5–40% progressive marginal rates	20%	10%	10%
VAT	28%	15%	14% (1% reduction every year until 2009)	11%
Social Tax	Several inpayments for social needs; 1999 unified social tax: 26%	20% to 7% (regressive rates)	20% to 7% (regressive rates)	11%

Source: Svetlana Babkina, "Novaya nalogovaya politika," *Finansy Kazakhstana*, no. 6 (1995): 37–39; Kalyuzhnova, (1998): 110; Zhanar Lukpanova, "Analiz izmeneniy nalogovo zakonodatel'stva Respubliki Kazakhstan," *Karzhly Karazhat—Finansy Kasachstana* (K.K.—F.K.), no. 2 (2006): 15–17; *Kapital.kz*, *Nalog na pribyl' snizhaetsya, a NDS rastet*, (July 26, 2007), <http://www.zakon.kz/our/news/news.asp?id=30113781>; Semen Vernikov, "Kodeks pomothet biznesy," *Ekspress Kazakhstan*, November 9, 2008, 170, http://www.express-k.kz/show_article.php?art_id=20019.

Although these reforms give the impression of simple and transparent taxation, there are a whole range of exemptions and preferences granted to certain enterprises and businessmen.⁹² In his annual message to the nation in February 2008, President Nazarbayev mentioned more than 170 such preferences.⁹³ They generally apply to the corporate income tax, but also to the property and land taxes. Instead of stimulating economic development, they cause unequal conditions of competition and provide opportunities for rent-seeking and corruption. Local government representatives and scholars hold that without these tax preferences, private entrepreneurs would be too reluctant to invest in projects the government deems necessary. Meanwhile, however, the president and the government seem to have become aware of the counterproductive impacts of the preferences. In August 2008, the Kazakhstani government announced another revision of the tax code, effective in 2009. The intention is to abolish all exemptions and further reduce tax rates. Corporate income tax will be reduced to 20 percent and then to 15 percent in 2011; VAT, which according to the 2007 revised Tax Code should have been 12 percent in 2009, will be reduced an additional one percent to 11 percent; and a flat tax of 11 percent will replace the current regressive system for the social tax with regressive rates from 20 to 7 percent from the taxable income.⁹⁴ To compensate for revenue loss, taxes will increase for users of mineral resources. At the same time, the government views this as an additional incentive to encourage investment in non-extraction sectors.

3.4.3. Investment Laws

BESIDES IMPROVING THE tax code, the government of Kazakhstan has passed legislation to make the country an attractive place to invest. Additional monetary sources are not the only reasons to attract foreign investment; the government also wants to import know-how

89. Kalyuzhnova, *The Kazakhstani Economy*, 113.

90. See Daulet Khan Baymurzin, "Nekotorye rezul'taty raboty nalogovoy sistemy Kazakhstana," *Bukhgalter i nalogi* (2006), http://www.bin.kz/2004/6_04/6_02.asp; Zhanar Lukpanova, "Analiz izmeneniy nalogovo zakonodatel'stva Respubliki Kazakhstan," *Karzhly Karazhat—Finansy Kasachstana* no. 2 (2006): 15–17. The ten remaining taxes are: 1) corporate income tax, 2) VAT, 3) excise duties, 4) tax on rents from the export of crude oil and gas, 5) taxes and special payments for users of natural (mineral) resources, 6) property tax, 7) tax on means of transport, 8) social tax, 9) land tax, 10) individual income tax.

91. Depreciation has also been simplified. The nine groups of assets (and 75 subgroups) eligible for favorable depreciation rates have been reduced to four groups. The depreciation rates have been increased, ranging from 8 to 40 percent, depending on the group of fixed assets. Higher depreciation rates reduce profit—and thus corporate income tax—leaving more financial resources for self-financing.

92. Lochmann, "Hang zum Protektionismus," *Deutsche Allgemeine Zeitung*, June 15, 2007, 3.

93. "Kazakhstan to get more improved tax legislation in 2009," *Kazinform*, August 18, 2008, www.inform.kz/showarticle.php?lang=eng&id=16865.

94. See Inga Budianskaya, "Nalogi pokazakhski," *Rossiyskaya gazeta*, Federal'nyy vypusk no. 4730, August 15, 2008, <http://www.minplan.kz/mime/files/852/prezentatsya.ppt>.

95. Olcott, *Unfulfilled Promise*, 144. She argues that the eagerness to attract foreign investment can also be viewed as an attempt to compensate for the emigration of specialists in the early 1990s.

for modernizing its economy.⁹⁵ Prior to independence, the government adopted the Foreign Investment Law of 1991 that allowed investment by foreign companies in any economic activity except the manufacture of military goods. The law contained provisions for duty-free imports as well as tax breaks. A new Foreign Investment Law passed in 1994 (amended in 2007) provided stronger protections for contracts should there be changes in Kazakhstan's legislation,⁹⁶ greater clarity on investment requirements and the credit facilities available to foreign investors, and a guarantee of the right of recourse to international arbitration to settle disputes.

Special legislation applies to hydrocarbon sector investments. The principal laws are the Decree on Petroleum of June 1995 and the Subsoil Law of January 1996. These require that any party wishing to explore or exploit hydrocarbons possess a license and enter a production sharing agreement with the Kazakhstani Ministry of Energy.⁹⁷ Amendments passed in 1999 to the Subsoil Law introduced a local content clause, requiring mining and oil companies to use goods, services, and personnel from Kazakhstan—provided these local inputs meet minimum project standards.

The Law on State Support for Direct Investments of February 1997 was Kazakhstan's first attempt to encourage investment in the non-extractive sectors of the economy. It defined these "priority sectors" as infrastructure, light industry, agriculture, housing, construction in the new capital city, health care, education, cultural facilities, and tourism. The law offered investors relief from the corporate income tax of up to 100 percent for up to 10 years and from the land and property tax of up to 50 percent for up to five years. It also provided for customs waivers on imported inputs required for an investment project.⁹⁸ To receive the tax relief, investors had to apply to the State Committee on Investments. The committee has great

discretion in determining the respective weight given to the different factors that must be considered for a successful application.

In 1998, the OECD concluded that "Kazakhstan's authorities were committed to developing an investor-friendly environment and had made significant progress."⁹⁹ Nevertheless, taking into account the mentioned restrictions and barriers, the investment environment was far from perfect. However, in the early 2000s, the government began to part from its relatively favorable treatment of foreign investment. In January 2003, the government enacted a new investment law that replaced the 1994 and 1997 regulations. It established a single investment regime for both domestic and foreign investors and weakened the so-called "grandfather's clause." The new law guarantees the stability of contracts concluded with the State Investment Committee unless "national or ecological security interests" necessitate a change in legislation. It limits exemptions from customs fees to one year, with extensions limited to no more than five years.¹⁰⁰ A particularly contentious aspect of the new legislation was the removal of the right that *all* investment disputes could go to arbitration. Now this right only applies to disputes arising from disagreement with the Investment Committee. Still, investors can choose either national or international arbitration courts for resolution of such disputes. However, according to Robert M. Cutler, senior research fellow from the Institute of European, Russian, and Eurasian Studies at Carleton University, Canada, the conditions under which international arbitration would be allowed remain unclear.¹⁰¹ In November 2007, the Kazakhstani government again changed investment legislation in ways that could further threaten foreign investors' confidence. Amendments to the Law on the Subsurface and Subsurface Use allow the government to amend and even annul natural-resource contracts in the interest of national security.¹⁰²

96. It guarantees the validity of provisions of contracts that were made in accordance to the Foreign Investment Law for a period of ten years, even if the law is subsequently altered.

97. Yelena Kuz'mina, "Investicionny klimat v Kazakhstane i Uzbekistane," *Finansovyy director*, no. 4, <http://www.fd.ru/toprinter/news/24608.html>.

98. In practice, investments up to US\$11.3 million are freed from corporate income tax for five years and from the property and land taxes for three years. Investments amounting to more than US\$164 million receive the maximum preferences. Investments of newly founded enterprises are exempt from the corporate income tax for ten years. <http://www.fic.kz/content.asp?parent=6&lng=en&mid=31>.

99. Organisation for Economic Co-operation and Development, *Investment Guide for Kazakhstan* (Paris: OECD, 1998), 49.

100. Kuz'mina, "Investicionny klimat v Kazakhstane i Uzbekistane."

101. Robert M. Cutler, "Kazakhstan's New Foreign Investment Law," *CACI Analyst*, February 26, 2003, <http://www.cacianalyst.org/?q=node/368/print>.

102. Cutler, "Kazakhstan's Foreign Investment Law Changes Again," *CACI Analyst*, December 12, 2007, <http://www.cacianalyst.org/?q=node/4754/print>.



Advertisements like these with quotations from President Nazarbayev's speeches are a common sight. This one praises Almaty as the city of free entrepreneurship and small business as the strategic reserve of the country.

A single investment regime for domestic and foreign investors is a positive change, as it helps to provide equal conditions for all actors.¹⁰³ On the other hand, the vague formulation of the “grandfather’s clause” and the amendments giving greater discretion to government officials are problematic, as they don’t provide stable expectations.¹⁰⁴ In spite of these regulations, foreign investors in general still consider the investment climate in Kazakhstan positive. Neither the German Association of Entrepreneurs nor the German Embassy in Kazakhstan knows of cases of *severe* arbitrariness from government officials against foreign investors. In fact, international agencies and organizations consider Kazakhstan the CIS country with the most favorable environment for investment.

The volume of foreign direct investment (FDI) into Kazakhstan does underscore this view of Kazakhstan’s investment environment as relatively liberal. Between 1993 and 2005, FDI in Kazakhstan reached almost US\$40.5 billion. US\$6.5 billion was from 2005 alone, the equivalent of US\$433 per capita. From 2001–2005, net FDI inflows averaged around 10 percent of GDP, compared with only 1.5 to 2.5 percent in Russia. As of 2006,

8,185 companies operated in Kazakhstan with foreign capital, up from 6,579 in 2005 and only 1,865 in 1999.

Kazakhstan received 80 percent of all FDI in Central Asia—the most of any CIS nation—and is among the top 20 locations in the world in terms of FDI per capita.¹⁰⁵

3.4.4. Support for Small and Medium Enterprises

IN ADDITION TO providing a *generally* favorable investment climate, since 1997 the government has started various initiatives to support small and medium enterprises (SMEs), providing adequate consulting and support infrastructure as well as more credits from government development institutions. Since 2006, SMEs have been able to make a simplified tax declaration. In late November 2007, the government decided to simplify the procedure to register a small or medium enterprise. Natural citizens can be registered within one hour and legal entities within three working days, provided all necessary documents have been prepared.¹⁰⁶ A “one-stop-window” makes quicker registration possible. One can even make an appointment in advance online, and then the registration pro-

103. This could be viewed positively, as Friedrich Hayek suggested that rules in a market economy be “general,” i.e. they must apply to an unknown and indefinite number of persons and cases without exceptions. See Friedrich August von Hayek, *Recht, Gesetzgebung und Freiheit* [Law, Legislation, and Liberty], (Bd. 1: Regeln und Ordnung, 2. Aufl., München: Verlag Moderne Industrie, 1986), 73.

104. *Ibid.*, 270.

105. Aksana Panzabekova, “Inostrannye investicii i problemy obespecheniya ekonomicheskoy bezopasnosti Kazakhstan,” *Banki Kazakhstana*, no. 6 (2006): 33. Almost three-quarters of the foreign investment in 2006 went into mining and prospecting activities, followed by trading, construction and financial activities (Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007*, 316).

106. Erden Shodyrov and Kausariya Istangali, “Tyanut—potyanut...,” *National Business* 49, no. 11 (November–December 2007): 6.

cedure can be completed within 20 minutes. However, Raimbek Batalov, the president of a business association, and Vladimir Ermakov report that in reality, this seems to be more the exception than the rule. Entrepreneurs still complain about long queues, an opaque and unpredictable system of getting allowances and licenses, and unprofessional officials. According to Ermakov, registration of a SME hardly ever happens within three days—it can take up to ten days just to get a tax registration number. According to one entrepreneur, the whole procedure costs US\$39 for individual enterprises, but for small and medium enterprises created as limited liability companies, the costs can reach US\$200–400.¹⁰⁷

Though the government is focused on supporting SMEs financially, surveys and interviews with entrepreneurs indicate the major impediment to SME development is not a lack of financing, but rather bureaucracy and poorly functioning formal institutions. Kaipova reports that SMEs often complain about a confusing accounting system and frequent changes in tax legislation. There are recurring clashes with tax authorities, and since small entrepreneurs lack knowledge and experience, they may hesitate to challenge decisions by the tax authorities in court. To avoid this hassle, SME businessmen try to make informal arrangements with tax officers for certain conditions of taxation.¹⁰⁸

As a result of these obstacles, the share of GDP produced and population employed by SMEs in Kazakhstan is low compared to more developed countries. In 2007, SMEs accounted for only 14.3 percent of GDP (down from 18.7 percent in 2005),¹⁰⁹ compared to 43 percent in Canada, 52 percent in the United States, and 57 percent in Germany. Almost half of all registered SMEs operate in trade, followed by agriculture (26 percent), transport and real estate (7 percent each), and construction (4 percent).¹¹⁰

3.4.5. Bureaucratic Barriers, Law Enforcement, and Corruption

THE EXPERIENCE OF small-scale entrepreneurs suggests that bureaucratic and informal barriers—notably corruption—seem to impede them from functioning as well as they could.¹¹¹ In 2005, Kazakhstan ranked 107th of 158 countries in the Corruption Perception Index of Transparency International, although the 2005 Business Environment and Enterprise Performance Survey, commissioned by the EBRD, shows some improvement since 2002.¹¹²

Interviewed businessmen hold that there are still too many administrative guidelines and allowances that contradict the laws or leave it unclear how to interpret them. This gives government officials discretionary power to accuse businessmen of violating regulations and forces enterprises to have a “black coinbox” for unexpected and unofficial payments. Such fines usually come from tax, custom, or sanitary authorities, or the fire brigade. Many businessmen decide the easiest way to settle these difficulties is to bribe officials. However, Ivan Mikhaylovich Kravchenko, the general director of the German-Kazakhstani joint venture “Bekker & Co.,” an established meat and bread company in Almaty, does not share this attitude. He thinks that if a government official demands a bribe, one should stay firm and not negotiate. The controllers have to prove that regulations have been violated. Only if they can prove this should one pay. According to his own experience, this is the most effective way to deal with such annoyances. Kravchenko believes too many businessmen pay too quickly, without countering accusations or suing an official for attempted bribery. In fact, a survey by the Forum of the Entrepreneurs of Kazakhstan revealed that 82 percent of the respondents believed they have no other choice but to pay. As both Kravchenko and Ermakov explain, this is mainly because very few businessmen are familiar with the rights and duties the laws prescribe. The costs of such a lawsuit are an additional deterrence. Kravchenko maintains that it is possible to go to court and reject false accusations.¹¹³

107. See Raimbek Batalov, interview by Alina Utesheva, “Paimbek Batalov: Progress biznessa neizbezhen,” *Byterek* 22, no. 1 (February 2007): 36 or Vladimir Ermakov, “Dorozhe vsego stoyat darmovye den'gi,” *Bayterek* 27, no. 6 (December 2007): 31.

108. Gul'nara S. Kaipova, “Nalogooblozhenie v malom biznese,” *Karzhy Karazhat—Finansy Kasachstana*, no. 3-4 (2006): 55.

109. The state-owned JSC Small Entrepreneurship Development Fund ‘Damu’ reports a share of GDP produced by SMEs in 2007 of 16 percent but confirms the 2005 figure of 18.7 percent. *Analyticheskoe issledovanie makroekonomicheskikh pokazateley sub'ektiv malogo biznesa v Respublike Kazakhstan*, (Almaty, 2008, 3, [http://www.fund-damu.kz/UserFiles/File/Doc2\(1\).pdf](http://www.fund-damu.kz/UserFiles/File/Doc2(1).pdf)).

110. Gabit Lesbekov and Ermeke Abdibekov, “Analyticheskiy obzor malogo biznesa v Respublike Kazakhstan,” *Finansy i kredity*, no. 3 (2008), 10.

111. See Raimbek Batalov, interview by Alina Utesheva, “Paimbek Batalov: Progress biznessa neizbezhen,” *Byterek* 22, no. 1 (February 2007): 36 or Vladimir Ermakov, “Dorozhe vsego stoyat darmovye den'gi,” *Bayterek* 27, no. 6 (December 2007): 31.

112. www.info.worldbank.org/governance/beeps.

113. Ivan Kravchenko, interview by Alina Utesheva, “Nasha konceptciya—sovershenstvovat' kachestvo,” *Bayterek* 20, no. 5 (2006): 27–35.

A young lawyer working in an international law company confirms this, unless the business involves higher political spheres.¹¹⁴

There are certainly understandable reasons for the prevalence of bureaucratic and informal barriers: a lack of understanding of modern commercial concepts, little experience at enforcing laws in a market economy, and even poor salaries for officials, especially in the years immediately following independence. Furthermore, the country's whole court system had to be built up from nothing. Regulations for Kazakhstan's administrative courts are still being determined.¹¹⁵ Another, perhaps more important, reason for the obstacles and corruption might be what Nobel Laureate Douglass North called "path dependence"¹¹⁶ or O.E. Williamson called "embedded institutions." Both concepts describe how the prevailing mental models of economic and political decision makers, shaped by historical informal rules, customs, norms, traditions, and religion, may hamper the acceptance and enforcement of new formal rules.

There does not seem to be a consensus on what the specific Kazakhstani embedded institutions are—clan and family ties or Soviet mentality and Soviet-era ties.¹¹⁷ Irrespective of the origin, there is agreement that personal relations do play an important role in Kazakhstan's society. People still rely more on personal relations than formal rule of law to solve problems. Again, history can provide an explanation. The leaders of the Russian Empire and the Soviet Union, both of which Kazakhstan has been a part, traditionally viewed the law as an instru-

ment that did not apply to themselves and could arbitrarily be used to ensure power and access to economic resources. As Stefan Hedlund, professor of East European Studies at Uppsala University in Sweden and a long-standing specialist on the Former Soviet Union, explains, government officials have been remunerated by a system called "kormlenie" as far back as Moscovite times.¹¹⁸ Literally, kormlenie means "feeding" and implies that officials have the right to "feed themselves from official business," i.e. extract additional income from the people under their authority whenever the tsar is short of funds. Besides, since the tsar—to keep his power secure—often appointed lower-level officials only for a short time, the system offered strong incentives for personal enrichment.¹¹⁹ Kazakhstan's political system today still shows such traits. Dmitry Sivakov and Andrey Vinkov, economists at the business journal *Ekspert*, confirm that the president tries to secure his own power through frequent changes of staff.¹²⁰ Such a system of rule *by* law rather than rule *of* law reduces "the subjects to bribery and pleading for mercy rather than demanding rights."¹²¹

The president of Kazakhstan has repeatedly announced the government's commitment to stringent anti-corruption measures. In 2007, approximately 2,400 policemen were fired for service violations, disciplinary action was taken against 1,500, and 49 high-ranking officers were demoted. Another 3,600 left office of "their own will."¹²² In 2008, the number of judges was increased to 2,481, one judge for every 6,300 inhabitants, and their monthly salaries raised.¹²³ While these measures point in the right direction, they do not guarantee success as long as traces

114. See also Dmitry Sivakov and Andrey Vinkov, "Kazakhstan: Giant of Natural Resources and Services," *Expert Online 2.0* 14, Special issue no. 9 (December 25, 2006), <http://eng.expert.ru/printissues/countries/2006/09/kazakhstan>.

115. Jens Deppe, "Zur Entwicklung eigenständiger Gerichte in Zentralasien," *Zentralasien-Analysen*, no. 7 (March 17, 2008): 2–6.

116. Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990); North, "Economic Performance Through Time," *American Economic Review* 3, no. 84: (1994) 359–368; Oliver E. Williamson, "The New Institutional Economics: Taking Stock, Looking Ahead," *Journal of Economic Literature* 38 (September 2000): 595–613.

117. For more detail on this question see Schmitz, "Elitenwandel und politische Dynamik in Kasachstan," 8; Murphy, "Illusory Transition? Elite Reconstitution in Kazakhstan, 1989–2002," 525; Beate Eschment, "Elitenrekrutierung in Kasachstan. Nationalität, Klan, Religion, Generation," *Osteuropa* 57, no 8-9 (2007): 175–193; Uwe Halbach, "Das Erbe der Sowjetunion. Kontinuitäten und Brüche in Zentralasien," *Osteuropa* 57, no. 8-9 (2007): 77–88. Kathleen Collins, "The Logic of Clan Politics: Evidence from the Central Asian Trajectories," *World Politics* 56, no. 2 (January 2004): 224, 261; and Collins, *The Logic of Clan Politics in Central Asia: Its Impact on Regime Transition* (Cambridge: Cambridge University Press, 2006).

118. Stefan Hedlund, *Russian Path Dependence: A People with a Troubled History* (London, New York: Routledge, 2005), see in particular 133 and 151.

119. *Ibid.*, 69. "Subjects do not have rights; they have privileges, which endure for only as long as the prince wishes."

120. Sivakov and Vinkov, "Kazakhstan: Giant of Natural Resources and Services."

121. Hedlund, *Russian Path Dependence*, 152.

122. Lochmann, "Beginn einer neuen Ära in der Korruptionsbekämpfung?" *Deutsche Allgemeine Zeitung*, March 28, 2008, 3.

123. Deppe, "Zur Entwicklung eigenständiger Gerichte in Zentralasien," 6.

of the old mentality remain deeply rooted in government officials and the rest of the population. This can be a lengthy process; the well-functioning legal systems in the western world are also a relatively recent invention.

3.5. Active Industrial Policy for Diversification

THE PREVIOUS SECTION shows that the Kazakhstani government realizes that entrepreneurs are critical to economic development in a market economy. However, the 1997 Investment Law and 2008 Program for SMEs indicate the government does not completely accept the notion that entrepreneurs are best at finding profitable business opportunities.¹²⁴ Rather, the government determines which sectors need to be developed and then provides various investment incentives. Some Southeast Asian tiger countries like Singapore, South Korea, and Malaysia have followed this strategy of government planning, and Kazakhstani leadership views this approach as the reason for their success. President Nazarbayev has held Malaysia up as a model for Kazakhstan to follow, pointing to the two nations' following similarities: multiethnicity, the marginalization of the nation's titular language in everyday life, a political system with a powerful head of state,¹²⁵ and an economy with an initially heavy reliance on raw materials.

3.5.1. The Growth of Government Programs

FOLLOWING BOTH THE Soviet planning tradition and the Southeast Asian example, the Kazakhstani government has authorized a multitude of development strategies and programs. The first and so far longest-ranging strategy is the vision of "Kazakhstan 2030," presented by President Nazarbayev in 1997. In his speech, Nazarbayev not only reaffirmed the government's commitment to an "open-market economy with a high level of foreign

investment and domestic savings," but also stated that "one cannot rely on the market only. The government must set about launching an active industrial policy of diversification, thus transferring the emphasis from the macro to the microeconomic level." This was the starting point of a large growth in development programs, all of which aim more or less to implement "Kazakhstan 2030."¹²⁶ However, it was not until 2003 that the government intensified its industrial policy activities. In 2003, the "Innovative Industrial Development Strategy of the Republic of Kazakhstan for 2003–2015," one of the most important of these development programs, was passed. It outlines quantitative goals and a timetable for reaching them, priorities for industrial and innovation policy, and potential tools for achieving a diversified and competitive economy. On May 8, 2003, the government announced a list of priority areas for development, for which it grants investment preferences. The list includes sectors linked to oil extraction (machines and equipment, chemical products, transport and construction), high-value-added sectors (space, nuclear, and information technology), and the agro-food sector. One year later, the government issued a plan for acting on these priorities by pursuing a policy of "clusterization," i.e., encouraging a kind of industrial organization in which geographically proximate firms and associate institutions are linked. In the spring of 2006, Nazarbayev announced "The Strategy for Kazakhstan to Become One of the Top 50 Most Competitive Countries in the World" and instructed the government to work out a "Program of 30 Corporate Leaders." The goal is to create 30 "national champions" that will play a leading role in increasing the country's competitiveness.¹²⁷

3.5.2. Government-Led Clustering

PROponents of clusterization argue that clusters promote innovative behavior and productivity, thus raising the competitiveness of individual firms, whole sectors,

124. Economist Israel Kirzner called this the *alertness* of entrepreneurs. Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973); Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature* 25 (March 1997): 60–85.

125. Nazarbayev refers especially to Malaysia's fourth and so far longest-serving prime minister Mahathir Mohammad, who led the country for 22 years from 1981 to 2003. Malaysia is a constitutional monarchy with regular parliamentary elections held at intervals no longer than five years. However, experts on Southeast Asia criticize its electoral system for irregularities and the ruling party for intimidating the political opposition. The Malaysian political system is therefore sometimes labelled as "semiauthoritarian rule in a participatory political system," "semi-democratic," or "quasi democratic," mixing coercive elements with electoral and democratic procedures (On this and for more detail on Malaysia's political system, see Rainer Heufers, "The Politics of Democracy in Malaysia," *Asien: The German journal on contemporary Asia* 85 (October): 39–69, <http://www.asienkunde.de/articles/Malaysia2.pdf>).

126. Lochmann, "Die kasachische Strategie-Inflation ist kontraproduktiv," *Deutsche Allgemeine Zeitung*, March 14, 2008, 3.

127. Government of the Republic of Kazakhstan, *Programma "30 Koporativnykh liderov Kazakhstana,"* <http://ru.government.kz/site/Reviews/rev2/15>.

and the overall economy. Kazakhstan's government was convinced by these arguments and has become the first CIS country trying to apply the cluster approach.¹²⁸

Due to financial and management limitations, the Kazakhstani government activated a limited number of clusters, determined based on their ability to “meaningfully affect economic development.” A board of experts—representatives from government bodies, business associations, universities and research institutes—selected the following sectors for clusterization: tourism, textiles, oil-and-gas machine building, metallurgy, food processing, transport logistics, and construction materials. These branches were chosen based on supposedly objective scientific analysis, with the help of international consultants from J.E. Austin Associates Inc.

However, this clustering approach remains controversial. Opponents argue that it is impossible to objectively determine future competitiveness in advance because (1) the knowledge required to make these decisions, such as choosing a favored industry, is dispersed among many people in a society and cannot be possessed by just a few policymakers making top-down decisions and (2) the cognitive abilities of every human being—both economic agents acting in the markets *and* economists observing the markets—to capture and process all that relevant information are limited.¹²⁹ Or as economist Israel Kirzner puts it, “No systematic process seems at work through which regulators might come to discover what they have not known.”¹³⁰ So, clusterization really amounts to nothing more than picking desired industries or firm structures.¹³¹

There is reason to believe that the selection process was not solely the result of objective analysis. From the outset, the government has regarded some sectors as more important than others in order to enhance not only the country's international competitiveness but also its “economic independence,” i.e. a relatively low reliance on imports. The Kazakhstani government is not limiting its role to providing overall favorable economic conditions. It explicitly provides targeted subsidies and protection to propel chosen sectors into a certain direction.¹³²

Clusterization policy in other parts of the world, among them Malaysia (Kazakhstan's example for economic development),¹³³ has yet to achieve the results its promoters seek. There is no reason to expect a different outcome in Kazakhstan. So far, the country's clustering process has not left its initial stage, and the participating enterprises have only been formally united into branch clusters.

128. Aleksey Prazdnichnykh, “Vpervye na territorii SNG startuet proekt, stavyashchiy cel'yu povyshenie konkurentosposobnosti v masshtabakh strany,” *Cluster Prelease* (2004), http://www.compet.ru/PRelease_Kazakhstan.pdf.

129. Hayek, “The Use of Knowledge in Society,” reprinted in Hayek, *Individualism and Economic Order* (Chicago, London: University of Chicago Press, 1996), 77–91.

130. Kirzner, “Taxes and Discovery: An Entrepreneurial Perspective,” reprinted in Kirzner, *Discovery and the Capitalist Process* (Chicago: University of Chicago Press, 1985), 93–119.

131. Wolfgang Kerber, ed., *Die Anmaßung von Wissen. Neue Freiburger Studien* (Tübingen: Verlag Mohr Siebeck, 1996), 16–36.

132. As an analysis of clusterization in the agro-food sector indicates this direction seems to be (1) to create some sort of vertical cooperation and integration, (2) to overcome a scattered firm structure, and (3) to boost the introduction of modern production technology. See Wandel, “The Cluster-Based Development Strategy in Kazakhstan: A Case Study of the Agro-Food Sector from an ‘Austrian’ Perspective,” paper presented at the International Conference *Institution Building and Economic Development in Central Asia* at the International School of Economics and Social Science at the Kazakh-British University, June 5–6, 2008, Almaty.

133. The Malaysian government adopted clustering as a formal strategy in 1996 as part of the Second Industrial Master Plan (IMP2) for the period 1996–2005. See Renuka Mahadevan, *Sustainable Growth and Economic Development: A Case Study of Malaysia* (Cheltenham, UK, Northampton, MA, USA: Edward Elgar, 2007), 8. For more detail on clustering in Malaysia, see Rajah Rasiah, “Fostering Clusters in the Malaysian Electronics Industry,” (draft paper, Asian Development Bank Institute, 2005), http://www.adbi.org/files/2005.11.28.cpp.fostering_clusters.linkages.pdf; Akifumi Kuchiki, “A Flowchart Approach to Malaysia's Automobile Industry Cluster Policy,” (IDE Discussion Paper no. 120, Institute of Developing Economies (IDE), Chiba, Japan, 2007), <http://www.ide.go.jp/English/Publish/Download/Dp/pdf/120.pdf>. Kuchiki holds that Malaysia's clustering policy has not been very successful, either.

"30 CORPORATE LEADERS" AND STATE HOLDINGS

Besides clustering, the Kazakhstani government applies two other instruments in its active industrial policy: generating "corporate leaders" in several branches of the economy and creating state holding companies.

The generation of 30 "corporate leaders" is the explicit goal of a state program that designates 30 specific corporations to receive financial support to carry out particular government investment projects.¹ To target investment into the infrastructure and the priority sectors, four national holding companies have been founded: Samruk (JSC Kazakhstan Holding for Management of State Assets), Kazyna (JSC National Fund for Sustainable Development), Samgau (JSC National Scientific and Technological Holding), and KazAgro (JSC National Holding). These four unite a number of state shareholdings in companies and state development agencies.

Samruk is the biggest of them, combining state-owned stakes in 19 different enterprises.² Kazyna is the state-owned managing company and single shareholder of eight national development institutions.³ KazAgro is responsible for the development of the agro-food sector, a sector the government considers particularly essential for national security. Officials want to attain relative self-sufficiency in foodstuffs; moreover, they believe the sector has great potential to become competitive in the world market. The fourth holding, Samgau, aims to boost the research and development and high-tech sectors. It unites 13 institutions operating in the areas of information and communications, science and technology, broadcasting, postal, and financial services. The government explicitly promotes technology because it considers an innovation-driven economy the ultimate goal of economic development.⁴

In addition to steering investments into infrastructure and the priority sectors, all state holdings have the general mandate to increase the efficiency of corporate governance and improve the coordination between state-owned enterprises and agencies. The national holdings are intended to operate as "active shareholders" in their subsidiaries. This means they participate in strategic decision making, but will not interfere with everyday operations.⁵ They receive part of their funds from the state budget and the rest from their own and other resources. There is emphasis on professional management and commercial orientation of the state holdings.⁶ This does not rule out the privatization or outsourcing of state-owned assets. For example, Kazyna intends to privatize all of its development agencies by 2012.⁷ There are also reports that Samruk plans to sell some of its assets and is optimistic about preparing successful IPOs. However, so far, the government's attitude toward privatization is not discernable. It is not clear whether leaders really want to foster private entrepreneurial activity in the areas that are currently controlled by the state holdings or whether they only want to streamline the state holdings so they are more easily manageable but still under state control.⁸

Critics fear the state holdings might end up duplicating the tasks of government ministries. There may also be problems if the overall development task conflicts with sector-specific development tasks. Moreover, it remains to be seen whether the separation of political and commercial interest can be achieved and sustained since state holdings implement state economic policy, but also turn profits. A recent report indicates that the national holdings

have not been very successful in achieving their goals so far.⁹ For example, Samruk supposedly is having difficulties finding purchasers for its non-profile stakes, and Kazyna is not succeeding at steering investment via second-level banks into the economy.

1. Government of the Republic of Kazakhstan, *Programma "30 Koperativnykh liderov Kazakhstana."*
2. http://www.samruk.gov.kz/page.php?page_id=17&lang=1.
3. The eight institutions are JSC Development Bank of Kazakhstan, JSC Investment Fund of Kazakhstan, JSC National Innovation Fund, JSC 'Damu' Entrepreneurship Development Fund, JSC Corporation for Export Development & Promotion, JSC National Corporation for Insurance of Export Credits & Investments, JSC Kazyna Capital Management, and LLP Kazakhstan Center for Promotion of Investments. This holding was established explicitly to implement the "Innovative Industrial Development Strategy of the Republic of Kazakhstan for 2003–2015."
4. The innovation-driven economy is regarded as the ultimate goal of economic development because only invention and innovation ensure a constant upgrading of the industrial base, that is, a more efficient use of factories and investment, along with creating unique high-value added products and services. See Michael E. Porter, "Kazakhstan's Competitiveness: Roadmap Towards a Diversified Economy," presentation on January 26, 2008 in Astana, Kazakhstan, [http://wbln0018.worldbank.org/.../\\$FILE/Professor%20Porter's%20Presentation.pdf](http://wbln0018.worldbank.org/.../$FILE/Professor%20Porter's%20Presentation.pdf).
5. Aleksandr Konstantinov, "Mificheskaya ptica 'Samruk,'" *Ekspert Kazakhstan* 61, no.5 (February 6, 2006), http://www.expert.ru/printissues/kazakhstan/2006/05/kaz_gos_holding/.
6. Kanysh Izbastin, "Gosudarstvennoe predprinimatel'stvo v krupnykh strukturakh Kazakhstana," *Karzhy-Karzhar—Finansy Kazakhstana*, no. 1 (2008): 48.
7. "Samruk i Kazyna proinformovali o svoikh planakh na blizhshie gody," *Panorama*, September 12, 2008, <http://www.nomad.su/?a=4-200809150732>.
8. Kazyna is the single shareholder of the JSC Development Bank of Kazakhstan, JSC Investment Fund of Kazakhstan, JSC National Innovation Fund, JSC 'Damu' Entrepreneurship Development Fund, JSC Corporation for Export Development & Promotion, JSC National Corporation for Insurance of Export Credits & Investments, JSC Kazyna Capital Management, and LLP Kazakhstan Center for Promotion of Investments. Samruk holds stakes in the state oil and gas giant KazMunayGaz, the national railway company Temir Zholy, KazakhPost, KazakhTelekom, Air Astana, KazMorTransFlot for shipping oil on the Caspian, KazKuat, producer of energy facilities and the national energy provider KEGOC. http://www.samruk.gov.kz/page.php?page_id=17&lang=1.
9. "'Samruku' prishli vtoruyu golovu," *Ekspert Kazakhstan* 188, no. 41 (October 20, 2008), http://www.expert.ru/printissues/kazakhstan/2008/41/news_superholding_samrukkazyna/.

How Should the Government Take Care of Economic Development? Directions for Policy Improvements

TAKING INTO ACCOUNT the initial conditions inherited from 70 years of Soviet-style socialism, Kazakhstan has undoubtedly made tremendous efforts to transform its formerly centrally planned economy into a market economy. Kazakhstan has been recognized as a market economy by the European Union since October 2000 and by the United States since 2002. The Heritage Foundation and *Wall Street Journal's* Index of Economic Freedom also reflects this achievement (see figure 10).

In 2008, Kazakhstan was ranked the 76th freest economy, while ten years before it placed 136th. It ranks second in Central Asia next to Kyrgyzstan, but much higher than Russia, which even fell back from 105th in 1998 to 134th. Kazakhstan scores especially high in trade freedom, government size, labor freedom, and fiscal and financial freedom. Fiscal freedom is a measure for the tax burden and financial freedom is a measure of the banking security as well as its independence from government control. Both indicators confirm Kazakhstan's achievement in reducing the tax burden, making the tax system more transparent, and having one of the most transparent developed banking system in the CIS.

FIGURE 10: INDEX OF ECONOMIC FREEDOM IN CENTRAL ASIA AND RUSSIA

	Kazakhstan		Kyrgyzstan		Tajikistan		Turkmenistan		Uzbekistan		Russia	
	1998	2008	1998	2008	1998	2008	1998	2008	1998	2008	1998	2008
Ranking	136	76	110	70	137	114	147	152	150	130	105	134
Score	41.7	60.5	51.8	61.1	41.1	54.5	35.0	43.4	31.5	52.3	52.8	49.98
Business Freedom	55	56.5	55	60.4	55	43.4	55	30.0	40	67.8	55	52.8
Trade Freedom	61.0	86.2	65.0	81.4	68.4	77.8	40.0	79.2	50.0	68.4	58.6	44.2
Fiscal Freedom	73.3	80.1	72.3	93.9	57.5	89.3	56.2	90.6	57.4	88.0	74.2	79.2
Government Size	85.7	84.7	72.6	76.1	89.3	84.1	84.1	85.3	56.5	68.3	67.3	69.5
Monetary Freedom	0.0	71.9	41.1	75.6	0.0	65.8	0.0	66.4	0.0	57.5	24.3	64.4
Investment Freedom	30	30	50	50	30	30	30	10	30	30	50	30
Financial Freedom	30	60	50	50	30	40	10	10	10	20	70	40
Property Rights	30	30	30	30	30	30	30	10	30	30	50	30
Freedom from Corruption	10	26	30	22	10	22	10	21	10	21	26	25
Labor Freedom	n.a.	80.0	n.a.	72.0	n.a.	62.1	n.a.	72.1	n.a.	72.1	n.a.	64.2

Note: The scale is from 0 to 100. A score of 100 signifies an economic environment or set of policies that is most conducive to economic freedom.
Source: <http://www.heritage.org/research/features/index/downloads/2008PastScores.xls>.

Nevertheless, the tendency of growing state involvement in the economy and the persistence of informal barriers to entrepreneurship hamper Kazakhstan's economic potential. This is reflected in the relatively low and stagnating scores in the Heritage Foundation and *Wall Street Journal's* indicators for investment freedom and property rights.¹³⁴

The following addresses the normative challenges of these issues in a general way and derives recommendations.

4.1. The Problem of Knowledge

FRIEDRICH HAYEK STRONGLY emphasized that the knowledge of human beings is limited when dealing with complex phenomena such as a modern market economy. This is true not only for the economic agents acting in the markets but also for the economist and politician observing an economy. The reason for this is the limited cognitive ability of every human being to capture and process all relevant information on which he bases his economic decisions. Since this limitation is incurable, Hayek speaks of insuperable or "constitutional" limits to knowledge. The knowledge of relevant circumstances is dispersed among the many people in society. One economic agent possesses knowledge of one certain circumstance; another agent has knowledge of other facts. This knowledge is often not consciously known even to those who possess it (tacit knowledge) and it is never given to anyone in its totality. As a result, no one can predict specific outcomes of the economic process.¹³⁵

The crucial question, then, is how society can harness this dispersed knowledge to ensure a high level of economic development and prosperity. To do this, some mechanism must activate and communicate information about

which goods and services best satisfy people's needs. According to Hayek, in market economies, changes in relative prices, generated and transmitted by competition, codify this information. For example, if a natural disaster curtails the availability of a specific raw material, the reality of a reduced supply will be effectively communicated to potential users by higher prices—this also provides the incentive for the socially desirable economizing of that raw material.¹³⁶

The conclusion of these theoretical considerations is that it is impossible for anyone to claim to know which economic sectors a society needs or that a particular industrial or business organization (clusters, large business groups, state holding companies) is always and forever superior to others and the key element for economic development. Spontaneous emerging clusters or conglomerates should not be discouraged, for they are the result of the entrepreneurial discovery process, but there is no reason to foster them deliberately. Alert entrepreneurs constantly try to discover profit opportunities. If a certain sector does not appear and if in a certain branch or region there are no signs of clusters, this only shows that neither this certain sector nor this certain kind of industry structure provides anyone with any profit opportunities (at least not at the moment). As Israel Kirzner stresses, the government lacks both the necessary knowledge and the right incentive to discover competitive business structures.¹³⁷ Government bodies generally operate without the profit motive and when they attempt to, as is the case in Kazakhstan's state-owned enterprises and development institutions, they often do not face the same constraints as private firms, such as the menace of bankruptcy. The most competitive branches and most effective form of doing business is thus "as much one of the unknowns to be discovered by the market process as the prices, quantities or qualities of

134. For more detail on the indicators and the methodology, see William W. Beach and Tim Kane, *Methodology: Measuring the 10 Economic Freedoms*, http://www.heritage.org/index/pdf/2008/index2008_chap4.pdf. It should be noted, however, that economic freedom indices have their shortcomings. They are usually based on a combination of quantitative statistical data and surveys of experts. The question with the statistical data sources is how reliable they are, in particular in countries with totalitarian political systems like Turkmenistan; the problem with polls of experts is the subjectivity of the experts' opinions. Not less subjective is the selection of the indicators or factors that are considered to be vital to describe economic freedom. Moreover, without detailed knowledge of the respective country's economic and political reality the interpretation of the pure numbers of the freedom indices becomes extremely difficult and can lead to erroneous conclusions. For more information on the economic freedom indices for Central Asia and a critique of the indices, see Heiko Pleines, "Die zentralasiatischen Staaten in wirtschaftsbezogenen Länderratings. Wirtschaftssystem, Geschäftsumfeld und Kreditwürdigkeit im internationalen Vergleich," *Zentralasien-Analysen*, no. 3, (March 28, 2008): 9. Other critical assessments of the economic freedom indices can be found in Stefan Karlsson, "The Failings of the Economic Freedom Index," *Mises Daily* (January 21, 2005), <http://www.mises.org/story/1724> or Stefan Voigt, *Institutionenökonomik* (München: Wilhelm Fink Verlag): 144–169.

135. Hayek, "Use of Knowledge in Society," 77.

136. *Ibid.*, 85.

137. Kirzner, *Discovery and the Capitalist Process*, 140.

goods to be produced and sold.”¹³⁸ By directing firms into a “desired” direction, the government may in fact bar the discovery of yet unknown opportunities for profit.

Neither the threat of a resource curse (i.e. the idea that having natural resources can become detrimental rather than helpful for economic performance) nor the historically exceptional situation of transition from a centrally planned to a market economy can justify targeting certain sectors and business structures. The resource-curse threat is often based in Kazakhstan¹³⁹ on the Dutch-disease argument.¹⁴⁰ It assumes that an increase in exports of natural resources will lead to a decline in output of other tradable goods, primarily because exchange-rate appreciation will make them less internationally competitive. However, scholars familiar with Kazakhstan point out that to date, there is little evidence of a resource curse operating through the Dutch disease mechanism.¹⁴¹ The tenge did not appreciate considerably in real terms since 1999 nor was Kazakhstan exposed to a strong price volatility of natural resource—another possible transmission mechanism from resource abundance to economic growth—because so far it only experienced a boom period. Most studies of the Dutch disease phenomenon have focused on established market economies with competitive exporting manufacturing sectors that were wholly or partly displaced by a newly emerging oil sector. In contrast, Kazakhstan did not possess a large competitive manufacturing sector. So there was little established activity to be displaced by resource expansion. Political decision makers nevertheless fear that *potential* manufacturing and service sectors might be prevented from emerging because the booming oil sector provides enough foreign exchange to pay for imports and to balance trade without much need for the manufacturing or service sectors. However, as shown in the previous sections, there is no convincing evidence for this in Kazakhstan, either. Although the overwhelm-

ing importance of natural resources for GDP growth is undeniable, non-resource sectors *did* appear, in particular financial services and construction and to a smaller degree the food industry. If political decision makers’ choices do not lead to development or expansion, it is due to their poor understanding of the market process, not a resource curse.

The development of Kazakhstan’s relatively advanced banking sector despite the recent difficulties makes another argument in favor of industrial targeting—that transitioning countries lack developed capital markets that provide venture capital for prospective, growth-enhancing sectors—less convincing. As Miller and Côté point out, while most government-supported venture capitalists can indeed provide needed funds, they usually cannot provide business acumen. In fact, “government efforts to supply risk capital in substitute forms—like generous grants or government-supported venture capital pools—have actually retarded the emergence of local professional venture capitalists. No school exists to train successful investors.”¹⁴² Thus, the initial plans for Kazyna, one of the four national holding companies, to privatize some of its subsidiary development institutions would have been a step in the right direction, since it could have offered the chance that they might turn into private venture capitalists once they have passed the market test themselves. The recent merger of Kazyna with Samruk into a government-controlled, highly centralized body is likely to only aggravate problems associated with trying to pick winning industries.

Empirical studies confirm that economic development strategies based on clusters or classical active industrial policy fail. Rather than state holdings or other sophisticated government enterprises, it is the openness of markets and favorable institutional conditions for entrepreneurship that allow for successful economic devel-

138. Hayek, *Law, Legislation and Liberty, Vol. 3: The Political Order of a Free People* (Chicago: University of Chicago Press, 1990), 70.

139. See e.g. Aleksey Ikonnikov, “Slishkom khorosho?” *Kontinent* 151, no. 15 (August 2005), <http://www.continent.kz/2005/15/4.htm>.

140. The term “Dutch Disease” originated in the Netherlands during the 1960s, when the high revenue generated by its natural gas discovery led to a sharp decline in the competitiveness of its other tradable sector. The theory is that an increase in revenues from natural resources will deindustrialize a nation’s economy by raising the exchange rate, which makes other sectors of the economy, and in particular, the non-booming tradable sector, less competitive.

141. See Yelena Kalyuzhnova, James Pemberton, and Bulat Mukhamediyev, “Natural resources and economic growth in Kazakhstan,” in Gur Ofer and Richard Pomfret, eds., *The Economic Prospects of the CIS—Sources of Long Term Growth Since 1991* (Cheltenham, UK: Edward Elgar Publishing, 1994), 249–267. Balázs Égert and Carol Leonard, “Nominal and Real Exchange Rates in Kazakhstan: Any Sign of the Dutch Disease?” in Boris Najman, Richard Pomfret, and Gael Raballand, *The Economics and Politics of Oil in the Caspian Basin: The redistribution of oil revenues in Azerbaijan and Central Asia* (Routledge, London: 2009).

142. Roger Miller and Marcel Côté, “Growing the Next Silicon Valley,” *Harvard Business Review* 63, no. 4 (July/August 1985): 116. Good first-stage venture capitalists (1) identify and sort out high-potential entrepreneurs, (2) assist the entrepreneurial team in preparing a business plan and often raise the initial capital, and (3) give strategic advice on developing business.

opment, as in Ireland, Taiwan, and Singapore.¹⁴³ The case of Malaysia demonstrates that, while subsidization of selected industries can achieve economic growth, it can also retard technological development. Malaysia is “mired in mediocrity: neither price competitive with China nor technologically competitive with Singapore, the East Asian NICs, or the OECD countries.”¹⁴⁴ This evidence points to the conclusion that institutions that distort the incentives for entrepreneurial discovery are more to blame for the “resource curse” than the Dutch disease mechanism.¹⁴⁵

Competitive non-oil sectors and the most appropriate forms of industrial organization in Kazakhstan can only be realized through entrepreneurial trial and error—a discovery procedure—in the market process. Policy makers should avoid hampering or distorting its course. Hayek pointed out that

“if even in highly developed economies competition is important primarily as a discovery procedure whereby entrepreneurs constantly search for unexploited opportunities that can also be taken advantage of by others, then this is true of course to an even greater extent as far as underdeveloped societies are concerned. . . . where competition was previously limited. . . . it seems incredible to me to hold that we can determine in advance the future structure of a society in which the major problem is still to find out what kinds of material and human productive forces are present, or that we should be in a position, in such a country, to predict the particular consequences of a given measure.”¹⁴⁶

This does not mean that the government cannot experiment with different institutional approaches hitherto either unknown or uncommon in western market economies as long as they are exposed to equal competition and liability rules as private entities. Neither does it rule out that in addition to the establishment of favorable rules for entrepreneurial activities the state may take upon itself further tasks, “which are not absolutely necessary but yet desirable, for they provide favorable conditions for individual decisions.”¹⁴⁷ These are the provision—but not necessarily production¹⁴⁸—of classic public goods like standards and norms, health care, roads, or basic school education. With regard to agriculture, Hayek goes even further and favors the provision of public services in the form of information, however, only in a certain stage of economic development where the rural population has limited access to information that might be useful for entrepreneurial decisions and its dissemination cannot be easily provided in another manner. The information he has in mind is mainly about latest technological developments.¹⁴⁹ In the age of the Internet and other modern communication techniques, there might be no such necessity in developed countries, but that is not so in emerging economies like Kazakhstan that lack infrastructure in rural areas.¹⁵⁰

4.2. The Difficult Task of Making Institutions Function

THE GOVERNMENT’S MAIN contribution to broad-based and sustainable economic development is setting up and protecting a functioning set of formal and informal institutions that permit the exploitation of resources and opportunities and thus stimulate the potential for entre-

143. See Timothy Bresnahan, Alfonso Gambardella, and Annalee Saxenian, “‘Old Economy’ Inputs for ‘New Economy’ Outcomes: Cluster Formation in the New Silicon Valleys,” *Industrial and Corporate Change* 4, no. 10 (2002): 835–860. On Singapore, see Gavin Peebles and Peter Wilson, *Economic Growth and Development in Singapore: Past and Future* (Cheltenham, UK, Northampton, MA, USA: Edward Elgar Publishing, 2002).

144. Bryan K. Ritchie, “Politics and Economic Reform in Malaysia,” (working paper no. 655, William Davidson Institute, February 2004), <http://www.wdi.umich.edu/files/Publications/WorkingPapers/wp655.pdf>; Datuk Seri Anwar Ibrahim, *A Malaysian Economic Agenda*, <http://www.keadilanrakyat.org/library/documents/mea.pdf>.

145. See Pomfret, *Central Asian Economies Since Independence*, 165.

146. Hayek, “Der Wettbewerb als Entdeckungsverfahren,” in Hayek, *Freiburger Studien*, 2nd ed. (Tübingen: Verlag Mohr Siebeck, 1994), 249–265, published in English as “Competition as a Discovery Procedure,” in *New Studies in Philosophy, Politics and the History of Ideas* (London: Routledge & Paul, 1978), 179–190, chapter 6.

147. Hayek, *Die Verfassung der Freiheit* (Tübingen: Verlag Mohr Siebeck, 1991), 288, published in English as *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).

148. The only thing government has to do if it does not want to produce public goods is to specify demand and to organize the financing.

149. Hayek, *Die Verfassung der Freiheit*, 450.

150. Karadzhaeva et al. (2008), 21. According to the latest survey of the Ministry of Agriculture, 72.5 percent of all rural communities have no regular water and electric energy supply.

preneurial discovery. Then diversification will follow on its own.

The implementation of a favorable institutional framework for such development is, however, easier said than done. The past 17 years of transition in post-communist countries reveal that it is relatively easy to *introduce* formal institutions, but very difficult to enforce them. So far, economists lack the knowledge to bring informal institutions in line with formal institutions. It is equally important to recognize that, among developed market economies enjoying good economic performance, there is great diversity of established institutions.¹⁵¹ It is also undeniable that close cooperation between the government and private entrepreneurs characterized successful development in East Asia. So it is hard to imagine that there is *the* optimal set of institutions. However, the rule of law, binding the state from interfering with the private incentives that promote economic activity and guaranteeing private property rights and contract fulfillment, is important for economic growth.¹⁵² Laws and government policy should be predictable.¹⁵³ Conversations with foreign businessmen revealed that most of them are not deterred by national peculiarities like close contacts to the local government or investment requirements as long as rules remain predictable and ruling powers do not confiscate the returns on investments. Bad governance's arbitrariness, corruption, and lack of transparency create an uncertain and costly environment for prospective entrepreneurs.

The question is whether a more liberal and democratic political environment is more conducive than an authoritarian system to the enforcement of the rule of law. The examples of China, Singapore, and other East Asian tigers show that an authoritarian government dedicated to reform can achieve much economic transformation. Moreover, a high culture of civil service can sometimes prevent excessive corruption among government officials. Yet, if we agree that government officials and public servants are rational, self-interested individuals, the temptation for administrators to abuse their discretionary power is always present and seems more likely in an environment where officials stand above the law and there is little division of power or critical press to provide necessary political and social control. For just as mar-

ket competition checks monopolies, political competition can restrict the abuse of political and administrative power. Against this background, the motto "economic transformation first" could turn into an obstacle for economic development if the political transformation follows too slowly or too late. The developments in Russia, where in Putin's second term institutional developments were regressive with renationalizations and curtailment of political pluralism, seem to support this argument. It is the only post-Soviet country that recorded a sharp rise in corruption and—as Anders Aslund, a leading specialist on economic transformation and former economic advisor to the governments of Russia, the Ukraine, and Kyrgyzstan, argues—"appears to have fallen victim to the oil curse" because of rising political repression and declining transparency.¹⁵⁴

4.3 Recommendations

IT FOLLOWS FROM the previous two sections that, in order to ensure continued economic growth, the Kazakhstani government should abandon its interventionist course and concentrate on the improvement of the institutional conditions that enable entrepreneurship in general rather than support selected entrepreneurs directly and actively. In particular, the government should:

- Refrain from interventionist diversification programs as well as short-term rescue programs for ailing banks and construction firms. (See also section 5.2.4 of the appendix.)
- Tighten monetary policy to curb credit growth to fight inflation rather than resort to price controls. (See also section 5.3.4 of the appendix.)
- Concentrate government spending into infrastructure building and human capital formation. The support of the foundation of international universities in Kazakhstan like the Kazakh-British or German-Kazakh University goes in the right direction.
- Foster further professionalism in state bodies through the employment of young, well-educated specialists.

151. Just compare Germany, France, the United Kingdom, the United States, or the Scandinavian countries.

152. See also Hans-Jürgen Wagener, "On the Relationship Between State and Economy In Transformation," (discussion paper no 14/00, Frankfurt Institute for Transformation Studies, 2000), 5, http://www.euv-frankfurt.de/de/forschung/institut/institut_fit/publikationen/2000/00-14-Wagener.pdf.

153. The importance of the latter has been enumerated among the core institutional elements of a competitive order by Walter Eucken, *Grundsätze der Wirtschaftspolitik*, 6th ed. (Tübingen: Verlag Mohr Siebeck, 1990), 285.

154. Aslund, *Transformation of Central and Eastern Europe, Russia, and Central Asia*, 278, (citing Transparency International 2006).

- Separate the commercial and public functions of the national holdings and their subsidiaries. Develop them into private enterprises or at least into entities exposed to competition and the same liability obligations as private firms. (See section 3.5.2 of this Country Brief and the box on “30 Corporate Leaders,” as well as section 5.3.4 of the appendix.)
- Eliminate contradictory legislation and the scope for discretionary power for government officials, and follow through with plans to further lower and simplify taxation based on the privilege-free principle.
- Modernize the political system and establish the rule of law as prescribed by the president in his February 2007 speech.

The last two recommendations could reduce corruption more effectively than drastic penalties and increased supervision of government officials. However, as Friedrich Hayek has pointed out, there are too many political and economic actors that benefit from the status quo—and would lose their privileges or rents through the implementation of general rules—for these types of rules to be successfully adopted. It is then difficult to imagine how today’s decision makers would voluntarily agree to change rules that would diminish their power.¹⁵⁵ Under current circumstances, interventionist approaches like clusterization or the promotion of “corporate leaders” become attractive because they don’t take a more holistic view of economic development. Direct and active support measures for domestic entrepreneurs like subsidies, tax breaks, or protection from foreign competition are relatively easy to implement even with weak formal institutions. In addition, these types of political efforts are appealing, especially when there are significant oil revenues, because they are better suited to demonstrate to the population that the government cares about its economic well-being. The promotion of “institution building” is a much harder concept to grasp and to sell to the public. Moreover, a return to a more liberal economic policy in Kazakhstan has become even more of an uphill battle due to the general anti-market sentiment generated by the global financial crisis. Nevertheless, the risk of an interventionist economic policy is quite high. The supported sectors or enterprises may become permanently dependent on transfers from the state budget and will never mature. As Mancur Olson has shown in his famous book *Power and Prosperity*, without impartially enforced institutions that provide for well-defined

and secure individual rights, a country will not be able to reach rapid economic growth and high levels of income for its population.¹⁵⁶

Conclusion

SEVENTEEN YEARS AGO, scholars speculated about whether the Kazakhstanis could successfully manage the transition from a centrally planned to a market economy and, even if they could, whether they would also be able to sustain their independence. Today, Kazakhstan is generally considered the one success story in Central Asia, as well as one of the few real successes in the post-Soviet region. Considering both the Soviet legacy and that western market economies were built over decades and centuries, the government has done a commendable job of stabilizing and opening up the economy and providing a favorable institutional framework for entrepreneurial activities—witnessed by the high inflow of foreign investment and an unprecedented boom period from 2000 to 2007. However, Kazakhstan’s future success is far from guaranteed. Apart from ensuring a broad-based sustainable economic development, key challenges are managing the current banking and construction sector problems and lowering inflation. Much will depend upon whether policy makers in Kazakhstan choose a path toward liberal or illiberal economic policies. If political decision makers trust the capabilities of the market process as a discovery procedure and entrepreneurship as its driving force, focusing on its necessary institutions, Kazakhstan could not only reverse the current downturn, but also realize its great economic potential, achieve diversification, and become the first Central Asian snow leopard.

155. Hayek, *Legislation and Liberty, Vol. 3: The Political Order of a Free People* (Chicago: University of Chicago Press, 1990), 31.

156. Mancur Olson, *Power and Prosperity* (New York: Basic Books, 2000), 187.

Appendix

5

Developments in Selected Sectors

THE FOLLOWING DISCUSSES in greater detail the development of three major sectors of the Kazakhstani economy: the hydrocarbon and financial services sectors, which have most strongly contributed to GDP growth, and agriculture, which, though lagging, may yet become competitive.¹⁵⁷ Developments in the natural resources and agro-food sector reflect the government's vacillation between liberal, market-oriented economic policy and growing state involvement.

5.1. The Oil and Gas Sector

5.1.1. Potential

KAZAKHSTAN'S OIL AND gas deposits are concentrated in three fields, all in the western part of the country: Tengiz, in the swamplands along the northeast shores of the Caspian Sea, Karachaganak in the northwest corner of the country, and Kashagan, offshore in the Kazakhstani sector of the Caspian Sea. If present plans are realized, Kazakhstan's contribution to the world oil supply by 2010 will not be much more than 2 percent. Nonetheless, this output does place Kazakhstan among the leading oil producers and exporters of the world.¹⁵⁸

The natural gas sector is still in its infancy. In the 1990s, a modest 5–10 billion m³ gas was exploited; in 2006 the volume reached 26 billion m³. The total reserves are estimated at 75 billion m³.¹⁵⁹ Most of Kazakhstan's gas is produced in Karachaganak and in the Caspian shelf as gas condensate that accrues with oil extraction. A major problem with Kazakhstan's oil and gas deposits is that it is technically difficult to extract them. The Tengiz

oil field faces the challenge of removing and disposing sulfur found in the associated natural gas. At Kashagan, the oil field is in shallow water that is ice for up to five months of the year, making it difficult to use big tankers and conventional drilling platforms. The Kashagan oil also contains a high concentration of hydrogen sulfide, obliging the workers to wear respirator masks.

View of the Kashagan oil field in the ice-covered Caspian Sea.



5.1.2. The Problem of Access to Markets

DUE TO KAZAKHSTAN'S landlocked location far from open seas and the old existing pipelines running through Russia, it is expensive to move the oil and gas to export markets. Naturally, geopolitical difficulties have to be considered as well when developing alternative routes.¹⁶⁰ Nevertheless, Kazakhstan has made considerable progress in resolving the problem of access to export markets. In 1992, agreements were signed for the construction of a 1,600-km pipeline connecting Kazakhstan's Caspian area oilfields with the Russian Black Sea port Novorossiysk, leading to the creation of the Caspian Pipeline Consortium (CPC). The CPC includes major trans-national oil companies, as well as the governments of Kazakhstan, Russia, and Oman.¹⁶¹ Disagreements with Russia over oil-pumping tariffs and

157. Nursultan Nazarbayev, 2007 Address to the Republic of Kazakhstan.

158. See also Svetlana Tsalik, "Caspian Oil Windfalls: Who Will Benefit?" *Caspian Revenue Watch*, Central Eurasia Project, Open Society Institute, (2003): 128, http://www.eurasianet.org/caspian.oil.windfalls/full_report.pdf.

159. Roland Götz, "Mythos Diversifizierung: Europa und das Erdgas des Kaspiraums," *Osteuropa* 57, no. 8-9 (2007): 454.

160. Geography and commercial expedience would suggest a direct route to the Persian Gulf through Iran, but financing such a route would be extremely difficult given Iran's international position. Similarly, a route through Afghanistan would be exposed to high levels of political risk. Rudiger Ahrend and William Tompson, "Realising the Oil Supply Potential of the CIS: The Impact of Institutions and Policies," (working paper no. 484, OECD Economics Department, 2006): 63, <http://titania.sourceoecd.org/vl=15130521/cl=29/nw=1/rpsv/cgi-bin/wppdf?file=519r88s9cmzt.pdf>.

161. Pomfret, *The Central Asian Economies Since Independence*, 51. CPC is half owned by Russia (24 percent), Kazakhstan (19 percent), and Oman (7 percent) and the other half is divided among ChevronTexaco (15 percent), LUKoil (12.5 percent), ExxonMobil (7.5 percent), Rosneft/Shell (7.5 percent), Agip (2 percent), British Gas (2 percent), Kazakhstan Pipeline Ventures (1.75 percent), and Oryx Caspian Pipeline (1.75 percent).

shareholder profits¹⁶² delayed the start of construction until May 1999. In October 2001, Kazakhstan inaugurated the CPC pipeline. As a result, export costs of Tengiz oil decreased by roughly 50 percent. Kazakhstan has set up a fleet of large-capacity oil tankers to bypass Russia through the Caspian Sea and Azerbaijan. To further diversify transportation routes, Kazakhstan has invited China to invest in its hydrocarbon sector. The Chinese purchased a major stake in Aktobemunaigaz and have provided funding for a 980-km pipeline, running from Kazakhstan to China's Xinjiang province. Construction began in late September 2004; the second stage of the project will be finalized in 2009.

Kazakhstan still lacks a pipeline system to transport its natural gas from the point of production in the western part of the country to the consumers in the east and south. Imports from Uzbekistan and Russia mostly cover the demand in these regions.

5.1.3. Expanding the Role of the Government in the Natural Resources Sector

TO ATTRACT FOREIGN investors to its hydrocarbon sector, the Kazakhstani government initially followed a liberal policy that led to a favorable investment climate and allowed the privatization of most existing oil and gas enterprises. This policy was extremely successful. By the end of 2004, the cumulative stock of FDI in oil and gas extraction had reached around US\$16 billion.¹⁶³ The first big project involving foreign capital was the development of the Tengiz field. The most significant single project is the Kashagan offshore field, which is expected to absorb US\$20 billion and to be exploited for 70–80 years. It is developed by a consortium led by the western oil companies Eni, Total, ExxonMobil, and Shell.¹⁶⁴

Late in the 1990s, the first signs of a shift toward increasing state involvement in the oil industry began to appear. The goal was to expand the state's direct role in the ownership and management of oil-sector assets, thereby increasing the state's share of oil revenues. In 1997, a national oil company, Kazakhoil, was created to manage the state's remaining oil-sector enterprises. In February 2002, Kazakhoil was merged with the state-owned oil

and gas transportation group Transneftegaz (consisting of KazTransOil and KazTransGaz) to become the vertically integrated state oil and gas company KazMunayGaz. The purpose of this step was to ensure coherent government policy on hydrocarbon and, as in the case of newly created national holdings, to separate the state's commercial interests from its regulatory role. KazMunayGaz was to perform the commercial role, while the Ministry of Energy and Natural Resources was to have a purely regulatory role. Yet, as Rudiger Ahrend and William Tompson, senior economists at the OECD and experts on oil and gas issues in the CIS, report, this division of roles has not been fully realized.

The state's actions have caused tensions with foreign investors and cast doubts on the credibility of the government's commitment to property rights, contract stability, and market principles. Many of the conflicts deal with the interpretation of the major contracts concluded between investors and the state. Since the contracts themselves remain secret, it is impossible for outsiders to judge the merits of any given dispute.

Assessments of the conflicts are not unanimous among experts. According to Robert M. Cutler, "Western investors feel that the playing field has been tilted against them, while Kazakhstani actors feel that it has only been leveled."¹⁶⁵ Yet, he considers it unclear whether Kazakhstan is really planning a Russian-style "resource nationalism." Ahrend and Tompson are more optimistic:

While the last years have undoubtedly seen growing friction between the Kazakh authorities and the major oil companies, the situation should not be over-dramatised. Kazakhstan has not witnessed anything like the large-scale assault on property rights mounted against Yukos in Russia. The fact that the major private investors are foreign companies would in any case constitute a significant deterrent to any such attack on private property.¹⁶⁶

Bodo Lochmann, senior economist at the German-Kazakh University (DKU) in Almaty, has a similar opinion. He thinks the case of Eni did not severely harm foreign investors' confidence in Kazakhstan's economic policy.

162. Russia used its transport network to pressure Kazakhstan in the dispute over ownership of the Tengiz field. The dispute was resolved, and pipeline constraints eased, after Russian equity participation was agreed upon.

163. Ahrend and Tompson, "Realising the Oil Supply Potential of the CIS," 28.

164. *Ibid.*, 29; Birgit Brauer, "Der Streit um das Kaschagan-Ölfeld—Ressourcennationalismus oder Emanzipation auf Kasachisch?" *Zentralasien-Analysen*, no. 02, February 29, 2008, 3.

165. Cutler, "Kazakhstan's Foreign Investment Law Changes Again."

166. Ahrend and Tompson, "Realising the Oil Supply Potential of the CIS," 48.

Surely, the Kazakhstani side has tested how far it can go with its demands on renegotiation of agreements without alienating urgently needed partners. In the end economic rationality was stronger than short-sighted political and economic ambitions aimed to favor domestic business structures and to receive quick budget revenues.¹⁶⁷

Martha Brill Olcott underscores that the Kazakhstani government surely did try to carve out a bigger role for itself in the development of its own energy reserves:

Yet, the Kazakhs recognize that they can't deal with western firms, as the Russians have. They too have used often times tenuous "rule of law" based arguments to strengthen their claim for larger shares of existing projects, but have been nowhere as rapacious as their Russian colleagues. Though relations can sometimes be tense between the Kazakhs and their leading foreign investors, the Kazakhs repeatedly reassure them that "resource nationalism" or full nationalization is not on the table in Kazakhstan. President Nazarbayev seems determined to provide enough legal protection to insure investments made in his political life will be sustained after his passage from the scene.¹⁶⁸

As Ahrend and Tompson pointed out, the state dominates the oil industries in most of the world's major oil exporters. "Against this background the extent to which the private sector has dominated oil production in Kazakhstan since the early 1990s looks in fact quite anomalous. However, it appears to have been a *positive* anomaly, at least in terms of investment, efficiency and growth."¹⁶⁹ They conclude, however, that "the shift towards more direct state control over assets and intervention in markets is likely to contribute to poorer performance. The problem is not simply that renationalized assets are likely to be managed less efficiently. It is also that greater state ownership and

intervention in the sector is likely to distort the incentives facing private companies."

5.1.4. The National Fund of Kazakhstan

BESIDES SETTLING ON reliable rules of the game for investors, the government's most important challenge in the hydrocarbon sector is managing revenues successfully. Some resource-rich countries have channeled some of the revenues from resource exploitation into stabilization funds separated from the state budget.¹⁷⁰ Kazakhstan did something similar in creating the National Fund of the Republic of Kazakhstan in August 2000. The National Fund is managed by the National Bank of Kazakhstan and overseen by a governing board chaired by the president of Kazakhstan himself.¹⁷¹ Information on the fund's revenues, expenditures, and the audit results have to be published in the local press and the fund is subject to an independent audit annually.

Kazakhstan's fund has both a savings and stabilization component and fully invests in foreign markets. The income from the investment is intended to bolster the state budget. The government committed not to access the National Fund's resources for the first five years. In 2005, the National Fund valued US\$5.14 billion, which equals 35.7 percent of the country's gold and currency reserves, and by the end of July 2008, US\$26 billion had been allocated to this fund. At the end of 2008, US\$32 billion is expected.¹⁷²

The role of oil funds in the literature is controversial. One point of view is that they are unnecessary because if the conditions exist for these funds to function successfully, the revenue windfall can be managed without them within the budgetary process. The other point of view is that if it is impossible to create ideal conditions, the existence of oil funds could prevent excessive spending. It signals to private foreign and domestic investors that

167. Lochmann, "Kaschagan-Verhandlungen: Dieses Mal friedlich," *Deutsche Allgemeine Zeitung* (May 23, 2008), 3.

168. Olcott, "Kazakhstan: Will 'BRIC' be spelled with a K?": 41–53.

169. Ahrend and Tompson, "Realising the Oil Supply Potential of the CIS," 51.

170. Examples are Chile (stabilization fund for copper), Algeria, Canada (Alberta), Kuwait, Norway, the United States (Alaska), Venezuela, and Russia. See for more detail Yelena Kalyuzhnova and Michael Kaser, "Prudential Management of Hydrocarbon Revenues in Resource-Rich Transition Economies," *Post-Communist Economies* 18, no. 2 (June 2006): 167–187.

171. The governing board consists of the prime minister, the chairmen of both chambers of Parliament, the governor of the National Bank, the ministers of finance and economy, a representative from the presidential administration and the Accounting Committee, as well as external managers from international commercial financial services institutions.

172. See also Embassy of Kazakhstan, http://www.kazakhembus.com/National_Fund.html, June 14, 2008; "S nachala goda sredstva Natsional'nogo fonda uvelichilis' na \$3,3 mlrd," July 31, 2008, <http://www.regnum.ru/news/1034863.html?forprint>.

the government is fiscally self-disciplined. The experience of successful funds (e.g. Alaska, Norway) is usually cited in support of this argument.¹⁷³ Yet, as Kalyuzhnova, et al. show, these cases are the exception rather than the rule.¹⁷⁴ More often than not, lack of clear rules and operations limit the success of such funds. However, so far such fears have proved unjustified for Kazakhstan. The National Fund does have clear rules and the government has not given in to temptations to use the fund for short-term goals. Only most recently, on October 20, 2008, Prime Minister Karim Masimov has announced plans to use US\$10 billion to support the ailing economy due to the global financial crisis.¹⁷⁵

5.2. The Financial Services Sector

5.2.1. Institutional Characteristics

IN KAZAKHSTAN, THE banking sector is the dominant segment of the financial industry. Figure 11 shows that in October 2007, 82 percent of the aggregate assets of the financial market were kept by banks, followed by the pension funds. The securities and stock market is comparatively insignificant, although the Kazakhstan Stock Exchange (KASE) is the most developed in Central Asia. According to Clare Nuttall,¹⁷⁶ high listing conditions set by the KASE have deterred especially smaller Kazakh companies from listing locally. Kazakhstan's largest companies typically choose to list in London to gain access to high-quality international investors before listing on the KASE.

FIGURE 11: INSTITUTIONAL STRUCTURE OF FINANCIAL SECTOR ASSETS AS OF OCTOBER 1, 2007 (% OF TOTAL ASSETS)

Financial Institution	Share
Banks	81.9
Insurance companies	1.3
Securities market professional participants	2.6
Pension funds	7.9
Mortgage companies	1.3
Non-banking organizations	4.9

Source: *Kazakhstan Financial Stability Report, December 2007*, 38

Kazakhstan's banking system initially evolved in a similar manner to that of other former republics of the Soviet Union. The hyperinflation of the early transition years made founding banks very attractive. Prospects of quick profits led to an explosion in the number of banks.¹⁷⁷ By 1994, Kazakhstan had 210 banks. It was not until the inflation rate dropped in 1994, leaving loan delinquencies in its wake, that the cracks in the system began to show. When, in 1994 and 1996, major banks got into financial trouble and more than 20,000 investors had lost their savings,¹⁷⁸ the Kazakhstani government took decisive actions to make the country's banking system more efficient. The National Bank of Kazakhstan (NBK) enforced a presidential decree mandating stricter requirements to set up banks and introducing stringent international prudential standards for the operations, including requirements on capital adequacy, liquidity ratios, conformity to the International Financial Reporting Standards (IFRS) and the Basel Committee norms,¹⁷⁹ and existence of personnel training programs. Following legislative changes

173. See for more detail Kalyuzhnova, "Overcoming the Curse of Hydrocarbon: Goals and Governance in the Oil Funds of Kazakhstan and Azerbaijan," *Comparative Economic Studies* 48 (2006): 583–613 and the literature there cited.

174. Ibid.

175. Satpaev, "Anti-Nekrolog," *Liter*, October 21, 2008, www.liter.kz/site.php?lan=russian&id=154&pub=12132

176. Clare Nuttall, "Kazakhstan's Stock Market—The Missing Link," *Silk Road Intelligence*, June 20, 2008, <http://silkroadintelligence.com/2008/06/20/kazakhstans-stock-market-the-missing-link/>.

177. Since the interest margin is the key factor for banks, they can earn positive real returns even when real loan interest rates are negative, and can therefore skim off some of the inflation tax.

178. Thomas Röhm et al., *Kasachstan—Wirtschaft und Reformen 1995, ifo studien zur osteuropa- und transformationsforschung 20* (München: Weltforum Verlag, 1996), 31.

179. International Financial Reporting Standards (IFRS) are international standards for financial reporting and accounting. The aim is to facilitate the worldwide comparison of financial statements of enterprises and thus to enhance the integration of the world's capital markets. For more detail, see the homepage of the IASB at <http://www.iasb.org/Home.htm>. Basel Committee norms are international minimal risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. They were formulated by the Basel Committee on Banking Supervision, an institution created in 1974 by the central bank governors of ten industrialized countries in Basel, Switzerland. The norms are fixed in two Basel Accords, Basel I in 1988 and its Basel II revision of 2001–06. In general, the norms stipulate that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability. Advocates of these accords believe that such an international standard can help protect the international financial system from the problems that might arise should a major bank or a series of banks collapse. For more detail, see the homepage of the Basel Committee on Banking Supervision at <http://www.bis.org/bcb/index.htm>.



Construction boom in the two major cities: Left, the new capital Astana in the northern steppeland. Right, the southern "capital" and financial center Almaty at the bottom of the Tien Shan Mountains.

in July 2003, the Financial Markets Supervisory Agency (FMSA) was formed, and, as of January 1, 2004, it took responsibility for most of the supervisory and regulatory functions in the financial sector (previously performed by the NBK). This new and enforced institutional framework has cut the number of banks from 210 in 1994 to 36 in September 2008. No other country has reduced the number of banks as quickly as Kazakhstan. Sixteen of these 36 banks are in a NBK-sponsored deposit insurance scheme. Five large banks (Kazkommertsbank, TuranAlem (BTA), Halyk Bank, Alliance Bank, ATF Bank) dominate the sector and account for 79.5 percent of total assets of the banking sector.¹⁸⁰

These strict reforms helped Kazakhstan's banks quickly gain international competitiveness, becoming the best developed in the former USSR and the country's major success. Kazakhstani banks have entered the list of the

world's top 1,000 banks. They have also been expanding into neighboring countries, first into the Kyrgystan, where over 70 percent of the assets of the banking sector are Kazakhstani-owned, but also into Tajikistan, Russia, Georgia and Belarus.¹⁸¹ In contrast, foreign banks' participation in the total assets of the Kazakhstani banking sector is low.

5.2.2. Strong Inter-linkage Between the Banking and Construction/Real Estate Sector

ALTHOUGH KAZAKHSTAN'S BANKS have spread credit throughout the whole population,¹⁸² this credit has gone particularly to the construction and real-estate market, especially into the residential market of the affluent urban areas of Almaty and Astana. In 2005, construction credits amounted to 12.8 percent of bank loan portfolios and as of October 1, 2007, this indicator had risen to 25.6

180. National Bank of Kazakhstan, *Financial Stability Report 2007*, 66.

181. Pomfret, "Kazakhstan's Banking Problems."

182. Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*. Car loans and unsecured consumer credit have grown especially rapidly since 2005. The share of consumer credit in the total credit by the second-tier banks has risen from 6.7 percent in 2005 to 11.2 percent at the beginning of 2007.

percent.¹⁸³ The Asian Development Bank estimates that 70 percent of all loans were directly or indirectly linked to the real-estate sector, compared to about 25 percent in Russia.¹⁸⁴ Kazakhstani locals and experts explain this preference for the construction/real-estate sector: (1) A genuine need for new housing to compensate for under-supply from Soviet times,¹⁸⁵ and (2) Given few alternative possibilities for investment due to an under-developed securities and stock market, the general population viewed investment in real estate as the best option. In addition, the introduction of mortgages in the early 2000s helped the real-estate sector to expand quickly. As Karlygash Kuralbayeva and David Vines explain, a financial accelerator was set in motion: Rising incomes of households due to high GDP growth increased the demand for consumer goods and housing services.¹⁸⁶ As a result, house prices and thus the collateral value of homeowners increased. In fact, until June 2007, the cost of 1 m² in Almaty rose on average to US\$3,500–3,700, compared to a modest US\$100 in 1998. In the capital of Astana and the oil producing regional center of Atyrau, prices in June 2008 were about US\$2,000 per m² lower than in Astana, but still twice as high as in more rural regional centers like Kostanay or Taldykorgan where one m² costs US\$1,000.¹⁸⁷ The higher collateral value decreases the external finance premium, causing a further increase in housing demand.

5.2.3. The Impact of the U.S. Mortgage Crisis on Kazakhstani Banks

ALTHOUGH OBSERVERS HAVE for some time considered the construction/real estate sector overheated, this did not precipitate the economic problems in the banking sector.¹⁸⁸ Rather, they emerged because Kazakhstani banks borrowed heavily in international markets at shorter maturities to those on their loan portfolios, often with floating interest rates,¹⁸⁹ and the quality of their loan portfolios was poor. In the aftermath of the U.S. mortgage crisis in summer 2007, bank assets began to deteriorate in Kazakhstan and these holes in Kazakhstan's banking-sector success story became obvious. At the same time it revealed how much Kazakhstan's banking sector had already been integrated into the global financial markets.

There are several reasons for the preference for foreign funding: (1) a domestic deposit base that most Kazakhstani banks consider too small to finance growing private consumption,¹⁹⁰ (2) low risk-premiums on external borrowing due to high oil prices and excess liquidity on the international markets, and (3) little exchange-rate risk because the National Bank has kept the exchange rate (KZT130 to US\$1) relatively stable since May 1999, despite strong pressures for currency appreciation.¹⁹¹ As of October 2007, foreign borrowings accounted for more than 50 percent of the Kazakhstani banking sector's liabilities. By comparison, Russian banks raised only 18–20 percent of their non-equity funding on international markets.¹⁹²

183. National Bank of Kazakhstan, *Financial Stability Report 2007*.

184. As of July 1, 2007, 38 percent of Kazakhstani banks' portfolios consisted of mortgage credits, compared to 16 percent in Russia. Oksana Komardina, "Stavka na loyal'nost'," *Ekspert Kazakhstan* 160, no. 12, March 24, 2008, http://www.expert.ru/printissues/kazakhstan/2008/12/finansovyi_rynok/.

185. The decision to designate Astana as the new capital city of Kazakhstan resulted in increased demand for modern office space, housing, and infrastructure.

186. Karlygash Kuralbayeva and David Vines, "The Role of the Real Estate Sector in the Transmission of External Shocks in a Small Open Economy: A Financial Accelerator Framework: The Case of Kazakhstan," presentation at ISE Conference *Institution Building and Economic Development in Central Asia* at the Kazakh-British University, Almaty, June 5–6, 2008.

187. Olzhas Khudaybergenov, "Nuzhna li nam novaya zhilichnaya politika?" *National Business* 53, no. 3 (2008): 73.

188. See Lochmann, "Bankenkrise," *Deutsche Allgemeine Zeitung*, October 5, 2007, 3; Lochmann, "Zahl der 'verlorenen' Kredite in Kasachstan hat sich verdoppelt," *Deutsche Allgemeine Zeitung*, May 2, 2008, 3.

189. The maturity of the funds borrowed by Kazakhstan's banks abroad was on average 2–7 years while they lent this money for 10–15 years. Khudaybergenov, "Analiz antikrizisnykh mer gosudarstva," *National Business* 53, no. 3 (2008): 66.

190. Between 2001 and 2006, total loans grew tenfold, and the loans-to-GDP ratio rose from 18 percent in 2002 to 42 percent by the end of 2005.

191. Pomfret, "Kazakhstan's Banking Problems."

192. Komardina, "Stavka na loyal'nost'."

FIGURE 12: SELECTED INDICATORS OF THE KAZAKHSTANI AND RUSSIAN BANKING SECTORS

Indicators	Russia	Kazakhstan
Bank deposits of natural persons per capita as of 1 Nov 2007, US\$	1,334	744
Volume of bank deposits of the population in percent of GDP	14.2	11.3*
Credits, given to natural persons, per capita as of 1 Nov 2007, US\$	862	1,368
Volume of credits given to the population in percent of GDP	9.2	20.7*

* Estimations of the Rating Agency Ekspert RA.

Source: Oksana Komardina, "Stavka na loyality" Ekspert Kazakhstan 160, no. 12 (2008), <http://www.expert.ru/tables/kazakhstan/2008/12/document384928/>.

Figure 12 shows that until the end of 2007, in Kazakhstan 1.8 times more money per capita was lent to natural persons than deposits raised from them, whereas in Russia bank deposits from natural persons per capita were 1.5 times higher than the credits given to them. This bank policy contributed to a surge in Kazakhstan's external debt, which amounted to US\$93.9 billion by the end of September 2007. The private portion of the external debt is US\$62.5 billion, equal to about 60 percent of GDP, and that of banks alone to about 40 percent of GDP.¹⁹³

As figure 13 shows, even before August 2007, Kazakhstani banks' loan portfolios were of poor quality. By 2004, they had a high share of doubtful loans—40 percent of the total portfolio. It rose to 56 percent by October 2007. This indicates severe shortcomings in risk assessment and management. As a former employee in a medium-sized bank reported, some banks had given a large portion of the credit portfolio—in some cases, all of it—to a single borrower, often on the basis of a close relationship to the bank's director rather than a sound business plan and serious screening of the client's creditworthiness. The financial director of BTA Bank, Khalil Kamalov, reported in an interview with Talgat Ergaliev from *National Business* that before the crisis it was not uncommon to treat various projects from one construction company as a pool—now the bank checks and finances each single project.¹⁹⁴

The share of nonperforming loans in the portfolio of Kazakhstan's banking system was and still is less than the internationally applied critical value of 10 percent of total loan portfolios. The period-to-period comparison

of August 2008 and 2007 shows that the share of standard and doubtful loans as a whole has remained almost unchanged; however, there have been shifts between the categories of doubtful credits. The share of the first category, which denotes that a loss of the loan is highly unlikely in spite of temporary liquidity difficulties of the borrower, has decreased while the shares of category 3 to 5, indicating rising probability of non-payment, have markedly increased. Nevertheless, the director of Kazakhstan's Financial Services Supervisory Agency, Elena Bakhmutova, holds that the level of loan impairment is still not at critical levels.¹⁹⁵ Fitch Ratings supports this view. Their analysis shows that the margins and capital ratios of most Kazakhstani banks still provide meaningful capacity to absorb future losses.¹⁹⁶

FIGURE 13: QUALITY OF THE CREDIT PORTFOLIO, 2004 – 2008 (PERCENT OF TOTAL)

	YEAR				PERIOD-TO-PERIOD COMPARISON	
	2004	2005	2006	2007	1 Oct 2007	1 Oct 2008
Total Portfolio	100	100	100	100	100	100
Standard	56.2	59.4	58.2	52.7	42.9	41.4
Doubtful	40.9	38.4	39.5	45.7	56.0	55.8
Category 1	31.9	28.8	32.2	38.9	44.9	36.6
Category 2	1.4	3.1	1.1	1.8	5.8	5.6
Category 3	5.2	3.8	4.2	3.6	4.5	9.7
Category 4	1.0	1.7	0.9	0.6	0.3	1.8
Category 5	1.4	1.0	1.1	0.8	0.5	2.1
Loss	2.9	2.2	2.3	1.7	1.1	2.8

Source: Financial Supervision Agency of Kazakhstan: *Banking sector status, issues 2004–August 2008*; Talgat Ergaliev: "Proverka Boem," in *National Business* 53, no. 3 (March–April 2008), 35.

Since August 2007, Kazakhstani banks have struggled more and more to repay foreign loans. Simultaneously, they have faced difficulties in accessing further funds from the international markets due to rising risk aversion resulting from both the U.S. crisis and the high share of doubtful credits in the loan portfolio of Kazakhstani banks. The Kazakhstani banks have responded to the crisis by (1) curtailing new credit, (2) substantially increasing (doubling, even tripling) the interest rates on mortgages loans, (3) providing more care in evaluating the creditworthiness of their customers, and (4) intensify-

193. International Monetary Fund, *Republic of Kazakhstan: Staff Report for the 2007 Article IV Consultation*, 6; Asian Development Bank, *Asian Development Outlook 2008: Kazakhstan*.

194. Talgat Ergaliev, "Proverka Boem," *National Business* 53, no. 2 (March–April 2008): 36.

195. Asan Kuanov, interview in *Liter.kz* "Otkrytyy rynek," September 17, 2008, www.liter.kz/print.php?lan=russian&id=150&pub=9987.

196. Fitch Ratings, *Kazakhstan Special Report Kazakh Banks' Asset Quality: Trends Negative, Disclosure Opaque*, April 2008.

ing efforts to attract domestic deposits in order to diversify their funding portfolio.¹⁹⁷ Other Kazakhstani banks started looking for a foreign strategic partner. As a result of the more prudent lending policy, bank loans to the domestic economy grew by only 1.8 percent in the fourth quarter of 2007 and interest rates reached about 20 percent by the start of 2008, double the rates of two years earlier. The banks' reluctance to issue further loans has caused not only a dramatic fall in demand for new construction, but also a supply glut as many investors were forced to sell their properties to meet mortgage payments. Many construction companies have suspended projects in early stages of construction. This has left a significant number of investors, who frequently bought their properties before foundations were laid, without a home.¹⁹⁸ Real estate prices in Almaty and Astana have fallen 30–40 percent from their August 2007 peak.

5.2.4. Government Intervention

IN AN EFFORT to avoid a collapse in the real-estate market and an economic recession in general, the government charged Kazyna, one of the four national holding companies, to create and implement both a short-term and long-term action plan. Meanwhile, the government and financial authorities decided as an emergency measure to open a short-term credit line for liquidity support. The National Bank injected approximately US\$18 billion into the banking system in August and September 2007, mainly through repurchase agreements and foreign exchange swaps. In addition, the government allocated another US\$4 billion of budget funds as a rescue package for the economy. These funds target three areas: (1) construction companies, to enable them to complete unfinished residential construction (about US\$400 million), (2) industrial investment projects that were suspended by banks (about US\$200 million),¹⁹⁹ and (3) the support of small business. This financial support to the economy weakened the fiscal stance and deficits appeared

for the first time in three years. Revenues rose by 23.5 percent, but were outpaced by expenditure growth of 37.5 percent. Standard and Poor's (S&P) downgraded Kazakhstan's creditworthiness from BBB to BBB- but said they still consider Kazakhstan a solid country and expect the difficulties to be managed.²⁰⁰

The main purpose of such government action is psychological. It tries to demonstrate to economic actors that the crisis will be successfully overcome. The best long-term solution would be to allow the ailing enterprises go bankrupt and the market to reallocate scarce savings. The fact that some banks and construction companies have reached the edge of bankruptcy demonstrates severe management failures and a misallocation of savings. Providing access to money without proper scrutiny of borrowers has resulted in far too many buildings being built, relative to the real ability to pay for them. The big danger of any state intervention that provides guarantees in one form or another is that it encourages entrepreneurs to continue to make deals that are far too risky. Any system under which profits flow to private entrepreneurs while losses are borne by the whole society distorts incentives and misdirects capital.²⁰¹

5.3. Agro-Food Sector

5.3.1. Structural Characteristics

THE AGRO-FOOD SECTOR is a major part of the Kazakhstani economy. Over one-third of the national labor force was employed in agriculture in 2007, despite producing only 6 percent of GDP. The food industry employs nearly 11 percent of the working population, but accounts for one-quarter of total manufacturing output and provides 10 percent of overall industry production. Its share of the GDP is estimated at about 6.5 percent.²⁰²

197. Ergaliev and Boem, 34–38; Dilyara M. Seyilkhan, "Problemy likvidnosti v bankovskom sektore," *Banki Kazakhstana*, no. 2 (2008): 18–19.

198. Real-estate companies frequently sell about 25 percent of the apartments in a building when only 20 percent have been actually built. See Erden Shodyrov, "Vorpros na milliard," *National Business* 53, no. 3 (March–April, 2008): 56.

199. Altogether 130 projects have been selected that shall receive funds to secure completion. Khudaybergenov, "Nuzhna li nam novaya zhilichsnaya politika?" 68.

200. Komardina, "Stavka na loy'al'nost'." Gulnoza Saidazimova, "Kazakhstan: Global Financial Turmoil Hits Credit Rating," October 13, 2007, <http://www.eurasianet.org/departments/business/articles/pp101307a.shtml>. Russia and Kazakhstan are the only two former Soviet nations that S&P rates to "investment" grade. Russia's current rating of BBB+ is two notches higher than Kazakhstan's. Ukraine is rated BB-, three notches below Kazakhstan, while Belarus and Georgia are rated B+, four notches below Kazakhstan.

201. James A. Dorn, "What Price Stability?" The Cato Institute, September 15, 2008, http://www.cato.org/pub_display.php?pub_id=9642.

202. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2006*; Tulkin Tashimov and Sergey Smirnov, "Na importnoy diete," *Ekspert Kazakhstan*, no. 14 (April 2008): 7–13, 15–18.



Decline and Rise of Agriculture: Left, bankrupt former kolkhoz in the Almaty region. Right: restructured large-scale agricultural enterprise in Northern Kazakhstan using western production technology.

Due to privatization and farm restructuring, the number of collective farms has fallen. The area farmed by them also shrank from 92 percent in 1995 to 66 percent in 2001 and to 51 percent of Kazakhstan's total farmland in 2006. Family farms, on the other hand, grew rapidly and now about 48.1 percent of cultivated land belongs to individual farms. Household plots use about 0.7 percent of all agricultural lands.²⁰³ In 2006, large-scale agricultural enterprises accounted for only 25 percent of all agricultural production, while household plots for 54 percent and peasant farms for 21 percent. However, corporate and peasant farms produce most crops (83 percent and 84 percent of total output, respectively), while household plots are predominantly engaged in animal production (78 percent of total output).²⁰⁴

5.3.2. Performance

AFTER A SUBSTANTIAL decline—of nearly 30 percent—between 1992 and 1998, agricultural production has been growing since 1999 as food imports have become less attractive (due to currency devaluation), domestic demand has grown, and world agricultural prices have increased. The most successful branch in Kazakhstan's agriculture is grain production. In 2007, Kazakhstan gathered a bumper crop with 20.1 million tons—22 percent more than in 2006. This propelled Kazakhstan to

become one of the ten largest grain-exporting countries. The total value of grain exports in 2007 is estimated at US\$1.5 billion, almost double the previous year.²⁰⁵ However, 39 percent of corporate farms remained unprofitable in 2006 (down from 78.5 percent in 1998). The food industry saw similar development. Overall yearly output rose by 11 percent on average since 2000.

5.3.3. Actual Agricultural Policy

IN THE EARLY years of political transition, government support for agriculture farmers was substantially reduced. Subsidies fell from 10–12 percent of GDP before 1991 to 2–3 percent in 1993, and protection from foreign competition was reduced to a simple average tariff rate of 9.5 percent.²⁰⁶ This liberal policy was reversed in the early 2000s as the government responded to the oil boom by providing more support for agriculture. Implementing the billion-dollar Agriculture and Food Program for 2003–2005 increased public expenditure on the agro-food sector by an average of 40 percent per year between 2000 and 2005.²⁰⁷

In 2005, the Conception For the Sustainable Development of the Agro-Industrial Complex for the Period 2006–2010 was passed. It explicitly promotes a policy of export promotion and import substitution in order

203. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2006*, 175 and *Statistical Yearbook of Kazakhstan 2007*, 240.

204. Agency of Statistics of the Republic of Kazakhstan, *Statistical Yearbook of Kazakhstan 2007*, 245.

205. GFA Consulting Group GmbH, "Agrar- und Ernährungswirtschaft in Kasachstan: Sektorüberblick, Märkte und Investitionsbedingungen" (Bonn, 2008), 33.

206. Pomfret, "Has Kazakhstan Used Its Energy Resources to Promote Diversification through Support for Agriculture?"

207. Ibid.

to achieve a relatively high independence from food imports.²⁰⁸ To achieve these twin goals, the Kazakhstani government believes it necessary to (1) regulate the internal market, (2) industrialize agricultural production, (3) develop a modern infrastructure for the whole sector, and (4) promote branch clusters.²⁰⁹

Government regulation of the agro-food markets takes the forms of subsidies, tax privileges, and tariff policy. Similar support measures exist for the food industry.²¹⁰ By “industrialization of agricultural production,” the government primarily means that farm production technologies must be modernized—most are extremely outdated. Family farms also need to expand their size to increase competitiveness, especially in livestock production.²¹¹ The development of a modern infrastructure includes building roads in rural areas, as well as establishing a network of veterinary and phyto-veterinary services, procurement organizations, wholesale markets, information and marketing services, and financial and insurance institutions. The government views clusters as the most progressive form of industrial organization, best able to serve as “catalysts to raise productivity and quality in the agro-food sector on the basis of vertical and horizontal integration.”²¹²

5.3.4. The Battle Against Rising Food Prices

SINCE LATE SUMMER 2007, Kazakhstan has faced rising food prices—symbolically important, bread rose by 30 percent. After experiencing such a remarkable economic recovery, such a situation is hard for Kazakhstani citizens to understand. This is not only a Kazakhstani problem; worldwide, food prices rose by nearly 40 per-

cent in 2007, compared with 9 percent the year before. Systemic causes for this phenomenon are still debated, but generally some combination of high oil prices raising the cost of farm inputs and transportation, bad weather in important farming areas (Australia), increasing demand for higher-valued food (especially meat) in emerging countries, and the reduction of farmland available to grow foodstuffs in favor of growing biofuel crops are held responsible.²¹³

Kazakhstan itself suffered neither from bad weather conditions in 2007 (on the contrary) nor from a competition between food and biofuel production. However, rising fuel prices did affect Kazakhstan.²¹⁴ Its own middle-class consumers shifted demand away from traditional staples toward livestock products, which in turn increased demand for grains to feed livestock.²¹⁵ Moreover, there is reason to believe that infrastructural and policy shortcomings contributed to the rise of food prices in Kazakhstan. The shortcomings in infrastructure include the lack of storage capacities and transportation facilities, which makes the shipment of products from surplus to deficit areas costly.²¹⁶ The policy defect is the hybrid character of the state-owned Food Contract Corporation (FCC) as both a profit-oriented enterprise and a public institution. Initially established in 1995 to maintain state grain reserves, the FCC became responsible for regulating the domestic grain market, grain exports, and investment activities in the agro-food sector. As Oraz Zhandosov, a prominent opposition leader and Kazakhstani economist told *Business & Power*, a business weekly, the FCC showed a clear preference for the commercial tasks and earned enormous profits.²¹⁷

208. According to Kazakhstan's minister of agriculture, “food security” is reached when the share of imports in domestic supply is lower than 20 percent. See Ol'ga Flink, “Ideal'nye mery trudnoosushchestvimi,” *Ekspert Kazakhstan*, no. 14 (April 7–13, 2008): 19.

209. Government of the Republic of Kazakhstan, *Konceptsiya ustoychivogo razvitiya agropromyshlennogo kompleksa Respubliki Kazakhstans na 2006–2010*, section 2.

210. Ministry of Agriculture, *Razvitie pishchevoy promyshlennosti*, <http://www.minagri.kz/agro/index.php?ID=1449&print=Y>.

211. Dina Karadzhaeva, Alina Galieva, and Mukhtar Zhumaliyev, “Mlechnyy put’,” *National Business* 49, no. 11 (November–December 2008): 24.

212. Government of the Republic of Kazakhstan, *Konceptsiya ustoychivogo razvitiya agropromyshlennogo kompleksa Respubliki Kazakhstans na 2006–2010*, section 2.

213. Joachim von Braun, “High and Rising Food Prices: Why Are They Rising, Who Is Affected, and What Should Be Done?” presentation to the U.S. Agency for International Development conference *Addressing the Challenges of a Changing World Food Situation: Preventing Crisis and Leveraging Opportunity*, Washington, DC, April 11, 2008, 1, slide 1, <http://www.ifpri.org/presentations/20080411jvbfoodprices.pdf>.

214. Daur Dosybiev, “Kazaks Struggle With Oil and Food Prices,” http://www.groundreport.com/Arts_and_Culture/Kazaks-Struggle-With-Oil-and-Food-Prices. In early 2008, petrol cost ninety tenge (seventy five U.S. cents) a liter for 92-octane. Diesel was about one hundred and thirty tenge a liter.

215. Aleksey Ikonnikov, “Lozhka k obedu,” *Kontinent* 203, no. 18 (September–October 2007): 14–17; Daniyar Sabitov, “Khlebnyy spros,” *Kontinent* 203, no. 18 (September–October 2007): 22–25.

216. “Kazakhstan's Wheat Dilemma,” *Silk Road Intelligence*, March 6, 2008, <http://silkroadintelligence.com/2008/03/06/kazakhstans-wheat-dilemma/>; Saule A. Kalenova, “Gosudarstvennaya podderzhka infrastruktury agrarnogo sektora,” *Al'Pari*, no. 1 (2007): 156.

217. Cited in “Kazakhstan's Wheat Dilemma,” *Silk Road Intelligence*.

To prevent severe social tensions, the government introduced export licenses in 2007, ordered the creation of regional grain reserves, and called on food producers to refrain “voluntarily” from increasing prices. In reality, there is nothing voluntary about these memorandums—coming on their heels is the threat of more severe state intervention such as control of retail margins or the establishment of a state monopoly on bread production.²¹⁸ In April 2008, the government introduced an export ban on grain but lifted it in September when estimates projected a wheat harvest of 16 million tons—allowing an excess of 5.5 million tons to be exported.²¹⁹

Countries limiting exports create an artificial scarcity in the world market, raising world prices still higher and only worsening the crisis. Government officials overlook the fact that any shortage indicates an improper functioning of the market process. High prices signal increased profitability and would increase the production and supply of grain to meet demand, which would in turn push the price back down.

218. Aleksey Ikonnikov, “Eksportnyj kompromiss,” *Kontinent* 226, no. 17 (September 2008), <http://www.continent.kz/2008/17/5.htm>.

219. Ministry of Agriculture of the Republic of Kazakhstan, <http://www.minagri.kz/news/4327/>.



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