Economic Diversification: The Case for Kazakhstan

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Section 1. Introduction

Among transition economies, Kazakhstan is considered a successful, resource-rich country that sustained robust economic growth, averaging 10 percent per annum during the past decade. Yet government policies aimed at shifting the economy away from the natural resource sector failed to meet their targets. Prime Minister Karim Masimov admitted policy failures during a cabinet meeting in January 2007 when he said, "We set a lot of goals regarding diversification, but we have yet to achieve real diversification.".[1] This paper examines the country's diversification experience and assesses the effectiveness of government policies in fostering diversification.

This study argues that a combination of factors account for lack of progress in the economic diversification strategy designed by the Kazakh government. In particular, government diversification policies failed to produce the desirable outcomes due to some misaligned economic policies, weak regulation of the financial sector, shortcomings in the diversification strategy, weaknesses of political and economic institutions, and the country's geographic location. Given lax regulations, the banking sector excessively borrowed from the international capital markets and provided loans to the construction sector and for the consumption of durable goods instead of lending to the manufacturing sector. Another reason for ineffective diversification policies lies in the design of a faulty diversification strategy. The government drew heavily upon the East Asian experience and overlooked local peculiarities. Absence of viable democratic and economic institutions hampered government accountability and responsiveness. Finally, the country's landlocked position hindered the execution of an effective diversification policy.

Kazakhstan is well-endowed with hydrocarbon resources and minerals. The country's proven oil reserves are estimated at 30 billion barrels, while its proven natural gas

[1] Alisher Khamidov, "Pravitselstvo Kazakhstana korrektiruet plany po diversifikatsii ekonomiki (The government of Kazakhstan modifies its plans regarding economic diversification)," *Voice of America*, Oct. 27, 2010, http://www.voanews.com/russian/news/former-ussr/Kazakhstan-2010-10-27-105915548.html.

reserves are projected at 3 trillion cubic meters. At current production levels (about 1.5 million barrels per day in 2009), Kazakhstan is the 18th largest oil producer in the world.

Currently the hydrocarbon sector totally dominates the economy. In 2009 the oil sector accounted for approximately 25 percent of GDP, 60 percent of total exports, and about 40 percent of total budget revenues. Furthermore, about 75 percent of total FDI inflows went to the oil and gas sectors during the same year.

After the demise of the Soviet Union in 1991, Kazakhstan became an independent state and started its transition to a market economy. The process has been very turbulent; it involved building new political institutions and implementing structural reforms due to disintegration of regional economic links and disorganization. Since the USSR had collapsed, all economic ties among the Soviet republics were lost. Rapid liberalization of economic activity without the institutions required to support a well-functioning market economy further depressed the economic activity. The initial fall in GDP was far worse than the projected levels in the Commonwealth of Independent States (CIS).[2] When compared with other transitional economies, the magnitude of transition recession was larger and the duration of the output decline was longer in the CIS countries, with an average of 6.5 years of output decline, resulting in the loss of more than half of the initial level of measured output.[3] Much of the above trend can easily be used to characterize the development trajectory of Kazakhstan in the 1990s[5]. It is estimated that Kazakhstan has experienced a 45 percent drop in its GDP in the early 1990s.

Since 1996, with a brief interruption in 1998 due to the Russian financial crisis, the economy has registered positive growth rates in real terms.[4] Between 1992 and 1997,

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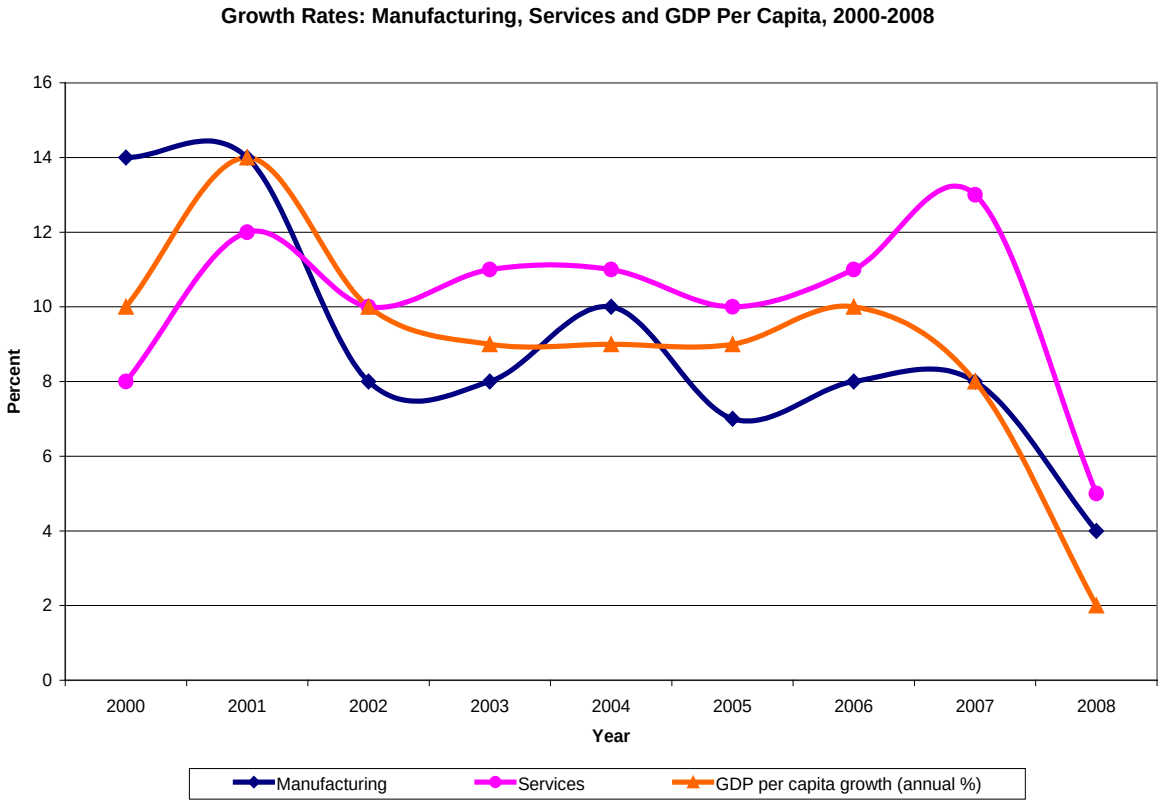
[2] Olivier Blanchard and Michael Kremer, "Disorganization," *Quarterly Journal of Economics*, 112, no. 4, 1091–127.
[3] European Bank for Reconstruction and Development, *Transition Report* (London: European Bank for Reconstruction and Development, 2008).
[4] International Monetary Fund, *Republic of Kazakhstan*, *IMF Country Report No. 10/241* (Washington, DC: International Monetary Fund, July 2010), http://www.imf.org/external/pubs/ft/scr/2010/cr10241.pdf

the Kazakh government liberalized most prices, imposed hard budget constraints on enterprises and banks, eliminated trade distortions and practically completed privatization of small- and medium-scale enterprises. Moreover, it has made substantial progress in reforming the banking and pension sectors, and has initiated programs aimed at augmenting the efficiency of financial and economic institutions. Consequently, the turn of the century, Kazakhstan emerged as one of the most vibrant, fast-growing economies not only among Central Asian republics, but also among other post-communist states.

Figure 1: Growth Rates: Manufacturing, Services and GDP per Capita, 2002-2008



Source: World Bank Data.

Figure 1 plots annual growth rates in manufacturing, the service sector and GDP per capita from 2000 to 2008. During this period the economy of Kazakhstan enjoyed strong growth rates in real terms (although it slowed down significantly in 2008).

Between 2000 and 2008, GDP per capita grew at an average annual rate of about 9 percent, and the manufacturing and the service sectors rose at an average rate of 9 and 10.1 percent per annum, respectively. However, the economic structure remained unchanged, since the mining, finance and construction sectors grew at comparable or higher rates. Given the high economic growth, the incidence of poverty declined from 46 percent in 2000 to 12 percent in 2007. Under these conditions, the greatest policy challenge was to manage the growing energy windfalls in such a way that would reduce the economy's dependence on the extractive sector for generating growth, revenues and foreign exchange.

The recent global economic downturn of 2008-2009 demonstrated that the economy of Kazakhstan is vulnerable to commodity price fluctuations and other external shocks because of its excessive reliance on a narrow production base and highly concentrated export basket. Furthermore, weak regulation of the financial sector magnified the impact the downturn had on the nation's economy and uncovered a direct link between the primary sector boom and excessive growth in the secondary booming sectors such as construction and financial. The downturn significantly limited banks' access to the international credit markets, and the financial sector began to experience a shortage of liquidity necessary to continue its routine activities. Moreover, a sharp decline in oil prices markedly depressed growth rates and hit both government budget revenues and foreign exchange earnings in 2009. Without any meaningful diversification of the economic structure and export basket, the Kazakh economy will continue to fall victim to fluctuations in commodity prices.

The rest of the paper is organized as follows. Section Two analyzes the structure of the economy and examines the dynamics of diversification in Kazakhstan since it adopted the diversification strategy. Section Three specifies the Kazakh government's development policy goals and discusses details of the diversification strategy. Section Four explores main factors that contributed to the diversification process in the context of the current policy debate, evaluates effectiveness of policies, and assesses the

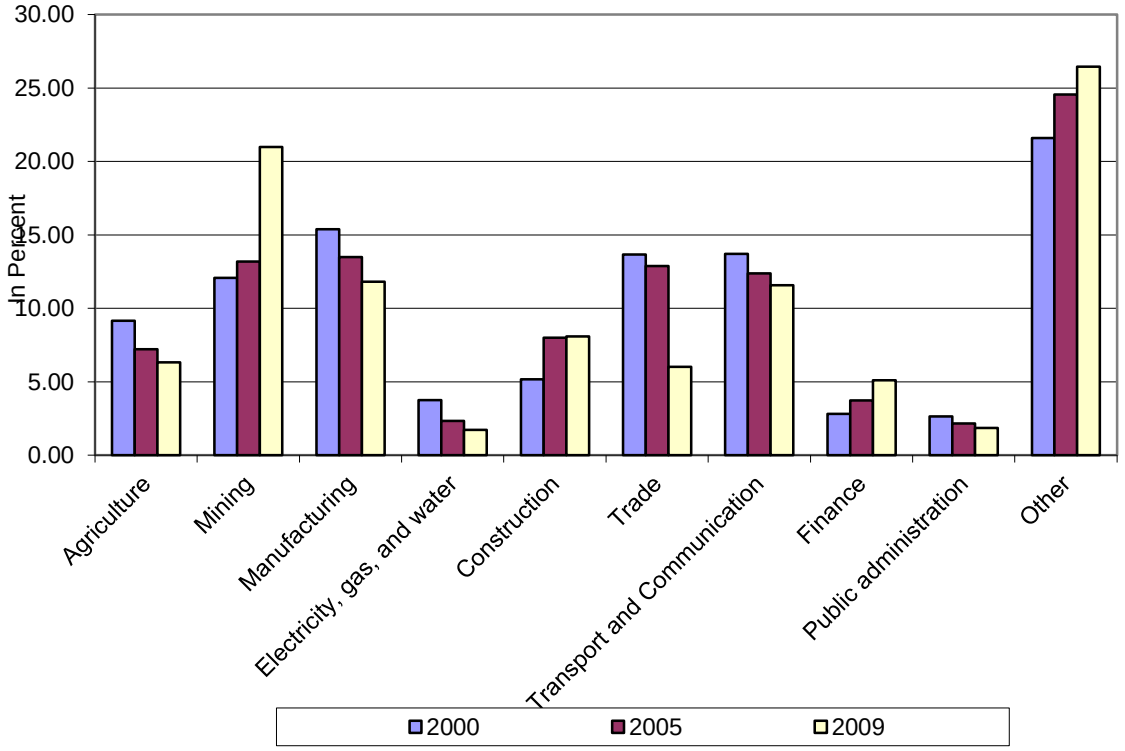
importance of resource revenues in driving the diversification process. The final section summarizes major findings and states policy implications.

Section 2. Diversification Trends

During the last decade, Kazakhstan has made significant advances in terms of real GDP growth that averaged 8.5 percent per annum in 2000-2009. Moreover, during this period main social indicators have substantially improved and the incidence of poverty noticeably declined. Yet, the economy's structure has not changed much, and the hydrocarbon sector continued to dominate.

As demonstrated in Figure 2, the structure of the economy has undergone some changes between 2000 and 2009. Since agriculture experienced slower growth throughout this period, its share in the total value added has significantly declined from 9.2 percent in 2000 to 6.3 percent in 2009. In a cursory look, it seems that what has been happening in the economy is consistent with the development trajectory experienced by developed countries throughout their development history. As these nations got wealthier, the share of primary sectors such as agriculture and natural resources steadily declined in their output, while manufacturing and service sectors gained additional ground.

Figure 2: Kazakhstan: GDP by Industrial Origin (2000, 2005 and 2009)



Sources: Asian Development Bank Data and author's calculations.

However, the share of manufacturing in total GDP has slightly declined during this period. Meanwhile, the mining sector has significantly increased its share in total output indicating that the development path of Kazakhstan over the past several years is different than the development trends experienced by wealthier countries in their early years of development. Figure 2 also indicates that the share of the service sectors in the total value added has markedly improved as predicted by the theory. In particular, the financial sector' has grown from about 3 percent in 2000 to slightly more than 5 percent in 2009.

The construction sector is another winner in the country's development process. The sector has seen almost a twofold increase of its share in the total output from 2000

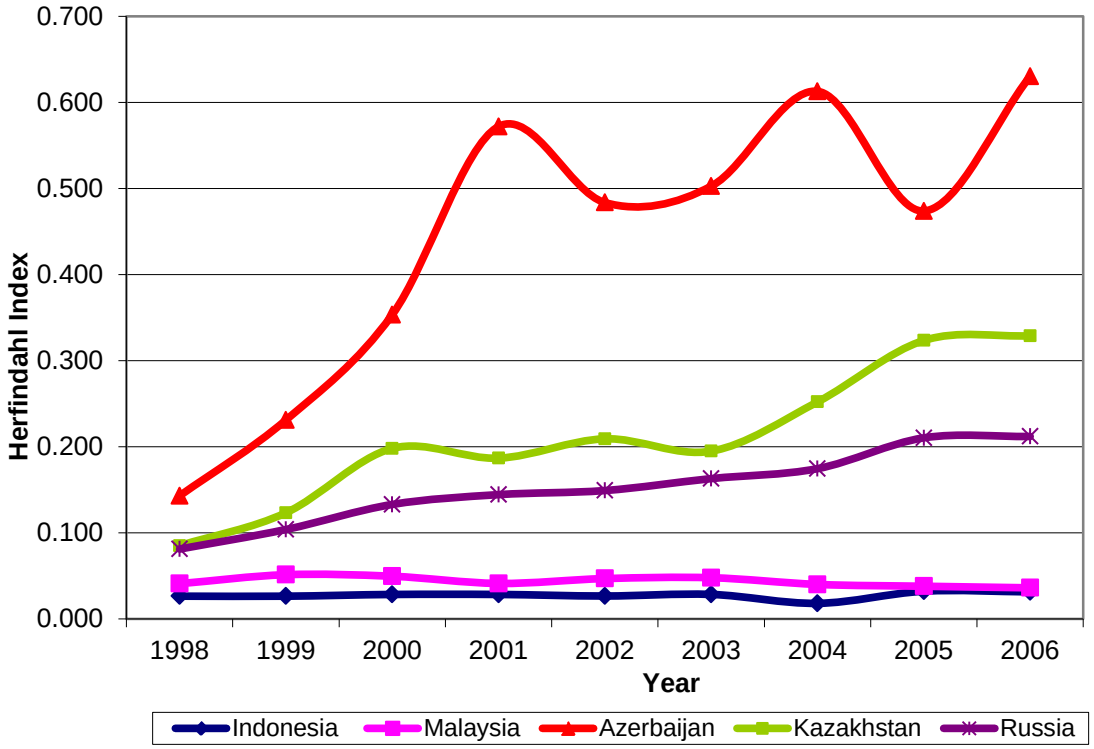
to2009. These significant changes in the structure of the economy within such a short period of time are related to the dominance of the extractive industry in the economy.

The mining sector accounts for the largest share of the total value added in Kazakhstan. Overall, the changes that occurred in the economy's structure during this period have not shifted the economic activity away from the mining sector. After about two decades of transition, the Kazakh economy still heavily depends on the resource sector for generating its GDP, revenues and foreign exchange earnings.[5]

Another widely used measure of diversification is export diversification that refers to deliberate policies intended to change the shares of commodities in the existing export mix, to introduce new products in the export portfolio, or to break into new geographical markets. Figure 3 presents export diversification index trends for selected countries, including Kazakhstan.

[5] When we calculated the HHI of economic diversification for two periods, THESE ARE TWO YEARS, NOT TWO PERIODS 1998 and 2009, the actual value got slightly worse between these two dates.

Figure 3: Export Diversification Index, 1998-2006



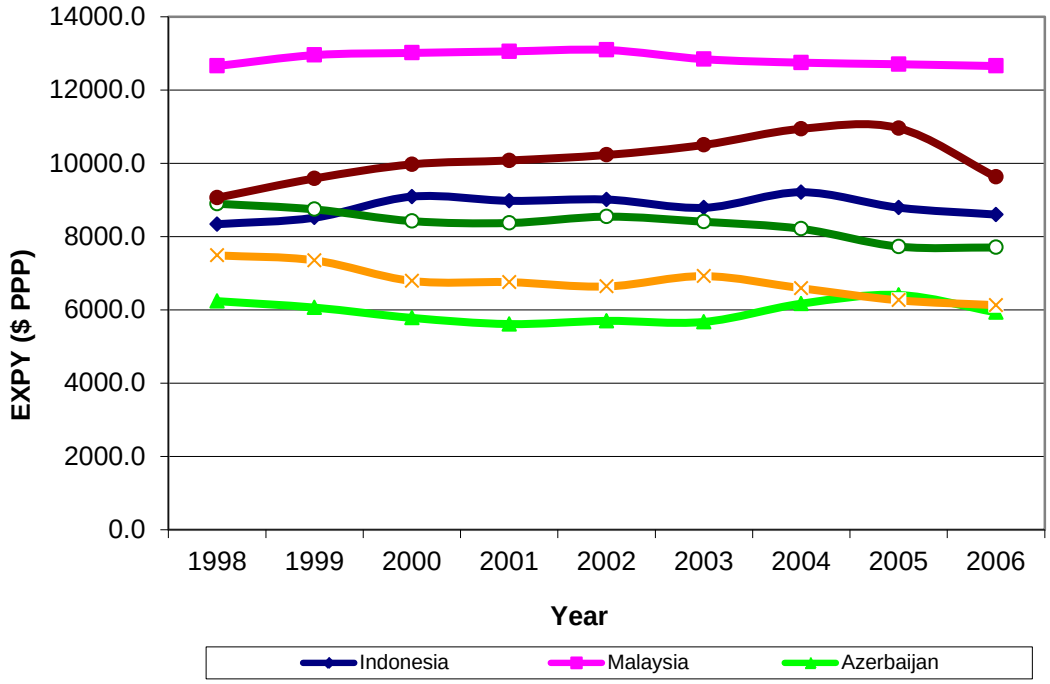
Source: World Bank Data. A higher number implies less diversification.

Greater values of the index indicate less export diversification. Figure 3 clearly demonstrates that from 1998 to 2006, the export structure of Kazakhstan became more concentrated or the export diversification index increased in values from less than 0.10 in 1998 to more than 0.30 in 2006. Other resource-rich countries in the region, Azerbaijan and Russia, have also experienced the similar trend, while the level of export concentration in Russia was significantly lower compared with Kazakhstan in 2006.

In Azerbaijan the trend is very volatile and the index is higher than the other countries in the sample. This can partially be explained by the fact that Azerbaijan is more

dependent on the oil sector and throughout the past decade the production of oil has significantly increased. Figure 3 also shows that Indonesia and Malaysia had more diversified export portfolios in 1998 compared with Kazakhstan or Russia, and the difference significantly widened by 2006 due to increased export concentration during this period in Kazakhstan.

Figure 4: Export Sophistication Index (EXPY), 1998-2006



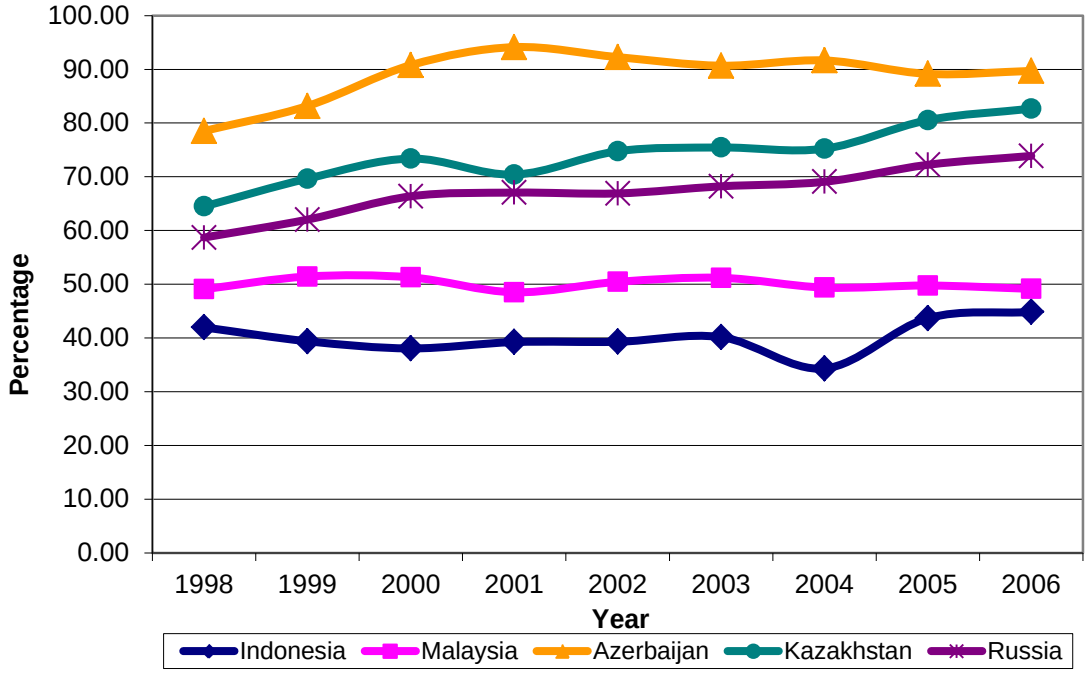
Source: World Bank Data.

Moreover, the export diversification index values for both Indonesia and Malaysia have not changed much during the sample period. It is most likely that high oil prices combined with new investment in the oil sector in Azerbaijan, Kazakhstan and Russia offset government efforts to enhance export diversification.

Recent empirical evidence illustrates that economic growth is faster in countries that export more sophisticated goods. Figure 4 presents the evolution of export sophistication index for selected countries. The higher the index number, the more sophisticated the exports. In 1998, the level of the index for Kazakhstan was higher than Azerbaijan, yet over the past eight years the index for Kazakhstan exhibited a downward trend. As figure 4 shows, in 2006 Kazakhstan exported less sophisticated commodities than it did in 1998. It implies that during this period Kazakhstan did not upgrade its export portfolio. In terms of export sophistication, only Azerbaijan has a similar level, and all other countries depicted in the figure exported more sophisticated goods, even though the income levels in these countries are comparable to Kazakhstan.

Figure 5 presents additional support for the premise that the past decade has brought no export diversification to the Kazakh economy. In this figure we depict shares of the 10 largest products exported over time in Azerbaijan, Indonesia, Kazakhstan, Malaysia and Russia. From 1998 to 2006, the share of the 10 largest products exported in the total export portfolio steadily increased from 65 percent in 1998 to about 82 percent in 2006. Two other resource-rich countries in the region—Azerbaijan and Russia—have also experienced a similar trend. In contrast, Indonesia and Malaysia, which had more diversified export portfolios in 1998, have been able to maintain their initial position achieved in 1998.

Figure 5: Ten Largest Products Exported (Percentage of Total Exports), 1998-2006



Source: World Bank Data.

While booming commodity prices from 2002 to 2008 helped the country benefit from its massive natural resource wealth, the policies and development plans designed to move the economy away from the resource sector have largely been unsuccessful. The recent global economic crisis of 2008-2009 clearly illustrated the risks of depending on a single industry. The Kazakh economy has been hit hard by the crisis, which severely slowed down its economic growth and uncovered vulnerabilities in the banking sector. The export earnings significantly declined, the fiscal performance deteriorated, and the government was forced to withdraw about $10 billion from its National Oil Fund to support the ailing banking sector.

Next, we discuss the main factors that could explain why Kazakhstan's diversification record has been disappointing during the past decade, despite the government's valiant

attempts. First we outline the diversification strategy that the government adopted, and then we analyze specific factors that hindered progress in this area.

Section 3. Evolution of the Diversification Strategy

There are two types of industrialization strategy: import substitution strategy and export promotion development strategy.[6] The development experiences of the East Asian tigers are dubbed export-led development, while the development strategies that many African countries adopted in the 1980s and 1990s are based on import substitution. By the early 1990s, the predominant view in the policy-making community was that development strategies based on import substitution policies were inferior to the export-led development model. Most governments discarded import substitution as a viable development strategy. This policy discourse profoundly influenced the choice of industrialization strategy in Kazakhstan. The development policies that the government pursued resembled the export-led development strategies adopted by the East Asian high-performing economies.

Upon completing the first generation of economic reforms and economic stabilization, the Kazakh government recognized the limitations of commodity-based economic development and the country's potential for rapid growth. The authorities announced a long-term development strategy for the first time in October 1997. This policy document was titled "Kazakhstan 2030: Prosperity, Security, and Improvement of Welfare of Citizens of Kazakhstan," or simply Kazakhstan-2030. This specified the following national development plans:

a) the Medium-term Development Plan for 1998-2000 to set the stage for growth to take off by finalizing political, economic and social reforms undertaken since 1991;

[6] For an overview of these strategies, see Michael Todaro and Stephen Smith, *Economic Development*, 9th ed. (Addison-Wesley, 2006).

b) the Strategic Development Plan of Kazakhstan until 2010 to list specific development targets to be met within Kazakhstan-2030's first 10 years; and

c) the Innovative Industrial Development Strategy of Kazakhstan to promote the manufacturing sector, to diversify the production base, and to reduce the oil sector's importance in the economy.

The document stated that the overall strategy would be implemented in three stages: (1) preparation (2003-2005); (2) active implementation (2006-2010); and (3) active diversification (2011-2015). The government is committed to spend $260 million (in 2002 prices) a year to implement Kazakhstan-2030. The document set a number of specific targets for the year 2015: the share of industry in GDP should increase from 46.5 percent in 2000 to 52 percent, whereas the share of the service sector in GDP should decline from 47.5 percent in 2000 to about 40 percent. The strategy assumed that the share of the mining sector in industrial output would increase from 31 percent in 2000 to 55 percent in 2015 in the absence of this strategy. The major focus of the Innovative Industrial Development Strategy was to produce export-oriented goods and services.

Moreover, the Strategic Development Plan until 2010 announced by the government in 2001 identified building a competitive economy as a priority and set a target of doubling the 2000 GDP by 2010. This plan called for more government involvement in the development process and assigned the government a special role in generating economic growth. The strategy clearly indicated that the state had to act as the locomotive of growth until a viable private sector emerges with long-term investment capacities. The plan stated that the government adopts an export-oriented development strategy and promotes production of high-tech goods that have a high value added. It also specified horizontal and vertical industrial policies to promote various sectors of the economy and identified the extractive, petrochemical and chemical sectors as export-oriented industries.

In 2003, the government made major progress in refining its development objectives by publicizing a series of development strategies. Among these documents, the most important ones were "The Rural Area Development Program for 2004-2010" and "The Innovative Industrial Development Strategy for 2003-2015" (IID). The government set up several development agencies to finance the development strategy and provided some guidelines as to how implement it. For the first time since 1991, the government accepted agriculture and rural development as a development priority and pledged to invest more than $1 billion from 2003 to 2005 for reviving agriculture. The announcement of IID signaled that the government was committed to more economic diversification and chose the export-led industrialization model as a way of achieving its development objectives. The IID was a comprehensive plan with detailed targets for industrial development. In particular, the document targeted 8.4 percent annual growth for manufacturing until 2015, at least a three-fold increase in labor productivity by 2015 compared with 2000, a two-fold reduction of GDP energy intensity measured as units of energy per unit of GDP, and more than tripling the 2000 level GDP by 2015 in real terms. The IID was estimated to cost $1.2 billion per annum in 2002 prices.

While these initiatives clearly specified diversification objectives and identified financing institutions, the execution and monitoring of the implementation process have not been clearly outlined in the government strategy. Furthermore, the IID made strong assumptions about the private sector and its participation in financing the diversification strategy. The Strategy admitted that the poor business environment kept the private sector from investing into nonresource sectors; however, it made public-private partnership central to the success of the industrialization strategy.

The government created several development institutions to carry out the IID: Kazakhstan Investment Fund, Kazakhstan Development Bank, Kazakhstan Innovation Fund and the Export Insurance Corp.. The IID specified decentralization, specialization, competition and transparency as main guiding principles for these development institutions. The decentralization principle is included to ensure that different sources

pay for private projects, to avoid relying too much on one development institution. The specialization principle sets out specific tasks for each development agency. The competition principle is supposed to provide fair competition in financing operations. And the transparency principle ensures that all state development institutions act in a transparent manner. This requires establishing a transparent system of corporate management and managers' accountability in handling government financial resources. It also ensures that government development institutions would recruit independent directors (well-trained foreign directors) and would use modern corporate management tools to use financial resources more effectively.

However, the transparency principle fails to require any sort of public oversight of these institutions or make them accountable to Parliament or the Kazakh people. As a consequence of this deficiency, corporate governance in state-owned development funds created to assist economic diversification has become less efficient, and this has hurt their performance. Without proper public oversight and accountability, development projects financed by the government and intended to support the diversification process have not achieved their original goals. For instance, the public does not have all the information about the financial and investment activities of the Sumruk-Kazyna Welfare Fund (SKWF). The government can fix this problem easily by asking state-owned funds to publicize all their financial and investment documents. This practice would give civil society organizations more opportunities to scrutinize the activities and make the funds' officials more accountable for their actions.

These new funds had specific mandates. The main objective of the Kazakhstan Investment Fund was to provide financial support for private initiatives through holding noncontrolling shares of enterprises both in Kazakhstan and abroad. The Kazakhstan Development Bank was established to provide medium- and long-term loans to the private sector and major state programs; the loans usually have low interest or below market rates and are expected to finance high-risk, long-term projects. The Innovation Fund was created to help develop high-tech innovation activities such as biotechnology,

nuclear technology and space technology, and to create techno-parks and research-intensive products in Kazakhstan. This fund also was supposed to provide financial support for applied research by making grants to scientists and research institutions. The Export Insurance Corp. was founded to provide insurance for export and import transactions against political and other risks. The government hopes that as a domestic insurance market develops, this corporation would provide insurance against political risks, and focus on marketing research and disseminating commercial information to domestic businesses about world markets.

In 2006 the president of Kazakhstan created two national development agencies to manage state assets and revenues. The first one, the Kazyna Sustainable Development Fund, absorbed all of the development agencies. Basically, this was done to improve management and increase efficiency. The fund's main task is to enhance innovative economic development that could boost the nation's industrial competitive edge and help the government carry out its diversification strategy. The other one, the Samruk State Holding Co., is charged with enhancing efficiency and accountability of managing state assets. By mid-2007, Kazyna has invested about $2 billion in various domestic development projects, and Samruk has started representing the state in major national companies. In 2008 these two merged to form the National Welfare Fund Samruk-Kazyna (NWF Samruk-Kazyna), and the government allocated additional $5 billion to boost its capitalization.

The NWF Samruk-Kazyna assists economic diversification and modernization, helps increase the long-term value of fund's companies, and implements state programs that support the financial sector. During the recent crisis of 2008-2009, the government used the fund to support the real estate and financial sector, along with small to medium enterprises. Basically, the fund manages the state's assets and participates in stabilizing the economy and investing government funds abroad. The fund's total assets equal 52 percent of GDP, and it employs 3.5 percent of country's total workforce.

On Feb. 1, 2010, the president issued a decree outlining the country's development strategy to 2020. This is the second stage of –Kazakhstan-2030. One of the top priorities is to achieve sustainable economic growth through accelerated diversification of the economy and industrialization, and developing better infrastructure.

According to the strategy, accelerating economic diversification would be done by promoting an active industrial policy with various policy instruments. The government has targeted the following sectors for this: the traditional extractive industries and new sectors capable of supplying goods to them; national companies; the government; sectors unrelated to the extractive one; and high-tech sectors such as information technologies, biotechnology and alternative energy sources. In addition, the strategy sets specific targets to create a favorable business environment through improvements in business legislation and financing.

The next section examines in detail the factors that derailed the diversification strategy since it started.

Section 4. Reasons for the Ineffectiveness of Diversification Policies

The adoption of the Strategy was driven by concerns about the challenges and opportunities the extractive sector may pose in the future. The Strategic Development Plan stated that while the availability of an enormous resource windfallhelps pay for development projects, it curbsthe tradable sector's competitiveness and makes the country more dependent on the resource sector. Therefore, the development strategy was designed to use the resource rents that the government accrued to promote the diversification process. The government also recognized that diversification is essential to sustained development, and short-term resource windfalls present great challenges to making policy in the absence of a well-defined development strategy. As a consequence, the development strategy made the resource sector a driver of the structural transformation process.

Yet, decade-long efforts to reduce the country's dependence on the extractive sector produced lackluster results. The factors that hampered economic diversification can be classified as follows:

a) Misaligned economic policies and weak regulation of the financial sector.
b) Adoption of an inadequate diversification strategy.
c) Underdevelopment of political and economic institutions.

In addition, geography also contributed to the failure of diversification efforts. Kazakhstan's distance to major trading partners, limited access to seaports, and harsh climate are strikes against it in economic terms, and the government cannot do anything about these limitations.

By the turn of the century, the economic environment in Kazakhstan had largely stabilized; inflation was brought to a moderate level, the financial sector was reformed, the fiscal house was put in order, exchange rates became stable, and the trade regime was mostly liberalized. Yet, the global economic crisis of 2008-2009 hit the Kazakh economy hard. The fiscal situation significantly deteriorated, and the financial sector suffered significant losses. The overall fiscal balance dropped from the surplus 1.1 percent of GDP in 2008 to the deficit -1.5 percent of GDP in 2009.

In response, the government introduced a large-scale stimulus package using money amassed in the National Oil Fund during the boom period. The total value of the anti-crisis program was estimated at about 9 percent of GDP; it was mainly spent on bank bailouts. This timely policy helped stabilize the banking sector and limited the impact of the global financial crisis on growth and employment.

The crisis exposed the tension between short-term stabilization policies and long- term development efforts. On the one hand, the government achieved macroeconomic

stability and amassed a larger portion of resource windfalls in the oil fund for a rainy day and future generations. Yet on the other hand, these large savings hampered government efforts to effectively implement the economic diversification strategy. The government kept much of its oil revenues outside the country, rather than investing them in the national economy to maintain macroeconomic stability. At least some of these savings could have been spent domestically to build physical infrastructure and develop human capital. This spending would have improved the business environment and provided incentives for private investment. However the government favored short-term stabilization over long-term diversification.

Although the authorities have maintained macroeconomic stability and advanced the structural reform agenda, there was some disconnect among the industrialization strategy, savings and fixed capital investments. It is apparent from the development strategy that the government is relying upon the extractive sectors and, to a lesser degree, household savings to finance its industrialization strategy. While the commodity boom generated about $32 billion from 1999 to 2007 and the government of Kazakhstan managed to save approximately 66 percent of total oil revenues, the global decline of commodity prices and weakened fiscal position of the government made the accumulation rate significantly decelerate. Kazakhstan's fiscal revenues from oil increased from $1 billion in 2001 to $17 billion in 2008. Until 2008, government spending remained relatively constant as percentage of GDP.

Household savings have also increased during the past eight years mainly in the form of pension fund accumulations. These private funds have invested their assets in capital markets. In 2007 the total assets of the pension funds reached 9.5 percent of GDP, which is more than a two-fold increase from the 2000 level. The global financial crisis of 2008-2009 and drop in the value of stock markets across the globe adversely impacted capital markets; consequently, private pension funds in Kazakhstan have lost some of their value. While the government has had sufficient financial resources to fund its diversification plan, it may run into problems in the future if it does not have a well-defined savings policy.

Table 1: Breakdown of Capital Investment by Sectors in 2001-2007

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Total investment	100	100	100	100	100	100	100
Agriculture, hunting and forestry	1.7	1.4	1.3	2.0	1.6	1.1	1.2
Mining	51	41.5	35.5	27.0	22.3	22.8	24.4
Manufacturing	9.8	9.4	9.9	11.8	10.9	10.6	9.4
Electricity, gas and water	4.4	2.5	2.1	1.6	1.4	1.4	1.9
Construction	2.2	4.6	6.2	8.9	12.3	12.6	12.2
Trade, car repair and household goods	3.2	4.3	4.4	5.3	4.7	4.4	3.0
Hotels and restaurants	0.7	0.3	0.3	0.5	0.3	0.3	0.2
Transport and communication	14.5	11.1	12.3	11.4	8.1	8.3	8.3
Financial	1.4	0.9	0.9	1.0	1.3	1.5	1.9
Property (real estate)	5.1	12.6	14.4	17.8	25.3	23.4	21.1
Public	1.4	9.7	11	11.2	10.6	12.0	14.8
Education	1.3	0.7	0.7	0.5	0.4	0.4	0.6
Health and social	1.2	0.4	0.2	0.3	0.2	0.3	0.3
Other municipal, social and personal services	2.1	0.6	0.8	0.8	0.5	0.8	0.6

Sources: Agency of the Republic of Kazakhstan on Statistics data and author's calculations (current prices).

Investment in fixed capital is a far better predictor of economic growth than the savings rate, though there is no investment without prior savings or borrowing. Table 1 presents the composition of investment in fixed capital across sectors as a percentage of total investment in 2001-2007. Broadly speaking, patterns of investment in fixed capital across sectors do not fit well with the industrialization priorities adopted in various government development programs. A lion's share of capital investment went to the mining sector in 2007. The second biggest recipient was the real estate sector, which received 21.1 percent of the total capital investments in 2007. In 2001-2007, the share of the construction sector in the total capital investment grew dramatically from 2.2 percent in 2001 to 12.2 percent in 2007, while the share of the real estate sector in the total capital investment has increased by about four times during this period. Over this period the share of the manufacturing sector in the total capital investment has not

changed much. However, the share of the transportation and communication sectors in the total investment has declined from 14.5 percent in 2001 to 8.3 percent in 2007.

The actual investment in 2000-2007 was not pro-diversification and largely helped the extractive sector strengthen its dominance in the economy. The manufacturing sector over this period has been recipient of only 10 percent of total investments. With the current pattern of capital investment, Kazakhstan greatly jeopardizes the sustainability of its growth potential and could encounter difficulties in meeting the targets set in the diversification strategy. Furthermore, despite relatively high returns on capital, Kazakhstan has not attracted large capital inflows into its non-oil sector. This may be due to constraints, such as backward technology and weak institutions, that significantly limit any potential high returns.

Banking Sector

The banking sector dominates financial intermediation in Kazakhstan. The financial sector in general and the banking industry in particular have undergone a comprehensive reform process since the collapse of the Soviet Union. In 1991, the Kazakh financial system consisted of the National Bank of Kazakhstan (the central bank or NBK), five state-owned banks and 72 commercial banks licensed between 1988 and 1991. Within the first two years of independence, the number of commercial banks operating in the country increased dramatically to more than 200, with the total assets of a few hundred million U.S, dollars. Yet the majority of them were undercapitalized, and these banks were mainly created to serve the financial needs of state-owned enterprises.

By 2002, the NBK has consolidated the supervisory function over the entire financial system, including banks, insurance companies, the stock market and pension funds. Then the government established a new entity to transfer the supervisory function from the NBK to the Financial Supervision Agency of the Republic of Kazakhstan (FSA). This

new agency is tasked with implementing the regulation and supervision of the financial system. By 2004 Kazakhstan arguably has created the most dynamic financial sector in the CIS, albeit its capital markets are not as liquid as those in Russia. The sweeping changes in the financial intermediation during this period have created a favorable environment for the growth of the banking sector in Kazakhstan.

In 2000-2007, Kazakh banks heavily borrowed from abroad and accumulated external debt of $44 billion (40 percent of GDP). Much of this money was used to provide loans for real estate, construction and consumer durables. When the global economic crisis began in 2008, capital stopped flowing into the country and Kazakh banks experienced shortages of liquidity. Four were forced to restructure their external obligations and nonperforming loans. The weakly regulated financial sector—specifically its shortcomings in supervisory and regulatory frameworks—created incentives for banks to borrow from abroad and lend the nontradable sector. The government overlooked the potential risks this practice posed to financial stability and the economic diversification strategy.

For comparison, when several East Asian countries went through industrialization phases, their governments discouraged investment in real estate in order to channel limited resources into the high-return manufacturing sector. Some of these nations put restraints on luxury consumption from abroad and created government postal-run savings schemes with high levels of security, while others have followed financial restraint policies to reduce competition among banks and keep profits up. Since the marginal propensity to save was higher for corporations than for households, this policy increased the overall rate of savings, hence contributing to higher growth.[7] Over the past several years, the pattern of the capital investment in Kazakhstan has indicated that the government lacked policies aimed at discouraging the private sector—specifically banking—from taking excessive risks. This small difference in government

[7] Joseph Stiglitz, "From Miracle to Crisis to Recovery: Lessons from Four Decades of East Asian Experience," in *Rethinking the East Asian Miracle*, eds. J. Stiglitz and S. Yusuf (Oxford: Oxford University Press, 2001), 509-26.

policies unsettled economic diversification efforts and greatly jeopardized the sustainability of Kazakhstan's growth potential.

Diversification Strategy

The development model of the East Asian countries and the development strategy of Kazakhstan share some similarities. In regard to export promotion, these states have used different policies, but the objective was to boost exports to technologically advanced countries and absorb knowledge to narrow the technological gap and thus increase productivity. Most of the newly industrialized East Asian countries started their industrial transformation with production of labor- and resource-intensive goods, and then gradually moved up the ladder of comparative advantage to produce skill- and knowledge-intensive products.[8]

In contrast, the government of Kazakhstan started its export-driven industrialization policy by supporting the high-tech sectors, hoping that they would be able to compete in the world market in the future. Given the presence of relatively well-educated labor and some physical infrastructure at the onset of the country's development journey, this course of action seems to be well justified. Yet by deciding to skip an important step in the industrialization process, producers in Kazakhstan missed the opportunity of assimilating valuable experience in business organization or entrepreneurial skills.

Another diverging point stems from labor productivity trend. As East Asian countries developed, they continuously improved their labor productivity, while Kazakhstan paid little attention to its productivity. Table 2 presents a dynamics of labor productivity

[8] John Weiss, "Export Growth and Industrial Policy: WHEN I LOOKED THIS UP, I FOUND "LESSONS FROM EAST ASIAN MIRACLE EXPERIENCE" NOT An Overview of East Asian Experience," SO DOUBLE-CHECK ADB Institute Discussion Paper No. 26 (Tokyo: Asian Development Bank Institute, 2005).

index for selected sectors in 2001-'09. The table shows that the total labor productivity grew until 2007 and since then has not changed much.

Table 2: Labor Productivity Growth in Selected Sectors (2000=100)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Overall productivity	105.5	115.8	122.0	130.5	142.4	155.8	167.5	167.5	167.8
Agriculture, hunting and forestry	96.2	99.5	98.2	100.3	110.1	117.4	125.2	118.3	136.6
Mining	94.0	108.8	110.5	121.9	125.9	133.5	132.3	134.8	146.6
Manufacturing	126.8	139.2	149.5	160.4	165.3	173.9	182.2	175.8	171.6
Construction	109.1	128.2	114.7	113.6	145.3	178.7	185.8	182.3	175.6
Hotels and restaurants	126.6	149.4	149.4	150.7	169.4	179.4	189.5	192.5	186.5
Transport and communication	118.9	131.4	144.7	157.4	171.9	187.3	205.9	208.8	209.2
Financial activity	102.0	109.0	120.8	133.4	164.3	210.3	269.0	242.4	205.5

Source: Agency of of the Republic of Kazakhstan on Statistics.

In 2001-2009, the service sectors witnessed significant improvements in their productivity. In particular, the financial and transport and communications sectors have grown: the former almost doubled, and the latter more than doubled. The manufacturing sector grew until 2007 and with the start of the global economic crisis the trend has reversed and in 2009 labor productivity in this sector was significantly lower than its value in 2007. In contrast, labor productivity in the mining sector continued to grow despite the decline in productivity in other sectors of the economy. In general, inter-sectoral productivity gaps are a feature of underdevelopment, and those gaps are wider in poor countries. Over the course of development, labor productivity disparity declines as countries get wealthier. Growing disparity in labor productivity across sectors puts the entire diversification program of the government at a risk.

Reflecting deteriorations in the productivity index, the competitiveness of the Kazakh economy steadily worsened after 2007. Table 3 provides information on a number of dimensions of the global competitiveness index of Kazakhstan. In 2009-2010, the score of the index for Kazakhstan was 4.1 and was ranked 67th out of 133 countries included.

A couple of years back, it was ranked 61st out of 134 countries even though the index score was the same. However, Kazakhstan ranks lower if we look at institutions, infrastructure or market efficiency. International experience suggests that as countries move along the development path, they go through three stages of competitiveness. In the first one, the economy is factor-driven and countries compete based on their factor endowments. In the second, countries move into efficiency-driven competition, and in the third, innovation is far more important to sustain economic development.

For countries such as Kazakhstan that fall between the first two stages, maintaining competitiveness mainly hinges on well-functioning institutions, infrastructure and macroeconomic stability. For countries that are in the efficiency-driven stage, a wide range of factors that enhance efficiency are important to compete globally. The recent government policies in Kazakhstan have not significantly improved institutions and basic infrastructure. If Kazakhstan wants to compete successfully in the global market with other countries, it needs to improve its infrastructure and institutions.

Table 3: Global Competitiveness Index (GCI), 2009-2010

	Rank (out of 133)	Score (1 to 7)
GCI 2009-2010	67	4.1
GCI 2008-2009	66	4.1
GCI 2007-2008	61	4.1
Basic requirements	74	4.3
Institutions	86	3.6
Infrastructure	75	3.5
Macroeconomic stability	59	4.7
Health and primary education	80	5.2
Efficiency enhancers	69	4
Higher education and training	59	4.1
Goods market efficiency	84	4
Labor market efficiency	18	4.9
Financial market sophistication	111	3.5
Technological readiness	69	35

Market size	55	4.2
Innovation and sophistication	78	3.4
Business sophistication	88	3.7
Innovation	64	3.1

Source: *The Global Competitiveness Report 2009-2010*, World Economic Forum.

In general, in designing its diversification strategy the government of Kazakhstan relied too much on the experience of fast-growing East Asian countries and borrowed many policies without due modification. As a result, the economy has experienced little change in its structure over the past decade. Without modifying its economic diversification strategy, the government is likely to run into new challenges during the implementation process.

Quality of General and Specific Institutions

The empirical literature provides clear evidence that institutional quality is associated with a measure of diversification.[9] Basically, the diversification process has been more successful in those countries that managed to improve quality of their institutions. Because good institutions are conducive to enhancing credibility of government policies, they send a positive signal to potential investors about the business environment and also help attract more FDI.

Over the past decade, Kazakhstan have made some improvements on such dimensions of governance like rule of law and government effectiveness, while failing to make progress on other important dimensions like voice and accountability. In 2000-2009, according to World Governance Indicators, the percentile ranking of government effectiveness increased from 20.4 to 48.1, whereas rule of law indicators increased from 20.5 to 34.9. Yet, during the same period, the percentile ranking of the voice and

[9] I'VE FIXED THIS, BUT ARE WE SURE IT WAS ABOUT AFRICA??? TEXT TALKS ABOUT EAST ASIA. Organisation of Economic Co-operation and Development, *Economic Diversification in Africa: a Review of Select Countries* (Paris: OECD/UN, 2010).

accountability indicator has actually decreased from 22.1 to 19. In addition, government efforts to reduce corruption have brought limited results.

In 2009, the corruption perception index developed by Transparency International ranked Kazakhstan 120 among 180 countries. Kazakhstan shared this ranking with the following five countries: Armenia, Bolivia, Ethiopia, Mongolia and Vietnam. In terms of per capita income, Kazakhstan is far more advanced than these countries and classified by the World Bank as an upper middle-income country, while the other five countries belong to the lower and lower middle-income group. Compared with its level of development, corruption is much higher in Kazakhstan, and this level of corruption signals to potential investors that institutions are weak in the country. The ultimate outcome is lower investment, less efficiency and misallocation of economic resources.

According to the Global Competitiveness Report, the most problematic factor for doing business in Kazakhstan was corruption in 2010. Table 4 presents information about that and the six other binding constraints. As shown, about 19 percent of respondents answered that corruption is the most problematic factor. The respondents also indicated that inflation, access to financing and tax rates are important factors that limit the business activity in the country.

Table 4. The Most Problematic Factors for Doing Business

	Percent of responses
Corruption	19.2
Inflation	14.4
Access to financing	11.9
Tax rates	11.1
Tax regulation	11
Inefficient bureaucracy	7.5
Inadequately educated workforce	4.8

Source: *The Global Competitiveness Report 2009-2010.*

In addition, according to a Freedom House report, democracy has failed to consolidate in Kazakhstan, and political institutions have steadily deteriorated. In 2001-2008, the democracy score increased from 5.71 in 2001 to 6.32 in 2009, reflecting a worsening of the electoral process, civil society and independent media, since lower scores of the index represent a higher level of democratic progress. In particular, weak civil society and independent media slowed the formation of transparent, accountable government. Lack of checks and balances have become a major problem that significantly reduced efficiency and effectiveness of government programs intended to foster the industrialization process. As a result, regardless of a well-designed diversification strategy, the final outcome has been below the target level.

While the absence of well-developed political and economic institutions constrained FDI flows into the nonresource sectors and increased the cost of doing business in the country, poor performance of specific economic institutions like as the NWF Samruk-Kazyna that were created to foster the economic diversification process have negatively influenced the pace of the diversification process. The NWF was created to manage the state assets and to support economic stabilization and diversification. It has played a major role in implementing the anti-crisis program since 2009. The fund holds interests in mining, finance, energy, transportation, property and construction. It is also the sole shareholder of the Kazakhstan Development Bank. The value of the NWF assets reached nearly 55 percent of GDP in 2010. In coming years the agency plans to invest $40 billion to promote economic diversification in Kazakhstan.

There are a number of reasons why the NWF is unable to effectively fulfill its functions. First, the fund's goals are broadly formulated and lack the specification of measurable performance indicators. The fund is supposed to facilitate economic diversification and modernization, maintain financial stability, and manage assets of state-owned companies. Implementation of these functions requires different sets of skills and a unique management model. It is very challenging for any single institution to effectively perform these multiple tasks. Second, it is difficult to distinguish the fund's social and

commercial objectives. Third, the fund unduly benefits from unconditional government support and fosters an unhealthy competition while it tries to maximize returns on its investment.

The biggest problem the fund faces is lack of transparency. The governing board does not include any representatives from NGOs. In addition, the system of checks and balances is quite weak. The principles of sharing power are bluntly violated, since all the power to make any decisions is concentrated in the hands of one agency.

Timur Kulibayev, a billionaire businessman, was named the CEO of the fund in 2011. He is widely perceived as one of Kazakhstan's most influential businessmen. At the same time, he is chairman of several companies that NWF controls, including the national oil and gas company KazMunaiGas, railway operator Kazakhstan Temir Zholy and power producer Samruk-Energo. Kulibayev also heads the KazEnergy Association, the nation's powerful oil and gas lobbying group. He also happens to be the son-in-law of Kazakh President Nursultan Nazarbayev. This appointment created some potential for nepotism and served as a signal that the president and his family are trying to gain full influence over big business.

The government of Kazakhstan needs to downsize the agency and transfer some of its functions, such as development-related activities and financial stabilization, to line ministries and other government institutions. Moreover, the governing board of the agency needs to invite at least two people from civil society groups and develop clear performance indicators.

Finally, geography matters for economic development. A landlocked country not only suffers from high transportation costs, but also depends upon the transportation infrastructure of its coastal neighbors. Kazakhstan's two biggest trade partners are China and Russia. They can be considered as potential export corridors to the seaports. The level of development in Russia is more or less comparable with the living standards

in Kazakhstan, while China is poorer than Kazakhstan in terms of per capita GDP. Traditionally, Kazakhstan has close trade relationships with Russia, and its economic ties with China are growing. While both China and Russia are emerging economies, Russia's economic structure is not that different from Kazakhstan's in many respects, and China has superior technological capacities and manufacturing sectors relative to Kazakhstan. This created certain disadvantages for Kazakhstan and created challenges for the industrialization process. If the nation continues to increase trade flows with these two neighbors and pays less attention to more advanced trade partners, then it risks upsetting its export-led industrialization strategy, since China and Russia have little to offer in terms of advanced technology. However, they have large, growing domestic economies and could serve as potential markets for Kazakh products and services.

The geographical location of Kazakhstan has hampered its efforts to find a niche in the world markets. The government should take these factors into consideration when designing its diversification policy.

Section 5. Conclusion

Since Kazakhstan became independent in 1991, it has undergone dramatic economic and political transformations. By the turn of the century, Kazakhstan completed most first-generation reforms such as trade liberalization and privatization, and some in the financial sector. It made significant advances toward a market economy. The commodity boom of 2003-2008 combined with prudent macroeconomic policies of the government fuelled strong economic growth during that time. From 2000 to 2008 real GDP growth averaged around 8.5 percent a year, while the fiscal position of the government remained strong, reflecting high commodity prices.

Understanding the potential challenges associated with depending on the resource sector, the authorities designed a long-run development strategy for Kazakhstan in 1997 and started to implement its first stage in 2001. This adopted many features of the East

Asian development model and aimed to use windfall revenues of the resource sector to develop nonoil sectors. The development plan identified a number of priority sectors to be supported by the government to accelerate its industrialization process. The authorities also created special development agencies to aid the diversification process by properly channeling government funds.

The analysis demonstrated that despite the government's massive efforts, there has been little progress in terms of diversifying the production base and export portfolio. After a decade of implementing the development strategy, the structure of the economy remained unchanged, and the economy continued depending on the extractive sector for generating revenue and foreign exchange reserves. We emphasized that misaligned economic policies and weak institutions were two major factors that held back private investment in the manufacturing industries. Basically, strong market reforms have not been followed by similar market-oriented institutional changes, and this situation created a tension between advanced market reforms and weak institutions. Furthermore, the country's location impeded the diversification process and forced the government to make additional efforts. The uneven path of economic and institutional reforms has led to unbalanced growth across different sectors. Neither the structure of economy nor the export basket have experienced a significant shift.

The analysis indicated that Kazakhstan attempted to use the East Asian development strategy with little modification and faced significant challenges. Any development model borrowed from other countries needs to be adapted to local conditions. In addition, activities of the special government institutions established to aid diversification should be transparent, and these public agencies should not compete with private entities.

In sum, the results of Kazakhstan's diversification policies have been disappointing and made it clear that the government needs a better strategy if it wants to sustain strong economic performance based on broad-based economic growth. In particular, the

government should focus on improving its infrastructure and institutions. Creating various government agencies to support the export-oriented industrialization strategy without addressing basic infrastructure needs and improving governance is not sufficient to shift the economy away from the resource sector. Furthermore, the diversification strategy should be closely linked to the short-term management of natural resource revenues. While short-term macroeconomic stabilization is important for shifting the economy away from the resource sector, without a well-designed diversification strategy and better institutions, the diversification process hardly makes any progress. Economic policies in Kazakhstan focused more on short-term revenue management and paid less attention to long-term development challenges.