

ASIAN DEVELOPMENT BANK

TAR: KAZ 37318

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO THE

REPUBLIC OF KAZAKHSTAN

FOR

FINANCIAL SECTOR GOVERNANCE

November 2004

CURRENCY EQUIVALENTS

(as of 1 November 2004)

Currency Unit	–	tenge (T)
T1.00	=	\$ 0.0076
\$1.00	=	T131.97

ABBREVIATIONS

ADB	–	Asian Development Bank
CSP	–	country strategy and program
FSAK	–	Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan
GDP	–	gross domestic product
IAIS	–	International Association of Insurance Supervisors
IMF	–	International Monetary Fund
IOSCO	–	International Organization of Securities Commissions
IT	–	information technology
KASE	–	Kazakhstan Stock Exchange
NBK	–	National Bank of Kazakhstan
TA	–	technical assistance
USAID	–	United States Agency for International Development

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	–	Targeted Intervention
Sector	–	Financial Sector
Subsector	–	Finance Sector and Development Reforms
Theme	–	Governance
Subtheme	–	Financial and Economic Governance

NOTE

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. The Government of Kazakhstan (the Government) has requested technical assistance (TA) from the Asian Development Bank (ADB) to improve governance in support of financial sector development. A Mission visited Kazakhstan from 3 to 9 August 2004 to undertake an initial needs assessment and design a TA to address some of the governance issues in the sector. The Mission reached an understanding with the Government on the objectives, scope, cost estimates, terms of reference, and implementation arrangements for the TA. The logical framework is in Appendix 1.¹

II. ISSUES

2. In recent years, the Government has embarked on significant reforms in the financial sector. A key measure in this direction was taken in January 2004 with the establishment of an independent financial sector regulator and supervisor for bank and nonbank financial institutions, i.e., the Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan (FSAK). This was preceded by measures to improve the soundness of the banking system: capital requirements have gradually been raised and the framework for market entry and exit has been put in place. A deposit insurance system was also created in 1999 to improve confidence in the banking system and to mobilize savings. The infrastructure for domestic equity and bond markets has been established. A fully funded pension system was successfully launched in 1998. Favorable macroeconomic developments, including a significant increase in revenues from export of natural resources, have facilitated these reforms. As a consequence, financial intermediation has increased, with the ratio of broad money to gross domestic product (GDP) growing from 14% in 1999 to 22% in 2003. Financial sector indicators and key macroeconomic indicators are shown in Appendix 2.

3. Notwithstanding these positive developments, the financial sector in Kazakhstan remains largely underdeveloped. The recent gains achieved were mainly due to improvement from a relatively low base. The domestic securities market, for instance, has yet to become a relevant source of financing for the entire enterprise sector. In 2003, corporate bond and equity issuance together amounted to only 0.8% of GDP. With limited domestic investment opportunities, an increasing proportion of funds accumulated under contractual savings schemes is invested abroad. On the other hand, bank lending has grown rapidly. However, more recently, the quality of bank loans has deteriorated: 39% of the loan portfolio was classified as substandard, doubtful, or loss at the end of 2003, compared with 23% at the end of 2000. As important, the growth of household deposits has lagged behind the overall growth of bank lending due to lack of confidence in banks. Banks have increasingly relied on external borrowing to meet the growing demand for lending. This has created risks (due to currency mismatch) in the financial system, as seen in Asia before the 1997 financial crisis. To minimize this vulnerability, the authorities will have to promote a more balanced development of the financial sector to enable the sector to mobilize domestic resources and channel them, as well as growing revenues from exports of oil and minerals, into investment projects in other sectors of the economy.

4. Recognizing these weaknesses in the financial system, the authorities aim to bring regulation and supervision fully in line with the Basel Core Principles for Effective Banking Supervision, the Objectives and Principles of Securities Regulation established by the International Organization of Securities Commissions (IOSCO), and the Principles of the

¹ The TA first appeared in *ADB Business Opportunities* (Internet edition) on 12 July 2004.

International Association of Insurance Supervisors (IAIS) by 2007.² Full compliance would also lay the groundwork for Kazakhstan to move closer to its goal of becoming a financial hub in the broader Central Asian region.

5. To ensure overall macroeconomic and financial stability, the authorities are also seeking to establish a monetary policy based on an inflation-targeting³ framework. This is being pursued with the objectives of (i) anchoring inflationary expectations, thereby increasing predictability of interest rate setting; (ii) strengthening the capacity of the economy to absorb exogenous shocks, including those stemming from changes in terms of trade; and (iii) increasing the liquidity and variety of traded securities. Introducing inflation targeting requires technical preparation. First, the money market must be developed to ensure market depth and liquidity for effective pricing of demand and supply of loanable funds. Second, infrastructure needs to be developed, including a suitable economic model to support the decision making of the National Bank of Kazakhstan (NBK) by showing how changes in NBK's policy variables affect the economy. Further, market surveys gauging inflationary expectations must assess enterprise and household perception of future inflationary trends.

6. With respect to national wealth, the authorities are stepping up efforts to improve governance for better management of official reserves and the rapidly growing National Fund by NBK. This fund was established in 2001 to absorb and stabilize the Government's excess oil revenues and preserve them for future generations. At the end of 2003, official reserves together with the National Fund amounted to \$8.7 billion, or 29% of GDP. As such, NBK is the largest institutional investor in Kazakhstan. To meet this challenge, NBK aims to further strengthen its governance by improving accountability and preventing fraud and corruption. The mechanism for establishing and implementing NBK's investment policy is not yet in line with international best practices. For instance, no policy or formal mechanism exists for monitoring the recruitment, performance, and dismissal of external asset managers. No formal mechanism exists to ensure that internal asset management is in line with a particular investment policy. NBK's internal audit frequently notes violations of limits and investment guidelines. Further, no policy is in place on ethics or conflict of interests that prevents NBK's traders from abusing confidential information. NBK has no integrated and automated system for risk management. No independent risk management unit exists to support the work of the recently established risk management committee.

7. As a step to address key constraints on the financial sector, the Government established in June 2004 an interministerial commission to prepare a financial sector development strategy. The Government, through NBK and FSAK, has also requested ADB for advisory TAs to strengthen governance in the financial sector to promote the development of the sector. As financial resources are available overall, the primary interest is in knowledge products that ensure the efficient use of resources. The request is in line with ADB's Country Strategy and Program (CSP)⁴ for Kazakhstan. The increasing importance the Government attaches to strengthening financial sector governance has been acknowledged in ADB's 2004 CSP Update⁵.

² The Financial Sector Assessment Program of the International Monetary Fund and the World Bank concluded that—in early 2004—6 out of 25 Basel Core Principles for Effective Banking Supervision were materially not complied with. The assessment also identified remaining weaknesses as measured against IOSCO and IAIS principles.

³ Inflation targeting is a framework for policy decisions in which the central bank makes an explicit commitment to conduct monetary policy to meet a publicly announced numerical inflation target within a particular time frame.

⁴ ADB. 2003. *Country Strategy and Program (2004-2006). Kazakhstan*. Manila.

⁵ ADB. 2004. *Country Strategy and Program Update (2005-2007). Kazakhstan*. Manila.

8. To support the Government's initiatives, it is proposed that ADB provide three TAs from 2004 to 2007. The first TA (proposed for 2004) will help the Government (i) introduce inflation targeting to stabilize overall inflation and (ii) strengthen the governance of the National Fund and official reserves to prevent fraud and corruption. The second TA (proposed for 2005) will increase compliance with international regulatory and supervisory standards for the financial sector, and the third (2006) will help the Government implement the remaining part of its financial sector development strategy. The sequencing of the TAs is based on the Government's priority and request. All three proposed TAs will complement the regional TA for financial sector development.⁶

9. The Mission has been closely coordinating with other development partners of Kazakhstan. The International Monetary Fund (IMF) provided assistance totaling 2 person-month in September 2004 to provide a second opinion on pre-conditions for inflation targeting and to strengthen banking sector regulation, but is not planning further assistance for NBK or FSAK. The United States Agency for International Development (USAID) formally ended its assistance in the banking area in December 2003. Further assistance planned by USAID for consolidated supervision will not exceed 3 person-months. The European Union and World Bank are not planning to assist the financial sector.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

10. The TA will support the strengthening of the monetary framework by developing an inflation-targeting regime to ensure overall financial stability. Inflation targeting will enable the monetary authorities to effectively implement monetary stabilization policies according to international best practices. Inflation stabilization will, in turn, support broad efforts of macroeconomic stabilization and create an environment conducive to stable economic growth. The TA will support strengthening governance for financial assets managed by NBK, which include official reserves and the National Fund, by designing rules and procedures governing responsibilities and investment guidelines. Transparent management and proper oversight of these assets are crucial to prevent fraud, corruption, and the exploitation of the country's nonrenewable resources, and to support equitable transfer of resources to future generations to enhance the country's development.

11. The outputs of the TA include (i) an inflation-targeting monetary policy regime established in line with international best practices; (ii) asset and risk management systems of NBK in line with international best practices; and (iii) capacity building for NBK in asset management, risk management, and inflation targeting.

B. Methodology and Key Activities

12. The TA methodology will comprise comprehensive diagnostic assessments of capacities needed for inflation targeting and governance of financial assets managed by NBK. Knowledge transfer will include training, procurement of information technology (IT) equipment, dissemination seminars, and three study tours. The TA will undertake the following activities under these two main components:

⁶ ADB. 2003. *Technical Assistance for Financial Sector Development*. Manila. This project supports know-how transfer in the area of banking sector risk management and aims to strengthen the regulatory framework for corporate governance and financial disclosure.

1. Developing an Inflation-Targeting Regime

13. This component will entail the following:

- (i) Capacity and needs assessment for inflation-targeting monetary policy, including an assessment of the monetary policy framework, its medium-term strategy and short-term stance, and its supporting operational strategy, especially with regard to open market operations.
- (ii) Assessing the suitability of the current measure of core inflation as a key indicator for inflation targeting, defining price stability, and recommending the degree of transparency and accountability required to support inflation targeting.
- (iii) Developing an economic model that supports monetary policy decision making under an inflation-targeting policy regime and a concept for a new monetary transmission mechanism.
- (iv) Establishing household and enterprise surveys to adequately capture inflationary expectation.
- (v) Developing a concept and procedures for an NBK communication policy that ensures market discipline and consistency of monetary policy decisions. Establishing supporting market infrastructure, such as timely and reliable publication of economic data, to help market participants gauge inflationary trends.
- (vi) Knowledge transfer and capacity building for an inflation-targeting monetary policy, including training, development or purchase of IT systems and tools, one study tour, coaching, and one dissemination seminar.

2. Strengthening Management of the National Fund and Foreign Reserves

14. This component will entail the following:

- (i) Capacity and needs assessment for management of the National Fund and official reserves by NBK against international best practices, particularly with respect to accountability, transparency, audit, risk diversification, and rate of return.
- (ii) Developing proposals and a time-bound action plan for establishing an investment policy, asset management, and risk management oversight structure in NBK in line with international best practices and reflecting the degree of transparency and accountability required.
- (iii) Technical support to implement the action plan, including development of documents outlining structural and procedural requirements and establishment of IT systems and tools.
- (iv) Knowledge transfer and capacity building for asset and risk management, including development or purchase of IT systems and tools, training, two study tours, and one dissemination seminar.

C. Cost and Financing

15. The total TA cost is estimated at \$2.22 million equivalent, including \$1.786 million of foreign exchange cost, and \$434,000 equivalent of local currency cost. Given the priority that NBK attaches to the TA and given the substantive size of the TA, NBK has agreed to finance 64% of the TA cost in the total amount of \$1.42 million equivalent, comprising \$1.041 million of foreign exchange cost and \$379,000 equivalent of local currency cost. NBK will finance the domestic consultants, equipment purchased in line with domestic procurement guidelines, and

provide office support and workshop facilities. ADB will provide the remaining 36% of the TA cost in the total amount of \$800,000 equivalent to finance \$745,000 of the foreign exchange cost and \$55,000 equivalent of the local currency cost. The TA will be financed on a grant basis by the Japan Special Fund, funded by the Government of Japan. The cost estimates and financing plan are in Appendix 3.

D. Implementation Arrangements

16. The TA will require 18.0 person-months of international consulting services and 58 person-months of domestic consulting services. The international consultants will be (i) a financial governance expert with risk-management background for 4.0 person-months, (ii) an asset management specialist for 3.0 person-months, (iii) a monetary policy specialist for 4.5 person-months, (iv) a securities market expert for 1.5 person months, (v) an econometrician and model builder for 3.0 person-months, and (vi) a survey specialist for 2.0 person-months. The domestic consultants will be (i) a financial sector specialist for 10 person-months, (ii) an econometrician for 12 person-months, (iii) a survey specialist for 12 person-months, and (iv) two IT experts for a total of 24 person-months. The international consultants will organize and participate in three study tours aimed at supporting know-how transfer in financial governance and inflation targeting. The domestic consultants are expected to report to the international consultants and to the departments of NBK that they are supposed to support. The outline terms of reference for the consultants are in Appendix 4.

17. In view of the specific nature of the TA and the cost-sharing agreement all international consultants will be engaged on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants*. All domestic consultants will be engaged by NBK in line with other arrangements satisfactory to ADB. The monetary policy specialist will be the team leader for the first component.⁷ The financial governance expert will be the team leader for the second component.⁸ The team leaders will coordinate the inputs of their component's consultants and consolidate their reports. Inception reports will be presented within 3 weeks after services start. The teams will also provide two interim reports for each component. Draft final reports shall be provided to ADB and NBK 2 weeks before the end of the TA, and be finalized upon receipt of comments from NBK and ADB.

18. NBK will be the Executing and Implementing Agency for the TA. NBK will provide the consultants with the necessary office support, including computers and Internet access. Close cooperation between ADB and NBK in administration and implementation will ensure strong country ownership for the TA. For this purpose, NBK will appoint a focal point at a higher management level of NBK for each component of the TA, with whom all matters affecting the TA will be closely coordinated, including recruitment of consultants and purchase of equipment. The TA will commence in December 2004, and is expected to be completed in November 2006.

IV. THE PRESIDENT'S DECISION

19. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$800,000 on a grant basis to the Government of Kazakhstan for Financial Sector Governance, and hereby reports this action to the Board.

⁷ The consultants for the first component include (i) a monetary policy specialist, (ii) a securities market expert, (iii) an econometrician and model builder, (iv) a survey specialist; and (v) the following domestic experts: (a) econometrician, (b) survey specialist, and (c) IT expert.

⁸ The consultants for the second component include (i) an international financial governance expert, (ii) an international asset management specialist, (iii) a domestic financial sector specialist, and (iv) a domestic IT expert.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal Monetary stabilization policies and governance of the National Fund and official reserves in line with international best practices</p>	<ul style="list-style-type: none"> • Declining inflation and/or increasing capacity of the economy to absorb exogenous shocks • Optimal generation of wealth accumulated under the National Fund, subject to attendant risk • Prevention of fraud and corruption related to the National Fund and official reserves in line with international best practices 	<ul style="list-style-type: none"> • Annual reports of National Bank of Kazakhstan (NBK) and the Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan (FSAK) • NBK's audited annual reports and internal incident reports • Incident reports of FSAK and Kazakhstan Stock Exchange (KASE) • Country reports and economic updates of the Asian Development Bank (ADB), International Monetary Fund (IMF), and other institutions and organizations 	
<p>Purpose</p> <ul style="list-style-type: none"> • Development of an inflation targeting monetary policy regime • Improved oversight and management of financial assets managed by NBK, including official reserves and the National Fund 	<ul style="list-style-type: none"> • All systems and procedures needed for inflation targeting developed in line with international best practices by 2006, including a new economic model, a new transmission mechanism for monetary policy, and surveys • Asset and risk management systems and procedures of NBK brought in line with international best practices by 2006 	<ul style="list-style-type: none"> • Annual reports of NBK and the FSAK, and NBK's audited annual reports and internal incident reports • IMF reports, including financial system stability assessments and reports on observance of standards and codes • Information provided on Web sites of NBK and FSAK 	<p>Assumptions:</p> <ul style="list-style-type: none"> • Sustained commitment of the authorities to introduce and sustain inflation targeting and financial governance of official reserves and the National Fund in line with international best practices • Efficient coordination of monetary and fiscal policies • Enhanced market surveillance by FSAK and KASE

Continued on next page

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Outputs</p> <p>Component 1: Developing an inflation-targeting regime</p> <ul style="list-style-type: none"> • Capacity and needs assessment for inflation-targeting monetary policy • An optimal benchmark to measure core inflation and define monetary stability • An economic model that supports monetary policy decision making under an inflation-targeting regime • A new mechanism to transmit monetary policy signals to the key policy targets 	<ul style="list-style-type: none"> • Comprehensive assessment, covering the monetary policy framework, its medium-term strategy and short-term stance, and the operational strategy to support the monetary strategy and stance, especially with regard to open market operations, to be available by mid-2005 • The measure, available by mid-2005, operational as key indicator for inflation targeting • The model, to be operational by the end of 2005, will enable NBK to identify the aggregates relevant to monetary policy, determine the effect of observed changes in such variables on the goal of price stability, and ascertain changes needed to the operating target to avoid deviations from the ultimate goal • The transmission mechanism, to be available by March 2006, takes into account the features of the Kazakhstani economy, as outlined in the economic model, and available policy instruments 	<ul style="list-style-type: none"> • Regular dialogue between NBK's focal point for inflation-targeting component and ADB's project officer • IMF mission reports • Back-to-office reports of ADB missions and consultants' reports, reflecting information made available by NBK and discussions with other stakeholders 	<p>Assumptions:</p> <ul style="list-style-type: none"> • The wealth of available data comprises the data needed for building an adequate model • Sustained commitment to implement inflation targeting monetary policy in line with international best practices <p>Risk:</p> <ul style="list-style-type: none"> • A critical number of NBK's staff agencies do not stay in their positions

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<ul style="list-style-type: none"> • Regular household and enterprise surveys to adequately capture inflationary expectation • A policy for NBK to communicate with market participants and market watchers on monetary policy objectives and issues to ensure market discipline and consistency of monetary policy decisions • Knowledge transfer in the area of inflation targeting 	<ul style="list-style-type: none"> • The surveys, developed and tested by mid-2005, provide information required for inflation targeting as detailed and regularly as needed • The policy, to be available by the end of the project period, will include a concept and procedures that are specific and operational • Training on the job, seminars, and a study tour, efficiently distributed over the project period, to effectively support capacity building for inflation targeting 	<ul style="list-style-type: none"> • Media articles and view of market watchers as expressed in newspaper articles and in interviews • Back-to-office reports and feedback from participants of training, seminars, and study tour 	
<p>Component 2: Strengthening management of the National Fund and foreign reserves</p> <ul style="list-style-type: none"> • Assessment of capacity and needs for management of the National Fund and official reserves by NBK against international best practices • Concept paper and time-bound action plan for establishing an investment policy and risk management oversight 	<ul style="list-style-type: none"> • All requirements for strengthening asset and risk management clearly identified and specified by March 2005 • All steps needed to bring NBK's financial governance systems in line with international best practices to be specified in a realistic action plan by June 	<ul style="list-style-type: none"> • Regular dialogue between NBK's focal point for asset and risk management component, and ADB's project officer • Back-to-office reports of ADB missions and consultants' reports, which will reflect information made available by NBK and discussions with other stakeholders • NBK's own reports and 	<p>Assumptions</p> <ul style="list-style-type: none"> • NBK management and NBK's supervisory board endorse the action plan • Sustained political will to respect and further the independence of NBK <p>Risk</p> <ul style="list-style-type: none"> • Critical number of NBK's staff agencies do not stay in their positions

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>structure in NBK in line with international best practices</p> <ul style="list-style-type: none"> • Assistance to implement the action plan, including documents outlining organizational and procedural requirements and knowledge transfer in the area of risk and asset management • Information technology (IT) systems needed to implement the action plan purchased or developed 	<p>2005, including policy changes, structural procedural changes, knowledge transfer, training, equipment purchase, and others</p> <ul style="list-style-type: none"> • The assistance is operational, well coordinated with the various units of NBK concerned, and provided in line with the time-bound action plan • Knowledge transfer through training on the job, seminars, and study tours, efficiently distributed over the project period to effectively support capacity building for asset and risk management • All hardware and software required for strengthening risk management and asset management purchased by the end of 2005 and operational by mid-2006 	<p>information made available on NBK's Web site</p> <ul style="list-style-type: none"> • Reports of NBK's external auditors 	
<p>Activities All items identified in the methodology and key activities section of the TA paper, including</p> <ul style="list-style-type: none"> – capacity and needs assessments for NBK's asset management, risk management, and inflation targeting; – econometric data analysis 	<ul style="list-style-type: none"> • Sound progress demonstrated by timely submission of interim assessments and reports 	<ul style="list-style-type: none"> • Periodic reports of consultants • NBK's reports • Interim project reviews 	<p>Assumptions:</p> <ul style="list-style-type: none"> • Data will be made available to consultants • NBK's management is available for coaching <p>Risk:</p> <ul style="list-style-type: none"> • Supervisory agencies do not send qualified staff into

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<ul style="list-style-type: none"> – two IT experts for 12 person-months each • Training on the job, workshops, and two dissemination seminars • Three study tours • IT equipment • ADB staff time required for project administration: 3 person-months 	<ul style="list-style-type: none"> • \$20,000 • \$65,000 • \$1.1 million (counterpart financing) 	<ul style="list-style-type: none"> • Documentation of equipment purchase 	<p>Assumption:</p> <ul style="list-style-type: none"> • Suitable institutions agree to host study trips <p>Risks:</p> <ul style="list-style-type: none"> • Actual price of the required equipment exceeds the budgeted amounts • Procurement does not take place in time

KEY INDICATORS

Table A2.1: Financial Sector Indicators

Item	1999	2000	2001	2002	2003
1. Sector Outcomes					
Increased financial intermediation					
Broad money (M3) as percent of GDP	13.6	15.3	17.5	20.4	21.8
Banking sector assets as percent of GDP	16.9	20.3	24.9	30.6	37.7
Insurance premiums as percent of GDP	0.3	0.3	0.4	0.6	0.6
Pension system assets as percent of GDP	3.2	4.3	5.6	7.2	8.3
Capitalization of stock exchange as percent of GDP ^a	6.0	4.4	5.4	5.5	7.8
Outstanding corporate bonds as percent of GDP ^b	0.2	1.0	2.6	5.0	8.7
Outstanding government securities as percent of GDP	3.2	4.2	2.9	4.8	8.5
2. Sector Outputs					
Improved financial sector					
Soundness and stability					
Total capital of banks as percent of assets (CAR)	27.6	25.7	18.6	17.2	16.9
Nonperforming loans as percent of gross loans	—	—	—	12.2	13.1
Classified loans as percent of gross loans	44.7	23.2	31.0	28.7	38.9
Foreign-owned banking sector assets as percent of total	23.5	19.8	17.3	34.3	30.0
Total number of commercial banks	55.0	48.0	44.0	38.0	35.0
Total capital of insurance companies as percent of assets	33.8	56.1	33.8	48.4	43.5
Total number of insurance companies	70.0	42.0	38.0	34.0	32.0
Efficiency					
Private-owned banking sector assets as percent of total ^c	96.8	98.0	96.5	95.0	95.0
Interest rate spread (lending - deposit rate) ^d	9.1	11.4	7.1	8.1	5.7
Return on equity capital as percent of equity	13.8	7.9	6.1	12.7	14.6
Money outside banks (M0) as percent of deposits	60.7	36.6	29.5	26.8	32.6
Annual stock market turnover as percent of capitalization	—	9.0	12.2	25.5	17.4
Longest available bond maturity in years	—	—	—	10.0	10.0
Population per bank branch (including retail outlets)	10,000	10,700	10,400	10,500	10,500
Access					
Credit to the private sector as percent of GDP	8.9	13.5	13.7	19.4	22.8
SME loans as percent of total loans	26.8	26.9	24.9	21.8	20.1
Rural loans as percent of total loans	7.9	9.4	10.3	11.4	12.0
Bank deposits as percent of GDP	8.4	11.2	13.5	16.1	16.5
Number of companies listed at stock exchange	17.0	16.0	21.0	25.0	40.0
Number of initial public offerings of stocks (equity)	2.0	1.0	1.0	7.0	13.0
Number of corporate bond issues	1.0	7.0	3.0	24.0	25.0
Coverage of labor force by pension schemes	42.4	52.3	61.9	73.0	83.3

^a Shares in circulation from companies listed at the Kazakhstan Stock Exchange.

^b Includes bonds denominated in foreign currency and partly traded abroad.

^c Includes the fully state-owned Development Bank of Kazakhstan.

^d For nonbank legal entities, long-term rates.

— = data not available, GDP = gross domestic product, SME = small and medium enterprises.

Sources: Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan, Asian Development Bank, International Monetary Fund, Kazakhstan Stock Exchange, and National Bank of Kazakhstan.

Table A2.2: Key Macroeconomic Indicators

Item	1999	2000	2001	2002	2003
National Accounts and Production					
GDP Growth (constant prices), percent	2.7	9.8	13.5	9.8	9.2
Industrial Production Growth, percent	2.2	14.6	13.5	9.8	8.8
External Sector					
Current Account Balance as percent of GDP	(1.4)	3.1	(5.4)	(3.5)	(0.2)
Trade Balance as percent of GDP	2.0	13.4	5.9	9.4	13.7
Merchandise Exports in \$ billion	5.9	9.3	8.9	10.0	13.2
Merchandise Exports as percent of GDP	35.5	50.8	39.9	41.0	44.4
Total Outstanding Debt as percent of GDP	71.4	69.4	67.8	74.5	76.7
Private Nonguaranteed as percent of GDP	47.4	47.9	50.8	60.2	64.6
Gross Official Reserves in \$ billion ^a	2.0	2.1	2.5	3.1	4.9
Gross Official Reserves as percent of GDP ^a	11.9	11.5	11.2	12.9	16.7
Assets of National Fund in \$ billion ^b			1.2	1.9	3.7
Assets of National Fund as percent of GDP ^b			5.6	7.9	12.3
Money and Prices					
Money Supply (M3), change in percent, end of period	84.4	45.0	43.3	34.4	27.0
Base Money, change in percent, end of or period	53.7	7.1	30.6	19.0	52.3
Inflation, period average	8.3	13.2	8.4	5.9	6.4
Exchange Rate T/\$, period average	119.5	142.3	146.9	153.3	149.4

GDP = gross domestic product.

^a Includes gold reserves.

^b The National Fund of Kazakhstan was established in 2001 to absorb the Government's excess oil revenues to stabilize and preserve them for future generations.

Sources: Asian Development Bank, International Monetary Fund, National Bank of Kazakhstan, and National Statistical Committee.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. International Consultants	555	5	560
a. Remuneration and Per Diem	485	0	485
b. International and Local Travel	70	5	75
2. Reports and Communication	20	0	20
3. Translation	20	0	20
4. Training Workshops and Dissemination Seminars ^b	0	20	20
5. Study Tours ^c	40	25	65
6. Miscellaneous Administration and Support Costs	15	5	20
7. Contingencies	95	0	95
Subtotal (A)	745	55	800
B. Counterpart Financing			
1. Domestic Consultants	0	165	165
a. Remuneration and Per Diem	0	145	145
b. International and Local Travel	0	20	20
2. Information Technology Equipment ^d	1,000	100	1,100
a. Software	1,000	20	1,020
b. Hardware	0	80	80
3. Office Accommodation and Workshop Facilities	0	79	79
4. Contingencies	41	35	76
Subtotal (B)	1,041	379	1,420
Total	1,786	434	2,220

^a Funded by the Japan Special Fund, funded by the Government of Japan.

^b Training workshops will take place for staff and management of the National Bank of Kazakhstan (NBK) and selected Government officials, on a flexible basis, to support training on the job in all areas covered by the TA. Two dissemination seminars are planned—one for risk management and asset management, the second for inflation targeting.

^c Three study tours will be undertaken to support knowledge transfer for asset and risk management, and inflation targeting.

^d Equipment consists of information technology software and hardware necessary to build capacity for risk and asset management in NBK. Equipment will be financed from NBK's budget for 2005 and purchased in accordance with domestic procurement guidelines.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. International Consultants (18 person-months)

1. Monetary Policy Specialist and Team Leader for First Component (4.5 person-months)

1. The consultant will be an economist with in-depth experience in monetary policy and relevant work experience in developing economies. The consultant will be supported by an international securities market expert, an international econometrician and model builder, and a domestic financial sector specialist. The terms of reference of the consultant will include, but not be restricted to, the following:

- (i) Assess the capacities and needs of NBK for inflation-targeting monetary policy, including the monetary policy framework, its medium-term strategy and short-term stance, and the operational strategy to support the monetary strategy and stance, especially with regard to open market operations.
- (ii) Develop a concept for transition from the current monetary policy regime to inflation targeting.
- (iii) Assess the suitability of the measure of core inflation, applied by the statistics agency since early 2004, to serve as key indicator for purpose of inflation targeting.
- (iv) Identify the definition of price stability to be used under inflation targeting framework and key pillars supporting the monetary policy strategy.
- (v) Review the monetary transmission mechanism with focus on establishing channels of transmission between interest rates, monetary aggregates, and real outputs.
- (vi) Develop a concept and procedures for NBK to communicate with market participants and market watchers on monetary policy objectives and issues.
- (vii) Recommend the degree of transparency and accountability required to support the inflation targeting policy framework.
- (viii) Develop a concept and recommend procedures for a communications policy of NBK that ensures market discipline and consistency of monetary policy decisions.
- (ix) Help establish a supporting market infrastructure to assist market participants in gauging inflationary trends in the economy, such as timely and reliable publication of economic statistics, yield curve, and forward exchange rates.
- (x) Provide training on the job for staff of the monetary policy department of NBK and coaching for senior decision makers of NBK in the area of inflation-targeting monetary policy.
- (xi) Undertake a workshop to disseminate the findings of the TA in inflation targeting.
- (xii) Organize and participate in one study tour to support knowledge transfer in the area of inflation targeting monetary policy.

2. Securities Market Expert (1.5 person-months)

2. The consultant will be an economist or lawyer with hands-on experience in fixed-income securities trading and a solid understanding of open market operations and interest rate policies of central banks. The consultant will closely coordinate with an international monetary policy specialist and an international economist and model builder and will be supported by a domestic

financial sector specialist. The terms of reference of the consultant will include, but not be restricted to, the following:

- (i) Assess the framework for NBK's securities operations for monetary policy purposes, including capacities within NBK and the relevant features of the securities markets.
- (ii) Based on the results of the work of the monetary policy specialist and the model builder, define the securities market framework required for inflation-targeting monetary policy.
- (iii) Based on (i) and (ii) prepare proposals and a time-bound action plan outlining the steps required to establish this securities market framework.
- (iv) Provide training on the job and coaching for NBK staff responsible for securities market operations.

3. Econometrician and Model Builder (3 person-months)

3. The consultant will be an economist or mathematician with strong econometric skills who specializes in model building and has a solid understanding for monetary policy. The consultant will closely coordinate with the monetary policy specialist and supervise the work of a domestic econometrician and, if required, be supported by one domestic IT specialist. The terms of reference of the consultant will include, but not be restricted to, building a reliable macroeconomic model that will enable NBK to achieve the following:

- (i) Identify, on a continuous basis and out of the wealth of available data, those aggregates and indicators that are relevant for monetary policy purposes in Kazakhstan.
- (ii) Determine what effect the observed changes in such variables will have on the ultimate goal of price stability.
- (iii) Ascertain what changes to the operating target are necessary to avoid any deviations from the ultimate goal.
- (iv) Help establish a supporting market infrastructure that assists market participants in gauging inflationary trends, such as timely and reliable publication of economic statistics, yield curves, and forward exchange rates.
- (v) Provide training on the job for staff of the research department of NBK.
- (vi) Help develop a concept for a new monetary transmission mechanism.

4. Survey Specialist (2 person-months)

4. The consultant will be an economist who specializes in surveys or have other similar educational and professional background. The consultant will supervise the work and be supported by a domestic survey specialist. The terms of reference of the consultant will include, but not be restricted to, the following:

- (i) Assess the suitability of existing household and enterprise surveys against the requirements of a survey that adequately captures inflationary expectations for monetary policy purposes.
- (ii) Develop a concept for such a survey in line with international best practice, including the development and iterative improvement of a questionnaire, selection of participants, procedures for distribution and collection, frequency, and interpretation of survey results.

- (iii) Support NBK and other relevant institutions in establishing such a survey. Provide guidance and advice on changes required to the questionnaire, selection of participants, procedures, frequency, and interpretation of survey results, during several rounds of pilot-testing the survey, before it becomes ultimately fully operational.
- (iv) Provide training on the job for staff of NBK and other relevant institutions responsible for establishment and maintenance of the survey.

5. Financial Governance Expert and Team Leader for Second Component (4 person-months)

5. The consultant will have in-depth knowledge of financial governance and a solid background in applied risk management in the banking sector, including its structural and procedural aspects. The consultant will also have relevant work experience in developing economies. The consultant will closely coordinate with the asset management expert, and supervise the work of a domestic financial sector specialist and an information technology (IT) expert. The terms of reference of the consultant will include, but not be restricted to, the following:

- (i) Assess the governance systems of the National Bank of Kazakhstan (NBK) with regard to management of official reserves and the National Fund, particularly under the aspects of accountability, transparency, audit, and risk management, against international best practices.
- (ii) Assess the current overall institutional arrangement for the National Fund against international best practice.
- (iii) With assistance from an asset management specialist, develop concepts to strengthen governance for both official reserves and the National Fund in line with international best practices, including the establishment of institutional mechanisms to develop investment policies and risk management policies.
- (iv) Draft a plan to establish a risk management department or committee, its organizational structure, roles and responsibilities, and staffing requirements.
- (v) Develop risk management strategies for official reserves and the National Fund, covering financial, policy, operational, and other risks, and risk management systems, including a risk matrix that identifies and quantifies risks, an approach to assess and measure risks, and standard risk management report formats.
- (vi) Recommend measures to safeguard the operations and management of official reserves and the National Fund.
- (vii) Based on (i)–(vi), submit a time-bound action plan to establish financial governance systems for official reserves and for the National Fund, covering risk and asset management and investment policies, and reflecting the degree of transparency and accountability required, in line with international best practices.
- (viii) Help NBK identify and purchase and/or develop suitable IT solutions that will strengthen risk management related to official reserves and the National Fund. Support NBK in drafting specifications for IT equipment before procurement.
- (ix) Provide training on the job for staff of the treasury department of NBK in risk management and undertake a workshop disseminating the findings of the technical assistance (TA) in this area.
- (x) Organize and participate in one study tour to support knowledge transfer in the area of financial governance.

6. Asset Management Specialist (3 person-months)

6. The consultant will be a financial economist or master of business administration with in-depth knowledge of and relevant experience in applied asset management, including its structural and procedural aspects. The consultant will closely coordinate with the financial governance expert. The terms of reference of the consultant will include, but not be restricted to, the following:

- (i) Assess NBK's management of official reserves and the National Fund, including investment policies and their optimum criteria, against international best practices.
- (ii) Undertake a needs assessment of the treasury department of NBK with regard to asset management and other aspects of financial governance.
- (iii) Develop a policy and formal mechanism to monitor performance of internal and external asset management, including the institutional establishment of a formal limit-setting mechanism for internal asset management, and including policies and procedures to recruit and dismiss external asset managers.
- (iv) Prepare a code of ethics for internal asset management, including policies to avoid potential conflicts of interest, abuse of confidential information, and fraud.
- (v) Based on (i)–(iv), prepare proposals to strengthen asset management related to official reserves and the National Fund, and submit a time-bound action plan.
- (vi) Help NBK identify and purchase or develop suitable IT solutions that help strengthen asset management. Help NBK draft specifications for IT equipment before procurement.
- (vii) Provide training on the job for staff of the treasury department of NBK for asset management, and undertake a workshop disseminating the findings of the TA in asset management.
- (viii) Organize and participate in one study tour to support knowledge transfer in asset management.

B. Domestic Consultants (58 person-months)

1. Financial Sector Specialist (10 person-months)

7. The consultant will have banking, securities, asset management, or other financial sector management background, and strong analytical skills. The consultant will work closely with the international financial governance expert and the asset management expert and report to the head of the treasury department of NBK. The work plan for the consultant will be detailed during inception of the Project in close coordination with the treasury department of NBK and be covered by the scope of the TA.

2. Econometrician (12 person-months)

8. The consultant will be an economist with strong experience in applied econometrics and background in model building. The consultant will be familiar with the wealth of data available in Kazakhstan. The consultant will be guided by an international economist and model builder and report to the head of the statistics and research department of NBK. The consultant will help develop an econometric model for monetary policy purposes. The work plan for the consultant will be detailed during inception of the project in close coordination with the department for statistics and research of NBK and be covered by the scope of the TA.

3. Survey Specialist (12 person-months)

9. The consultant will be an economist or sociologist with hands-on experience in developing and implementing surveys in Kazakhstan. The consultant will be guided by an international survey specialist and report to the head of the entity responsible for establishing a survey that captures inflationary expectations. The consultant will support the international expert and this entity in all aspects covered by the scope of this TA. The work plan of the consultant will be detailed during project inception.

4. Two Information Technology Experts (12 person-months each)

10. The consultants will have experience in undertaking programming work for financial institutions. They will support capacity building in NBK and FSAK, and be jointly guided by the international financial governance expert, international asset management expert, and international monetary policy specialist. The work plan of the consultant will be detailed during project inception in close coordination with NBK's treasury, research, and IT departments, and be covered by the scope of the TA. The consultants will closely cooperate with NBK's IT specialists.

C. Reporting Requirements

11. The two team leaders will each present an inception report for their respective components (inflation targeting, governance of financial assets managed by NBK) 3 weeks after services start. Two intermittent reports on the TA progress have to be provided for each component. Comprehensive draft final reports outlining all activities undertaken under the respective components will be presented two weeks before the end of the TA. A final report incorporating comments received from NBK and ADB has to be presented for each component at the end of the regional TA. The team leaders will integrate consolidated inputs from the other international consultants into their respective reports. The international consultants will integrate information about the work of the domestic consultants into their reports.