



Kazakhstan

The transition toward a market-based economy in Kazakhstan, initiated after independence, has been accompanied by a steep fall in GDP, substantial unemployment, and a widespread increase in the incidence of poverty. The Government, however, has achieved noticeable progress in its efforts toward macroeconomic stabilization, especially in the reduction of inflation. These efforts are setting the stage for moderate growth in the next few years. Structural reform measures, such as privatization and the establishment of the broad legal framework for a market system, have been well started; however, there is a significant unfinished agenda that must be completed for any recovery to provide for sustainable growth.

Recent Trends and Prospects

Immediately after independence, in common with most other former Soviet Union (FSU) republics, Kazakhstan's economy experienced serious economic difficulties. GDP declined on average at about 18 percent per annum between 1992 and 1994, and fell an additional 9 percent in 1995.

All economic sectors suffered. Following independence, the regular supply of inputs and the market for outputs were suddenly interrupted as trade arrangements among the FSU countries disintegrated. Output marketing was similarly disrupted. Heavy industry experienced a particularly large output contraction, reflecting directly the collapse of the Soviet military-industrial system. However, there are some indications that the contraction of the economy is coming to an end.

In the last quarter of 1994, industrial production indices for some products began to show moderate increases relative to the 1993 levels, increases that were sustained through 1995. Moderate strength is discernible in nonferrous metals and in chemicals and petrochemicals. Some of these subsectors have benefited from newly developing export markets in Europe.

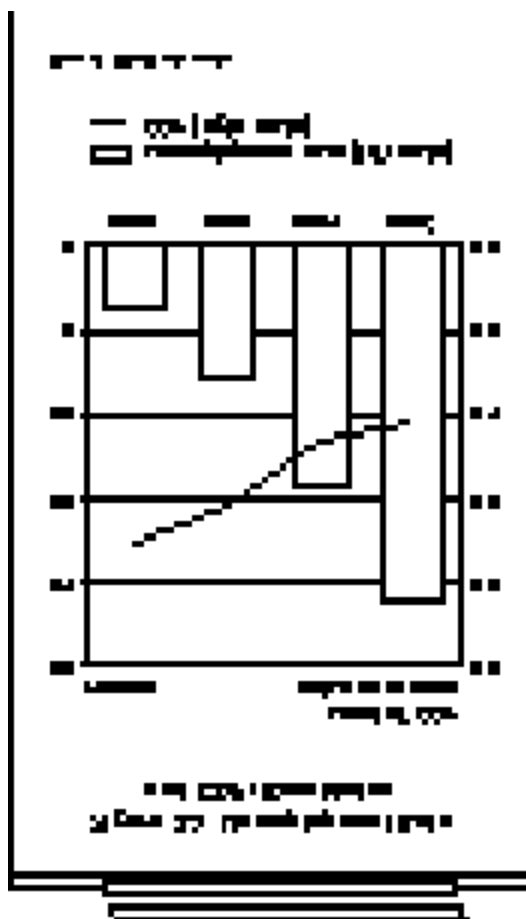
The collapse of central planning resulted in a deterioration in the terms of trade for agriculture and a serious erosion in farm incomes and profitability. Production has declined since independence for nearly all crops and products. Estimates for 1995 suggest a decline of between 22 percent and 33 percent in grain production compared with that in 1994. Poor weather conditions were a major contributory factor; average yields appear to have declined by more than 40 percent in 1995. The most important problems in agriculture include difficulties in the supply of inputs, lack of incentives for farm production, and a failure to restructure farm enterprises. In 1994, the Government began to reduce its presence in the sector, in particular by reducing orders for agricultural commodities; and in 1995, compulsory delivery requirements were abolished. Public needs are in the future to be satisfied through purchases in the market.

There are no reliable current estimates of saving and investment for Kazakhstan. Given the depressed and unstable economic conditions, new investment in plant and equipment was probably negligible in recent years. However, there still was significant inventory investment. The latter reflects the ability

of nonviable enterprises to continue production supported by soft credit either from suppliers or from official sources. Responding to the sharp fall in real income, saving has also declined. From a balance-of-payments perspective, the reduction in the public budget deficit in 1995 coupled with a large current account deficit suggests that private sector investment in relation to GDP is approximately 3-4 percentage points greater than private saving.

Labor markets under the former Soviet system were characterized by certainty and security. Employment was guaranteed; wages were paid in cash and were relatively undifferentiated; and there was generous additional support through a comprehensive system of transfers, social security, and special allowances. With the deterioration of the Kazakhstan economy, this situation changed dramatically. The sharp drop in output resulted in a large increase in unemployment. Combined open and hidden unemployment rose from 4 percent of the formal labor force at the end of 1992 to over 25 percent in 1995 (Figure 2.7). Companies are reluctant to fire employees partly because keeping employees on wage rolls at minimum wages can reduce the tax base for the enterprise. In addition, there are social and political pressures on firms to avoid mass labor shedding. As a result, many workers are put on forced leave resulting in hidden unemployment.

The poor economic performance has meant considerable welfare losses for most of the population. The deterioration of social infrastructure caused by a drop in public spending, the growth of unemployment, and the reduction of income has had a severe impact on the social conditions of the majority of the Kazakh population. This can be seen in the growing incidence of poverty. Using household survey data, in mid-1995 approximately 37 percent of the total population fell below the poverty line compared with 20 percent in 1992. Most affected are those people living in isolated industrial centers and rural agricultural areas, as well as particularly vulnerable groups such as pensioners, unemployed youth, and women. The latest internationally comparable per capita income measure is \$1,540 for 1993, down from \$1,880 in 1992, while estimates using current GDP figures and exchange rates show a figure for 1995 of under \$1,000 per person.



Fiscal difficulties have hindered government efforts to mitigate the socioeconomic costs of the transition to a market economy. In an effort to rationalize administration and collection, a new tax code was adopted in April 1995 that reduces the number of different taxes. Although the new code results in a simplification of the entire system, it contains some preferential elements that will hinder efforts to increase revenues. Total revenues for consolidated government operations in 1995 were 20.1 percent of GDP, little changed from the 1994 revenue effort. Net lending in 1994, at 8 percent of GDP, was the result of quasi-fiscal operations to clear accumulated enterprise arrears. With net lending in 1995 at negligible levels, and despite relatively constant revenues, the budget provided for increased expenditures. Total current and capital expenditures declined slightly to 23.6 percent of GDP, from 27.3 percent of GDP in 1994. Expenditures were increased, while the overall budget deficit was reduced in 1995 to 3.5 percent of GDP from 7.9 percent in 1994.

Constrained public spending has resulted in sharply lower resources committed to the social sectors and social assistance. As a result, the provision of social services for education and health and access to social assets such as kindergartens and public housing have declined. Government spending on health and education fell from 10.1 percent of GDP in 1990 to 6.2 percent in 1995. Social safety net spending on social assistance and social protection has also fallen, from 4.4 percent of GDP in 1990 to 3.5 percent of the much smaller 1995 GDP. Reduced social service provision and a weaker social safety net have increased the hardships of the most vulnerable groups in society during this difficult period of transition.

Hyperinflation characterized all the FSU economies in the ruble zone after the breakup of the Soviet Union, and in Kazakhstan annual inflation remained above 1,500 percent through 1994. The establishment of a national currency, the tenge (T), in November 1993 and the development of the tools of monetary control by the Central Bank offered the Government the opportunity to target a reduction in inflation. Serious anti-inflationary action began in the second half of 1994, and resulted in the average inflation rate in 1995 being reduced to 176 percent. Furthermore, by the end of 1995, inflation had been reduced to an annual rate of less than 60 percent. This significant progress towards macroeconomic stabilization necessitated tight controls on credit creation and directed lending and reflects the commitment by the Government to move toward the goal of lower inflation.

Progress on inflation and generally tightened monetary conditions have provided for some stability for the tenge. After the introduction of the national currency in 1993, at T4.7 to one US dollar, the tenge steadily depreciated, falling to T63.3 to one US dollar by mid-1995. Subsequently, with increasing monetary restraint, the tenge appreciated against the US dollar, rising briefly to T59 to one US dollar in the third quarter before again falling to T64 to one US dollar at the end of the year.

The merchandise trade deficit in 1995 is estimated to have been over \$0.9 billion, equivalent to 5.9 percent of GDP. This deficit is worrisome because it is occurring during a deep depression of levels of imports that would be too low to sustain positive

growth. Should the economy begin to grow as a result of higher domestic aggregate demand, higher levels of imports would be required. In particular, higher purchases of natural gas from Uzbekistan, electricity from the Kyrgyz Republic, and transport vehicles from the industrial world would be needed.

Although there are some indications that the worst of the deep output contraction in Kazakhstan has passed, GDP is likely to continue to fall in 1996 and thereafter experience only a slow recovery, though this is dependent on simultaneous economic recovery in Kazakhstan's trading partners, especially the Russian Federation which remains a major trade partner. In the near term, the economy will benefit from a return to normal weather conditions; agriculture in 1996 is unlikely to see a continuation of the drastic slide in output experienced in 1995. Overall, Kazakhstan appears to be following a pattern similar to that seen in other economies in transition, where positive growth emerged in two to three years after significant progress on macroeconomic stabilization.

Despite the new tax program, there will be little improvement in government revenue in 1996 because of the continued weakness in national income. This will mean continued restraints on public spending consistent with maintaining a public sector deficit target of between 3 percent and 4 percent of GDP. Continued monetary restraint will likely bring further progress in lowering inflation with the average price increase falling to less than 50 percent for the year.

With the projected slow recovery, the current account of the balance of payments will likely require approximately \$1 billion in annual financing. Some financing is expected to come from foreign direct investment; however, the major portion of the balance-of-payments financing is expected to come from medium- and long-term lending by multilateral development institutions or bilateral assistance programs. The debt/GDP ratio improved in 1995 on the strength of the cancellation of much of Kazakhstan's debt to the Russian Federation. In 1996, it is expected to increase, moving above 20 percent of GDP.

Policy and Development Issues

Over the longer term, recovery of growth and sustainable development will depend on the

resolution of the unfinished reform agenda. Particularly important steps to take will include continued efforts toward macroeconomic stabilization and a widening and deepening of the structural reform initiatives. The current macroeconomic stabilization program has been drawn up with the support of the IMF through a Standby Arrangement approved in June 1995. The present program focuses on reducing inflation and fiscal and external imbalances through tight monetary and fiscal policy. The relatively good performance under the current program is setting the stage for a possible shift in 1996 to the use of an Extended Fund Facility, which would involve a three-year program with a focus on structural reforms.

Two aspects of structural reforms will be important. One is the completion of those actions that are needed for the creation of a viable market economy. The other is the encouragement of competitive forces within such an economy. With respect to market creation, the Government took important moves in 1995 to reduce the size of the state order system for agricultural goods and to eliminate its compulsory aspects. International trade was liberalized by removing the remaining foreign exchange restrictions on current transactions, including the mandatory surrender requirements, and by eliminating most administrative restrictions such as export quotas that were completely abolished in the first half of 1995. In the domestic market, entry into different sectors has been promoted through the replacement of most licensing requirements by a more transparent registration process. At the same time, exit procedures have been provided through a new Bankruptcy Law approved in April 1995. Of the unfinished agenda in market creation, particularly important will be enhancing the development of relatively efficient land markets through the completion of land reform.

The development of competitive markets is a significant challenge, requiring in particular the distribution of state assets, enterprise reform, and the creation of strong financial markets. Significant progress has been made in the distribution of state assets. By the beginning of 1995, approximately 20 percent of all small and medium state enterprises had been privatized and more than one third

of the 2,500 agriculture farms or farm enterprises had been transferred to the private sector. Although privatization activities have often resulted in a change in formal ownership, neither the system of management nor the incentives for management behavior have changed. Enterprise reform will require the full restructuring and privatization or the liquidation of the remaining large state enterprises, the breakup of the large semi-privatized holding companies that exert monopolistic control over emerging markets, and the institution of hard budgets for remaining state and semi-privatized firms.

Some progress has been noted in the strengthening of the financial sector, and the development of institutions that can provide funds on commercial terms, encourage domestic resource mobilization, and facilitate domestic and international payments. By mid-1995, the private bank sector comprised approximately 150 banks. However, the majority of these are small establishments created mainly to get direct access to centralized credit resources. The prospects for these banks are problematic. They are burdened with nonperforming loans and have little institutional capacity to function in a commercial environment. The other banks are, however, not in much better condition; most institutions are technically insolvent and few have the institutional capacity to evaluate lending or borrowing on commercial terms.

The process of economic transformation has been accompanied by a widespread increase in poverty and a decline in the environmental resource base of the economy. The former is especially important in Kazakhstan where the needs of vulnerable groups such as the elderly poor or families headed by women may not be met given the rapid economic transformation. Environmental concerns are also important. Under the Soviet regime, natural resources were exploited in an environmentally unsound and unsustainable manner. Areas of ecological catastrophe are present throughout the country and include radiation contamination, increased flooding near the Caspian Sea, and desiccation and pollution of the Aral Sea. Checking pollution and safekeeping common resources will be necessary complementary activities for the development of a market system.