Kazakstan

While Kazakstan's postindependence economic trauma may have come to an end, much deeper reforms in policy and governance structures are now needed to accelerate growth. In addition, prudent management of the country's natural resource wealth will be critical.

RECENT TRENDS AND PROSPECTS

Following independence, Kazakstan was preoccupied with crisis management. On the dissolution of the former Soviet Union (FSU), Kazakstan's trade collapsed; income support from Moscow was severed; and its inherited economic and legal institutions, forged within a centrally planned system of production and distribution, were completely ill-suited to its new circumstances. Moreover, as a fledgling state Kazakstan lacked many of the institutions of modern government.

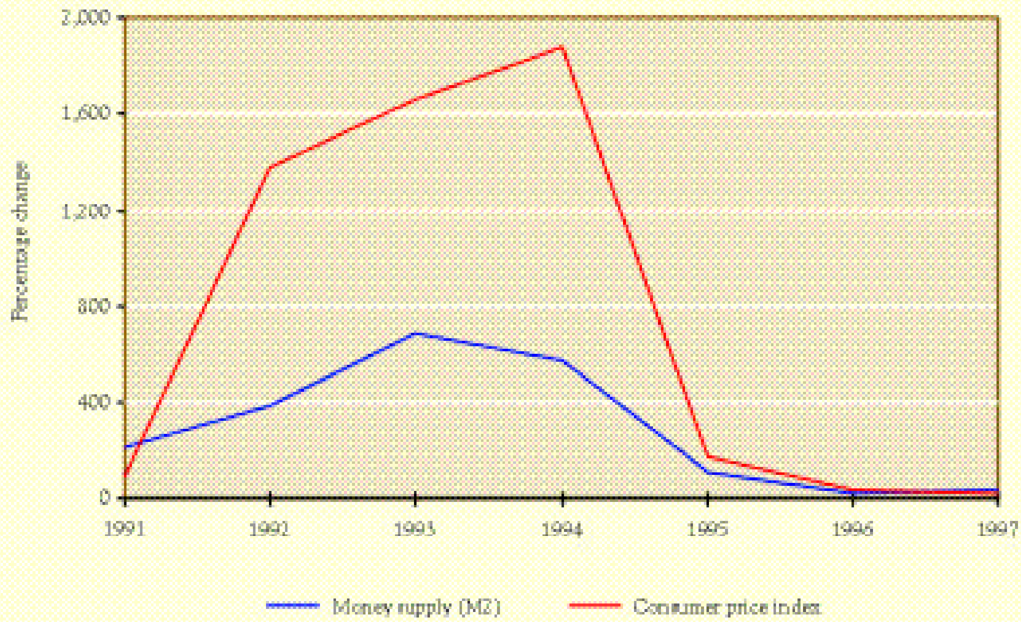
Against this backdrop, the country's output collapsed, and by 1996 output was only half what it had been five years earlier. Output declines were arrested in 1996. In that year GDP growth of 0.5 percent was recorded, and in 1997 moderate GDP growth of 2.0 percent was achieved. Two years of positive output growth have buttressed confidence in the view that the era of postindependence economic depression may now have ended. However, the economy is still narrowly based: a few export-oriented sectors—oil and gas and some nonferrous metals—dominate. These sectors have benefited from the shifts in the terms of trade since independence, and the bulk of foreign direct investment (FDI) has been directed toward these sectors.

Agriculture depends heavily on rainfed grain. While wheat and related crops have now recovered from a poor harvest in 1995, to date, signs of any underlying growth in productivity are few. Most crops other than grain show continuing production declines, but at more moderate rates than in earlier years. The reported livestock population has also declined, but with the ongoing privatization of farms some underreporting of livestock populations is possible.

Industry has tended to move away from processing raw materials toward primary, extractive activity. This trend reflects the shifts in the terms of trade that have occurred since independence, the cessation of subsidies from the FSU that had sought to encourage industrialization, and the concurrent collapse of traditional markets and supply relationships with FSU enterprises. For example, while the production of metals has grown, the machinery sector's output has declined. Similarly, the production of woolen textiles has contracted by almost twice as much as the production of raw wool. The oil sector, however, has exhibited considerable expansion. In recent years, investment in oil and gas has represented approximately one third of all FDI. Fuel and energy now account for just under 40 percent of total industrial output, up from 15.5 percent in 1990.

There is evidence that the service sectors are buoyant. In some urban centers, such as Almaty and Shimkent, the number of retail trade outlets and restaurants has increased markedly and a significant number of new hotels and service centers for vehicles, appliances, and computers have sprung up. The FSU economy had severely restricted the development of many of these services.

Figure 2.2 Growth of Money Supply (M2) and Consumer Price Index: Kazakstan, 1991-1997



Sources: Asian Development Bank (1997b) and staff estimates.

In mid-1997, 4.7 percent of the registered labor force was unemployed; however, a much larger number of people are thought to be unofficially unemployed or underemployed. In addition, real wages have fallen dramatically, and the payment in-kind of many wage obligations reflects the weakening of traditional payments systems. These in-kind payments are often of little utility to the workers and their families, thereby reducing disposable income severely. Wage arrears running to many months are also common: in mid-1997 the wage arrears of state enterprises were about $600 million, which posed serious political problems for the government.

A deterioration in the social indicators of well-being reflects the extent of economic dislocation. Estimates suggest a sharp increase in both the incidence and depth of poverty. In 1996 more than one third of households lived below the official poverty line. Pensioners and children have been particularly badly affected by the weakening of social support. Rapid inflation and a decline in the real value of pensions have destroyed the savings of the elderly, while the health, nutritional, and educational status of children in poor households has worsened dramatically as public services have contracted along with the resources available to the government.

The need to mitigate hardship has led to demands for the government to do more, but at the same time the resources available to the government have shrunk. As a result, maintaining fiscal balances has proven extremely difficult: in 1997 the deficit was over 4 percent of GDP. Efforts to collect revenues have been hampered by the poor economic situation of larger enterprises in the formal, registered economy and administrative difficulties in taxing smaller enterprises in the informal economy. In addition, the need to create public sector institutions in the wake of independence has strained expenditure control systems.

The government has, however, made significant headway in controlling inflation. In 1997 inflation was 20.4 percent, but in 1994 it was almost 2,000 percent. This reduction in inflation has been the outcome of much tighter monetary control and an improving fiscal position. Financial sector reforms have also helped promote monetary stability. Some banks have been restructured, others have had their licenses revoked, and the weakest banks have been allowed to fail. With lower inflation, capital market development has proved easier. Securities transactions have deepened, interbank credit and settlement systems for commercial banks have been developed, and investors are eager to acquire Treasury bills.

Large trade and current account deficits persist. In 1997 the current account deficit stood at more than 4 percent of GDP. The development of new markets for Kazakstan's output has been slow, and the Russian Federation remains as Kazakstan's largest trading partner. The lack of restructuring and reinvestment in farms and state enterprises and Kazakstan's locational disadvantages thwart the penetration of new markets. Inward capital flows, especially those related to the large foreign investments in oil and gas, mining, and metallurgy, continue to finance current account deficits.

Over the next two years, output growth of 3 percent is achievable. The oil and gas sector is expected to continue to show strength, but the current dependence on pipelines controlled by the Russian Federation restricts large increases in export sales of oil and gas. The construction of other pipelines to markets either in Europe or in the People's Republic of China is planned, but considerable political and administrative problems need to be resolved before construction begins, oil flows, and public revenues rise. Output from the minerals sector should also increase.

The squeeze on public resources will continue during the next few years, especially given the need to restore an adequate social safety net; to clear wage, pension, and social assistance arrears; to provide support for pension reform; and to finance a broader program of public capital investment. The last item is particularly important. The failure to increase public investment, particularly for infrastructure rehabilitation, will increasingly place farms and enterprises at a competitive disadvantage. The decision to move the capital from Almaty in the southeast to Akmola in the north-central region will place further pressure on public resources, as this relocation has necessitated large-scale construction of new public buildings, residences, and infrastructure facilities in a comparatively short period. As a result of these fiscal pressures, the fiscal deficit is expected to increase to more than 5 percent of GDP in 1998.

Although fiscal policy will ease to some extent, the government is likely to maintain a tight monetary stance. As a consequence, inflation is expected to continue to moderate, and could be as low as 10 percent in 1998. Faster economic growth is, however, anticipated to make further containment of the current account deficit difficult. As a proportion of GDP it is likely to remain at around its 1997 level.

POLICY AND DEVELOPMENT ISSUES

In the short run, the main challenge for economic policy is to consolidate the progress made toward macroeconomic stabilization while providing strong foundations for future growth. At the same time, the government must develop safety net mechanisms that can assist the most needy and ease some of the pain of poverty.

Future progress on macroeconomic stabilization will rest on three pillars, namely: the government must persist with its anti-inflationary monetary stance, it must strengthen its revenue mobilization efforts so that fiscal balances improve, and it must take steps to support the development of a modern and robust financial system. The banking sector remains weak and unable to provide attractive savings facilities and meaningful intermediation for loanable funds. It also has limited capacity for commercial risk assessment for evaluating loan portfolios.

Achieving sustainable growth over the longer run will require restructuring of and reinvestment in the operations of farms and firms. In most sectors, enterprises are handicapped by a set of interlocking disadvantages: they continue to operate with obsolete equipment from the Soviet era for which spare parts are often difficult to obtain; managers who possess basic business skills are in short supply; most enterprises are heavily indebted, owing suppliers and the government (for tax payments and pension contributions); deteriorating utility and infrastructure services, especially electricity, hamper enterprises' operations; and enterprises lack financing for either trade or investment credit. To date, privatization has resulted in the formal transfer of some assets, but not the development of entrepreneurs willing to take risks, new investment, and competitive markets.

Unreconstructed enterprises are a source of considerable inefficiency for the economy and jeopardize fiscal stability. In 1996 government subsidies to loss-making firms amounted to 2 to 3 percent of GDP; however, it has demonstrated some willingness to tackle this complex problem. It has shut down some nonviable operations, and retrenchments have occurred in others as part of restructuring. Nevertheless, more determined efforts are needed. While Kazakstan's location means that foreign investors are unlikely to be attracted to more than a few sectors, the role of foreign investment in providing needed capital and technological, managerial, and institutional know-how is still likely to be important. However, even where foreign takeover of enterprises has occurred, effective restructuring has been fraught with difficulties. Above all, foreign investors require a predictable legal and policy environment, which in turn necessitates evenhandedness and consistency in implementing rules and regulations. Without improved governance structures, particularly in government-private sector relationships, kindling growth is likely to prove hard.

While natural resources will be an important future source of income for Kazakstan, the management of these resources will present challenges. Looking to the longer term, the development of manufacturing industries often seems to be problematic in resource-rich economies like Kazakstan, partly because an abundance of natural resources automatically tends to shift the terms of trade against the manufacturing sector. To the extent that the manufacturing sector is where most productivity gains are realized, economic dynamism is then lost. In addition, large resource rents often seem to present difficult problems for public sector management, especially in economies where governance capacities are weak. Despite these difficulties, some economies have managed their natural resource wealth well. These economies have actively promoted economic diversification, partly through processing before export, but also through policies of openness to FDI and trade and wise investment of their resource windfalls. They have struck a judicious balance between investment and consumption uses of rents. Kazakstan could benefit from looking at these experiences.

Kazakstan faces a number of other difficult challenges. For a landlocked and remote country such as Kazakstan, regional transport and communications systems are particularly important. Regional cooperation aimed at harmonizing and coordinating investment in transboundary transportation and distribution would be one way to ease the constraints of geography. Regional cooperation might also help to develop markets, making investment feasible in sectors that might otherwise not be viable. While the difficulty of overcoming the disadvantages of physical isolation should not be underestimated, the process of integration in the global economy is likely to be easier if integration starts close to home.