PRIVATE SECTOR ASSESSMENT (SUMMARY)\(^1\)

1. The country partnership strategy (CPS) of the Asian Development Bank (ADB) emphasizes private sector development through sovereign and nonsovereign lending operations as well as advisory and technical assistance. This summary analyzes the major constraints facing the private sector, identifies possible solutions, and suggests approaches for ADB interventions to promote private sector development in Kazakhstan.

A. Macroeconomic Management

2. Economic management. Economic management has bolstered private sector confidence. Kazakhstan’s macroeconomic management during and since the financial crisis of 2008–2009 was a success. The clarity and firmness of policies and its decisive execution provided confidence to the private sector. The country has maintained its investment grade rating. The government expanded demand to counter the economic cycle. Economic fundamentals remain strong. Fiscal policy is conservative—the oil fund in the central bank is being run in a cautious, rules-based manner, thereby reducing the dangers of a resource-fed overheated economy; and sovereign debt to the gross domestic product (GDP) ratio is low. The cyclical stimulus is being withdrawn.

3. Low efficiency. Nonetheless, low efficiency needs to be addressed through reforms. Private activities account for about two-thirds of the economy. The private sector is vigorous and is projected to expand markedly over the medium term, but suffers from low efficiency and productivity (one-third of the Republic of Korea’s and one-quarter that of the United States). First-generation structural reforms have been accomplished but notable weaknesses lie in enterprise restructuring; large enterprise privatization has not advanced and competition policy remains underdeveloped. Inconsistency in the application of laws and regulations and corruption sap confidence.

4. Customs union. The impact of the customs union needs to be assessed. The phased implementation of the customs union with Belarus and the Russian Federation will affect the pattern of production and prospects for private investment. The average tariff and its dispersion will rise, and could lead to trade diversion and a negative shock to output. However, new opportunities will open up in the Russian Federation’s market with the removal of border controls.

B. Problem Loans

5. Problem loans. The failure to resolve problem loans in banks will block output recovery. A critical weakness is the proliferation of nonperforming loans (NPLs) in Kazakhstan’s banking portfolio and the lack of effective policy initiatives. NPLs in 2011 ranged from 21% to 31% of the overall asset portfolio (depending on the definition). Though adequately provisioned, the deteriorated quality of the portfolio needs to improve and credit default swap rates must be brought down. In addition, the provisioning cover of overdue loans may be overstated by doubtful recoveries of restructured loans. Another issue is the continued rise in accrued (as opposed to received) interest income of banks, equivalent to about 60% of regulatory capital.

6. Tax code. A top priority is amendment to the tax code. Recent tax amendments are expected to reduce disincentives to the writing off of NPLs by banks. Changes to the insolvency

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framework are also required, permitting all the creditors of the enterprise to work out their claims simultaneously in a collective action.

7. **Local currency.** Local currency finance market development is another priority. Such markets would reduce the risk of booms and busts in capital inflows, encourage domestic savings and financial intermediation, and improve control of risks within banks and borrowers.

C. **State Involvement in the Economy**

8. **Industrial sector.** State involvement in the industrial sector is extensive. With the adoption of the Plan for Development 2020, the Accelerated Industrialization Development Program, and the Productivity-2020 Plan, state involvement in the industrial sector has increased. The role of the National Welfare Fund, Samruk-Kazyna, has expanded greatly. Samruk-Kazyna holds more than $70 billion (50% of GDP) of public enterprise, utilities, and banking assets to be deployed to finance planned industrialization and infrastructure projects.

9. **Private markets.** Partnership with private markets would avoid a large waste of public resources. There is a need to allow a much greater sphere for decisions to be taken on market principles and for private risk-taking investors to be guided by prices, subject to interest rates free of distortions. The government should concentrate on building up world-class infrastructure (in partnership with private firms); removing other key impediments to private sector expansion such as difficulties in trading across borders, excessive controls, and discretionary powers of tax and customs authorities; improving overall governance; and addressing banking and capital market problems.

D. **Business-Friendly Environment**

10. **Constraints.** Constraints to running a business remain severe. Business Environment and Enterprise Performance Surveys of the World Bank and the European Bank for Reconstruction and Development (EBRD) show that the average firm in Kazakhstan relies heavily on internal finance for investment, and under-trades significantly; only 5% of firms are exporters, and the number of firms exporting over 2005–2009 has declined sharply. The country lags its peers regarding technology use and international standards for accounting.

11. The overall regulatory burden on firms is heavy, with the average firm experiencing three visits per year from tax officials—higher than most Europe and Central Asia countries. Some 25% of Kazakhstan firms state that the business licensing and permitting process poses major constraints to conducting business.

12. Corruption remains a major constraint to private sector activity. Business Environment and Enterprise Performance Surveys shows that 34% of firms in Kazakhstan are expected to make informal payments to get things done. The transparency and stability of the legal and regulatory environment is a key concern for investors. Reforms and the willingness of the political leadership to engage in dialogue with foreign investors are strong investment-promoting factors. The government is also taking actions to promote foreign direct investment, even though the bureaucratic burden remains to be rationalized.

E. **Laws and Regulations**

13. Improvements have occurred in crucial areas such as securities legislation, concessions, derivative transactions, competition, insolvency, and anti-money-laundering legislation. However, commercial laws still fall short of internationally accepted standards. In company law, the major shortcomings are in the legislation on disclosure and transparency and on ensuring the basis for an effective corporate governance framework. The insolvency law is weak in addressing reorganization processes, liquidation processes, and treatment of real estate assets.
The means of enforcement of security rights is reported to be problematic owing to deficiencies of the court system, uncertainty regarding enforcement mechanisms, incidents of noncompliance with enforcement rules and decisions, difficulties in locating and ensuring control of the pledged assets, and possible application of exchange control rules for repatriation of enforcement proceeds.

14. Despite improvements, problems remain with the Law on Concessions, enacted in 2006 and amended in 2008, which do not seem to have been adequately addressed by the new Project Finance Law enacted in December 2011. In the Law on Concessions, among others, security issues, including collateral, present a significant obstacle to the bankability of potential projects as pledging financial assets is still not allowed (although it may be possible to pledge shares in a concessionaire). The Project Finance Law appears to have weakened a lender’s direct step-in rights compared to earlier versions of the draft law.

F. Public–Private Partnerships

15. Government has declared that public–private partnerships (PPPs) will be a major instrument for securing investment in the infrastructure sectors—chiefly power generation, transport (railways and roads), and municipal utility services. Samruk-Kazyna has initiated a program of 21 projects in the infrastructure, metals, and pharmaceuticals sectors amounting to $21 billion by 2015. Some of these projects could be realized through PPP arrangements. Moreover, for water utilities investments, $300 million annually has been set aside as the public contribution to total investments. Altogether, the government is prepared to allocate a total of $6 billion by 2015 to finance and support PPP arrangements.

16. The promise of PPPs will be realized only if legal and regulatory constraints are addressed and fundamental policy and organizational changes made. The sparse record of PPP arrangements thus far, despite government policies purporting to support PPPs, reflects the lack of decisive leadership on PPPs. Consequently, Kazakhstan’s record in implementing successful PPP transactions has been disappointing. Long and expensive preparations undertaken by both the public and private sectors without closing successful PPP deals, because of failed tenders or negotiations at the very last stage, need to be avoided.

17. A successful PPP regime has to reflect new market realities. Securing financing will require greater financial and guarantee support from the government, and a relative shift in risk-shouldering toward the public sector. The country has the fiscal space to support PPPs and fiscal expenditures on PPPs will yield a high return. Capital grants have the potential to significantly reduce private sector project costs and associated debt service payments. Some financing for projects could be captured through charges or taxes. Availability-based payments could help deal with risks of inadequate demand for services.

G. Large Potential for Subnational Finance

18. A large potential for subnational finance exists, given the very significant municipal infrastructure needs. However, a framework for subsovereign borrowing has to be developed. Capital grants, other budget transfers, and investments from Samruk-Kazyna will finance a significant portion of the huge capital needs of the utilities sector. However, borrowing from domestic capital markets and international financial institutions, and private participation, will also be necessary. The development of a subnational debt market will require setting up regulations, consisting of fiscal rules that will govern the purpose and volumes of debt issued, limiting debt for capital investments, and relating its volume to key fiscal variables within a medium-term fiscal framework. Apart from prudential rules, the development of subnational
finance will require a widening of the authority to borrow, which is at present confined to the municipalities of Almaty and Astana.

H. Implications for ADB Strategy

19. Overall development strategy. There is resonance between the government’s development and diversification plans and ADB’s Strategy 2020. Both envisage a leading role for the private sector, especially in infrastructure. There is a need to clarify the most effective supporting policies for private sector development. ADB in this regard could provide support through a strategic knowledge product on developing a coherent and fiscally effective approach to diversification and industrialization based on existing plans and programs.

20. Reinvigorating the financial sector. A knowledge product on developing local currency markets would fill a vital gap. Through its small and medium-sized enterprise (SME) work in Kazakhstan, ADB has an interest in the development of local bonds for SME finance. A financial operation involving equity and debt participation in a special purpose vehicle for resolving problem loans in banks could be considered. Support for developing the nonbank financial market could also be considered.


22. Improving access to finance. ADB could support improving the regulatory regime governing microfinance institutions. Currently, microfinance institutions are not able to offer financial services beyond lending, which seriously reduces their impact on poverty alleviation.

23. Supporting public–private partnerships. ADB’s assistance on PPPs can take various forms—upstream advisory work on the preconditions necessary to win back investor confidence, downstream transaction advisory work, and participation in PPP projects through a range of instruments. Participation in an energy efficiency project and one or more transport projects over the CPS period could be considered. ADB is collaborating with the International Finance Corporation (IFC) to explore how best to assist the government with attracting more private sector investment, including through various PPP modalities.

24. Developing the foundations for subnational finance. ADB could support studies on (i) the creation of subnational debt markets; and (ii) adaptations to utility management, corporate structure, and financial flows for utilities to be able to borrow.

25. Role of other development partners. The CPS seeks to build strong partnerships with development partners active in private sector development and operations in Kazakhstan. Besides having supported improvements to the business environment, the EBRD has provided the most support to date for private sector operations, with a total business volume, including co-financing, of €10.4 billion in 2011. The IFC’s investment portfolio is mostly concentrated in the financial sector and manufacturing, although it has also begun making investments in the agribusiness sector. The European Investment Bank, European Union, Islamic Development Bank, World Bank, Eurasian Development Bank, the United Nations system, and several bilateral partners including the Japan, the People’s Republic of China, and United States also support private sector development and operations in Kazakhstan.

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