



Report and Recommendation of the President to the Board of Directors

Project Number: 40908

Proposed Assistance to Private Bank in Kazakhstan

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 1 March 2006)

Currency Unit – tenge (T)

T1.00 = \$0.0075

\$1.00 = T134

ABBREVIATIONS

ADB	–	Asian Development Bank
ALB	–	JSC Alliance Bank
CIS	–	Commonwealth of Independent States
FMSA	–	Financial Markets Supervisory Agency
GDP	–	gross domestic product
IFRS	–	International Financial Reporting Standards
KKB	–	Kazkommertsbank
NBK	–	National Bank of Kazakhstan
PSOD	–	Private Sector Operations Department
PSOP	–	Private Sector Operations Division
SME	–	small or medium enterprise
TA	–	technical assistance

NOTE

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

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INVESTMENT AND PROJECT SUMMARY

Investment Proposal	Asian Development Bank (ADB) proposes to provide a financial intermediation loan of up to \$50 million to JSC Alliance Bank (Alliance Bank or ALB). The proposed loan is focused on lending to small and medium enterprises (SMEs) in Kazakhstan.
Borrower	JSC Alliance Bank
Classification	Targeting classification: General intervention Sector: Finance Subsectors: Banking systems, finance sector development, small and medium-scale enterprises Themes: Sustainable economic growth, private sector development Subthemes: Promoting economic efficiency and enabling markets, private sector investment
Objectives	To assist ALB in growing its SME loan portfolios by providing part of the needed debt funding and in turn assist the Government of Kazakhstan in its efforts to steer the Kazakh economy towards a more sustainable SME-led growth and to diversify from the dominance and dependence on natural resources industries.
Rationale	<p>The Kazakhstan economy is heavily dominated by and dependent upon its oil and other natural resources exports. The SME and manufacturing sectors are currently underrepresented in the national economy. However, the SME sector is relatively more labor-intensive, contributing approximately 40% of employment. SME growth is hence significantly more inclusive and “pro-poor” in nature, and therefore it is of key importance to create conditions for growth of the SME sector.</p> <p>One of the most pressing problems identified for SME development in Kazakhstan is difficulty in accessing capital, especially debt financing. For the companies that drive pro-poor growth, such as manufacturing-sector SMEs, funding is a constraint. If Kazakhstan is to move out of its heavy dependence on oil exports and to further develop SMEs—and especially in the manufacturing sector—then these hurdles will have to be overcome.</p>
Justification	<p>The proposed loan is justified for the following reasons:</p> <p>Development Impact. Diversification of the economy toward non-oil investments is crucial for Kazakhstan’s sustainable and inclusive economic development. Kazakhstan faces two challenges in creating a sustainable economic base for after the oil boom recedes. The first is to achieve economic diversification, both through strengthening the non-oil sectors of the real</p>

economy and through appropriate diversification of its growing financial assets. Improving access to finance by SMEs helps to achieve both of these. The second challenge is to improve transparency standards in the financing of private firms, especially SMEs. ADB's proposed loan will directly contribute to expanded financial intermediation to SMEs, including those in rural areas, via the existing and growing branch network of the selected bank, and they will foster the diversification of loan portfolios.

Value Added by ADB. ADB's proposed loan will add value by (i) enabling ALB to grow its SME loan portfolio; (ii) providing access to longer maturities; and (iii) increasing depositor confidence in Kazakhstan's relatively young banking market. ADB's loan would be specifically targeted at SMEs and will contribute to strengthening the selected bank's capacity to serve the SME sector.

**Environmental and
Social Guidelines**

Environment category: FI
Indigenous peoples and resettlement category: C

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior financial intermediation loan of up to \$50 million to JSC Alliance Bank (Alliance Bank or ALB). ALB is focused on lending to small and medium enterprises (SMEs) in Kazakhstan.

II. BACKGROUND AND RATIONALE

A. Kazakhstan Economy: Overview and Outlook

2. Kazakhstan maintained its solid economic growth in 2005 (in excess of 9% during January–September 2005) that is based on foreign direct investments in the energy sector, increased pipeline export capacity, conservative fiscal and monetary policy balancing increased public programs with price stability, and strong banking system regulation and supervision. Continued fiscal discipline seems likely, with approval of the 2006 budget deficit at 1.4% of GDP. For 2006, GDP growth is predicted to be sustained at 8.5%. The country has benefited in recent times from higher oil prices and greater exports, both of which have increased foreign currency inflow and assisted debt-servicing efforts. For these economic strengths, Kazakhstan is rated Baa3 by Moody's and BBB by Standard and Poor's with a positive/stable outlook. For more details on the economic assessment, please refer to Appendix 1.

3. Nevertheless, Kazakhstan's high dependence on oil exports poses a potential threat for the economy given potential volatility in the international oil market. To mitigate such risk, in this time of growth, the Kazakhstan Government has created a National Fund that would, if needed, reduce the country's vulnerability to external commodity price shocks. Moreover, the Government is pushing hard for higher diversification of the economy, especially by promoting the SME sector alongside strong commercial development of the financial (principally the banking) sector.

B. Small and Medium Enterprises' Contribution to the Economy

1. SMEs' Contribution to the Economy and Government Focus

4. The Kazakhstan economy is heavily dominated by and dependent on its oil and other natural resources exports. The SME and manufacturing sectors are currently underrepresented in the national economy.¹ However, the SME sector is relatively more labor-intensive, providing approximately 40% of total employment. SME growth is hence significantly more inclusive and "pro-poor" in nature, and therefore creating conditions for growth of the SME sector is of key importance.

5. Consequently, SME development has become a focus area for the Kazakhstan Government. It has a declared policy of fostering the development of SMEs, and especially of small businesses, by promulgating certain SME laws² and establishing several organizations to implement this policy.³

¹ The SME sector is estimated to have contributed only 14%–15% of GDP in 2005.

² Law on State Support to Development of Small Business in the Republic of Kazakhstan.

³ The policy has included various support measures, provision of services via business development centers, and small business loans. There is also an exhibition and information center (a wholly state-owned joint-stock company) that works in accordance with the Government's program to support SMEs. In addition, the Government set up the SME Support Fund in 1997 as a nonbanking financial institution. The main objective of the fund is to effectively use financial resources allocated within the framework of state and regional programs for projects and activities aimed at supporting SMEs. The fund is tasked to (i) broaden access to finance for SMEs, (ii) effectively use state and nonstate resources aimed at SME support, (iii) develop SME infrastructure, and (iv) provide consultations for SMEs.

2. Scarcity of Capital as Major Constraint for Small and Medium Enterprise Development

6. In a survey on small businesses conducted by UNDP,⁴ one of the most pressing problems identified for SME development was the difficulty in accessing capital, especially debt financing. For the companies that drive pro-poor growth, such as manufacturing-sector SMEs, funding is a serious constraint. Sources of credit were mostly family and friends, as well as moneylenders in an informal sector.⁵ If Kazakhstan wants to move out of its heavy dependence on oil exports and to further develop the SME segment—and especially the manufacturing sector—then these hurdles will have to be overcome.

C. Banking Sector in Kazakhstan

1. Introduction

7. Kazakhstan's financial sector has grown rapidly in recent years, with improvements in the economic and operating environment through the past 5 years leading to enhanced creditworthiness and commercial profiles for the domestic banking sector. In particular, the Government and National Bank of Kazakhstan (NBK), the central bank, have undertaken structural reforms aimed at promoting consolidation and improving the overall viability of the banking system.

8. Encouraged by the improving macroeconomic environment and robust growth, Kazakh banks have increased lending volumes by an average of more than 40% per year in the last 5 years (albeit from a very low base) while generally maintaining healthy asset quality and profitability. This is especially true for the top performers within the first two tiers of the banking system. Market observers expect this pace of growth to be sustained throughout 2006. While focusing mainly on the domestic market, some Kazakh banks are increasingly expanding their operations in other regional Commonwealth of Independent States (CIS) countries, including Kyrgyz Republic, Russia, and Ukraine, in order to expand and diversify their businesses and market exposures.

9. Kazakhstan's financial sector has several strong points compared with those of other Central Asian and CIS countries. First, the size of the sector relative to GDP is significantly larger than are those in other Central Asian countries. The ratio of bank credit to GDP reached 27% in 2004, which is roughly twice as high as those in Kyrgyz Republic, Tajikistan, and Uzbekistan.⁶ Second, while the development of the local bond markets has lagged behind that of the banking system, domestic pension funds have increasingly emerged as important investors in the local bond market since the launch of the pension reform in 1998. The steadily accumulating pension funds provide a supply of long-term funds that is lacking in most emerging markets, including many other former Central Asian and CIS countries. Third, the core legal framework for the financial sector is already in place.

⁴ United Nations Development Program (UNDP). 2002.

⁵ As of end 1999, only about 20% of the private sector credit came from commercial banking. To access funds outside the formal banking sector, businesspersons reported that they often were forced to operate in the informal sector so that the identities of those supplying them with funds could be concealed. Repayment is enforced by social pressure (and also the fear of physical harm).

⁶ However, 27% bank credit to GDP remains quite low when compared to more developed markets, where it is typically near or even above 100%.

2. Overview

10. The commercial banks in Kazakhstan can be divided into four groups: (i) large local banks (Tier I Banks),⁷ such as Bank TuranAlem and its principal competitors, which are Kazkommertsbank (KKB) and Halyk Bank; (ii) banks under foreign ownership, such as ABN AMRO Bank Kazakhstan, HSBC Bank Kazakhstan and Citibank Kazakhstan; (iii) second tier (Tier II Banks) medium-sized banks with a regional footprint; and (iv) smaller local banks. The decrease in the number of banks from 184 in 1996 to the current 34⁸ is primarily attributable to the ongoing sector reform undertaken by NBK.

11. Reform of the banking sector began in 1996 with the introduction of international prudential standards, including requirements on capital adequacy, liquidity ratios, transparency as to the auditing of banks by local and international auditors, harmonization of local accounting practices to International Financial Reporting Standards (IFRS), and personnel training programs. In addition, NBK required commercial banks to adopt recapitalization and corporate enhancement plans with the aim of boosting their abilities to attract long-term, private investors. In 2000, guidelines were established for bank inspections and for periodic reporting by commercial banks to NBK (and now also to the Financial Markets Supervisory Agency, or FMSA, which currently is the banking supervision body in Kazakhstan). In 2003, all banks were requested to develop and install internal risk management systems.

3. Credit Standing of Commercial Banks

12. The financial standings of Kazakhstan's banks vary. As of 30 September 2005, 18 of the 34 commercial banks had registered capital of over T2 billion, 15 banks had registered capital of over T2 billion, 15 banks had share capital of T1 billion to T2 billion, and one bank had registered capital of T500 million to T1 billion. There are no banks with registered capital of less than T500 million, and any bank whose capital falls below this level is required to submit to FMSA an application for voluntary reorganization into an entity performing only limited banking operations. As of 30 September 2005, aggregate provisions of Kazakh banks on overdue receivables were T52.5 billion.

13. As of 31 December 2005, all of the commercial banks licensed in Kazakhstan were in compliance with prudential regulatory requirements on capital adequacy, single borrower limits, liquidity ratios, foreign currency limits, and reserve requirements. As of 31 December 2004, two commercial banks had failed to comply with seven prudential regulatory requirements, compared to one bank out of compliance as of 31 December 2003 and one as of 31 December 2002 (Alliance Bank was not among these banks). The banks out of compliance did not meet any of the current liquidity ratios, own capital ratios, single borrower exposure ratio, open currency position ratio and maximum asset investment ratio. Provisions for bad debts of all banks operating in the Kazakhstan banking sector as of 31 August 2005 totaled T52.5 billion.

III. THE PROPOSED INVESTMENT

A. Project Selection

⁷ Technically, NBK would be the first tier. The terminology used here therefore only refers to commercial banks below NBK.

⁸ As of August 2005, there were 34 banks operating in Kazakhstan, excluding NBK, which included two fully state-owned special-purpose banks and 14 banks under foreign ownership. As of mid-2004, there were 27 representative offices of foreign banks.

14. Missions to Kazakhstan, in April and November 2005, respectively, by the Private Sector Operations Department (PSOD) met with key Government officials and identified several banks for potential cooperation. These missions were preceded by a visit of ADB's Board to the region that identified an urgent need for ADB's Private Sector Operations to increase its presence in the market. This mandate aligns with the recognition in the Medium Term Strategy II paper of March 2006 that the financial sector represents the top "Core I" focus for ADB. Subsequently, the Private Sector Operations Division (PSOP) of PSOD has deepened discussions with banks in Kazakhstan.

15. ADB has just started to explore private sector opportunities in Kazakhstan and other Central Asian republics, as these countries' framework agreements with ADB have been signed only recently. To create a sustainable footprint for ADB in this region, from both the risk and developmental perspectives, PSOP has taken a balanced approach and chosen two countries for its first moves: Azerbaijan⁹ and Kazakhstan. ADB recognizes that Kazakhstan is certainly a more developed country in the CIS region.

B. Alliance Bank JSC

1. Overview and History

16. Alliance Bank was incorporated in 1993 as an open joint-stock company under the name IrtyshBusinessBank JSC. It merged with Semipalatinsk City Bank in 1999. The combined bank primarily served large industrial enterprises in the Eastern Kazakhstan and Pavlodar regions. In 2001, a consortium of domestic companies acquired a 37% interest in ALB. In 2002, the bank changed its name to Alliance Bank and relocated its headquarters to Almaty, Kazakhstan's financial center. In 2004, Alliance Bank was reregistered as the joint-stock company JSC Alliance Bank.

2. Alliance Bank's Business

a. Overview

17. ALB is authorized to act as a commercial bank and to offer a wide range of traditional banking services, including deposit taking, lending, issuing letters of credit and guarantees, and others. ALB's primary business consists of retail and corporate banking. Its retail banking activities include lending and deposit taking as well as providing payment cards. Its corporate banking division provides a broad range of banking products to a diversified group of domestic customers, and primarily SMEs. The bank is also an active participant in the fixed income securities and foreign currency markets in Kazakhstan.

b. Corporate Banking

18. ALB provides a broad range of commercial banking products and services, including deposit taking and lending, to SMEs and, to a limited extent, to large businesses in Kazakhstan. Although the bank has a number of large corporate clients, ALB's principal focus is on the SME sector.

c. Retail Banking

⁹ ADB. 2006. *Report and Recommendation of the President to the Board of Directors on a Proposed Assistance to the Republic of Azerbaijan for Private Banks and Leasing Companies in Azerbaijan*. Manila (AZE: 39930).

19. The bank offers a broad range of retail products, and its express loans represent a unique product being sold into a growing market in Kazakhstan.

d. Strategy: Focus on SMEs

20. ALB is strategically committed to the SME and retail segments. As Kazakhstan's economy grows and the private sector expands, ALB expects to see continued strong demand from private sector companies for financial services. Especially because it sees public confidence in the banking sector increasing, management believes that the demand for SME and retail banking services will continue to grow.

3. Ownership: Principal Shareholders

21. ALB's common shares are listed on the "A" list of the Kazakhstan Stock Exchange.

4. ALB's Credit Ratings

22. Currently, ALB is rated by two rating agencies: Fitch IBCA ("Fitch")¹⁰ and Moody's Investors Service ("Moody's"). The current ratings are as follow:

Table 5: Alliance Bank Credit Ratings

Fitch		Moody's	
Long-term Outlook	BB-Stable	Long-term Outlook	Ba2 Positive

Source: Alliance Bank.

IV. THE PROPOSED ADB ASSISTANCE

23. For Alliance Bank, ADB is contemplating a senior, unsecured loan for up to \$50 million.

V. INVESTMENT BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Justification of ADB's Loan

1. Investment Objective

24. ADB's objective in the proposed transaction is to assist ALB in growing its SME loan portfolios by providing part of the needed debt funding and, in turn, to assist the Government of Kazakhstan in its efforts to steer the Kazakh economy towards a more sustainable SME-led growth while diversifying away from the dominance and dependence on natural resources industries.

2. Development Outcome

25. Kazakhstan faces two challenges to create a sustainable economic base for after the oil boom recedes. The first is to achieve economic diversification, both through strengthening the non-oil sectors of the real economy and through appropriate diversification of its growing financial assets, particularly through improving access to finance by SMEs. The second is to

¹⁰ Fitch upgraded ALB to BB- only in December 2005.

improve standards of transparency in the financing of private firms, especially SMEs. ADB's proposed loan will directly contribute to expanding financial intermediation to SMEs—including those in rural areas—via the existing and growing branch network of the selected bank, as well as foster the diversification of loan portfolio.

26. As discussed in Section II, the diversification of the economy toward non-oil investments is a crucial factor for Kazakhstan's sustainable and inclusive economic development. While overall investment ratios have been increasing over the past few years, the investment ratio for the non-oil sectors has remained stagnant at around 7% of GDP.¹¹ Although the country is modernizing its extractive industries, with mining and metals contributing significantly to the local economy, non-oil exports have been sluggish at around \$2 billion since 1997.¹²

3. Value Added of ADB

27. ADB's proposed loan will add value by (i) enabling ALB to grow its SME loan portfolio; (ii) providing access to longer maturities; and (iii) increasing depositor confidence in Kazakhstan's relatively young banking market. ADB's loan would be specifically targeted at SMEs and will contribute to strengthening the selected bank's capacity to serve the SME sector.

4. Measures for Development Impact

28. PSOP will measure the expected development impact of the proposed loan. These performance measures follow the multilateral development banks' Evaluation Cooperation Group's Standards for Evaluation of Private Sector Investment Operations. Development impact is measured in three distinct categories: (i) business performance of the project itself, (ii) economic sustainability, and (iii) private sector development. Examples of development impact measures are provided below. Appendix 2 shows the full development impact framework.

5. Fit to Sector and Country Strategy

29. In view of the Government's medium-term targets for 2010, the development of a vibrant and competitive private sector is vital to ensure economic diversification as well as balanced and inclusive development. The Government has a particular focus on SME development and on deepening and developing the financial sector. The ADB program, as set out in the private sector development section of the country strategy and program for Kazakhstan,¹³ seeks to complement the Government's efforts through increased activities in private sector operations.¹⁴

30. As a result, the ADB Kazakhstan country strategy and program update 2006–2008 emphasizes the Government's policy on SME development to create jobs and recommends ADB assistance through providing credit to SMEs via domestic banks.

31. Therefore, the proposed loan will directly contribute to implementing the country strategy and program for Kazakhstan by fostering financial intermediation for SMEs. Indirectly, the assistance also supports rural area development, as the selected bank is providing loans to SMEs in these areas. The portfolio approach taken (Section III.A.) will ensure sustainability of ADB's intervention from a risk and development perspective.

¹¹ World Bank. 2005. *Republic of Kazakhstan. Country Economic Memorandum*. Washington, DC.

¹² In the Philippines, for example, exports of non-oil goods and services were \$43 billion in 2004.

¹³ ADB. 2005. *Country Strategy and Program Update (2006–2008): Kazakhstan*. Manila.

¹⁴ In October 2004, the Government signed the framework agreement signaling the start of ADB private sector operations in Kazakhstan.

32. Moreover, PSOP's initiatives are part of a wider effort to improve the efficiency of the financial sector, as these are accompanied by policy dialogue. The involvement of ADB's public sector operations through the East and Central Asia Regional Department ensures the necessary Government discussions enabling both a strong financial sector and reform in SME finance.

33. The Central and Western Asia Regional Department has undertaken various projects to increase ADB private sector operations in Kazakhstan. For instance, Technical Assistance KAZ: Urban Small Business Development¹⁵ has the objectives to promote development of the urban SME sector, review the legal and regulatory framework for SMEs, and foster financial intermediation. Most recently, ADB has approved Technical Assistance KAZ: Republic of Kazakhstan Financial Sector Governance Phase II,¹⁶ which seeks to foster a sound, efficient, and broad financial system by strengthening the supervision of banks, accumulation of pension funds, and operations of asset management companies. This assistance will play a central role in supporting ADB's private sector operations in the financial sector and in strengthening domestic banks.

B. Social and Environmental Safeguard Policies

34. The proposed loan has been assigned an "FI" environmental classification and a "C" with respect to indigenous people and resettlement. The implementation of an environmental management system represents an essential value addition by ADB to these financing transactions.

C. Anticorruption Policy: Combating Money Laundering and the Financing of Terrorism

35. ALB has been advised of ADB's anticorruption policy and of policy relating to combating money laundering and the financing of terrorism. Consistent with its commitment to good governance, accountability, and transparency, ADB will require ALB to institute, maintain, and comply with internal procedures and controls following international best practice standards for preventing corruption, money laundering activities, and the financing of terrorism.

VI. ASSURANCES

36. The proposed loan is within ADB's aggregate, country, industry, group, and single project exposure limits for private sector projects.

37. ADB will enter into suitable loan agreement and other legally required documents, following approval of the proposed financing by ADB's Board of Directors. These agreements will be on terms and conditions satisfactory to ADB. In addition, ADB will need to be satisfied with all terms and conditions of any other documents associated with the proposed financial assistance.

¹⁵ ADB. 2001. *Technical Assistance to the Republic of Kazakhstan for Preparing the Urban Small Business Development Project*. Manila.

¹⁶ ADB. 2005. *Technical Assistance to the Republic of Kazakhstan for Financial Sector Governance Phase II*. Manila.

38. A framework agreement relating to ADB's status, privileges, and immunities with respect to its lending operations in the private sector is in effect between Kazakhstan and ADB. Consistent with the Agreement Establishing the Asian Development Bank, the Kazakhstan Government will be requested to confirm that it has no objection to the proposed ADB loan to ALB. No investment will be disbursed until ADB receives such confirmation.

VII. RECOMMENDATION

39. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the financial intermediation loan of up to \$50,000,000 to JSC Alliance Bank from ADB's ordinary capital resources, with interest to be determined based on the procedures applicable to ADB's private sector operations and such other terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

22 May 2006

KAZAKHSTAN: MAJOR MACROECONOMIC CONSIDERATIONS

A. Economic Outlook

1. High oil prices, foreign investment, and good macroeconomic management underlie the continuing economic boom in this oil-rich export economy. Gross domestic product (GDP) growth, led by the oil sector, averaged 9.5% during 2002–2004 and 9.4% in 2005. Furthermore, representing 65% of GDP, the private sector is increasingly driving growth in the economy.¹

2. The above mentioned factors helped lift 2005's general budget revenues by 4.7 percentage points to 28.2% of GDP. This large gain was somewhat offset by the increase in budgetary spending before the December presidential election. The general government budget recorded a surplus of 0.6% of GDP, from a slight deficit of 0.3% in 2004. In view of its strong financial position, the Government made early repayments totaling \$850 million on its external public debt, reducing the total to about 4% of GDP at end-2005. The 2006 state budget was approved in November 2005. It raised revenues by 2% of GDP from the previous year's level, reflecting government projections for greater receipts from oil. The increase is earmarked for public investment and social programs.²

3. High world commodity prices helped ramp up exports by 40.0% to \$28.7 billion, oil and metals accounted for more than two thirds of the increase. Imports also leaped, by 37%, driven largely by machinery, equipment, and nonprecious metals. The trade surplus improved by about

¹ European Bank for Reconstruction and Development estimate. This is up from 55% of GDP in 1998.

² ADB. 2006. *Asian Development Bank Outlook 2006*: 96–97.

45% to \$9.8 billion, but the deficit on the services, income, and transfers account worsened sharply. The latter stemmed from greater payments for construction, freight, insurance, and information technology services, as well as a near doubling of income payments to foreign direct investors, nearly all associated with oil sector development. Consequently, the current account surplus in 2005 improved only marginally from a year earlier to \$750 million (about 1.3% of GDP). For the first time in 5 years, official reserves at the National Bank of Kazakhstan declined, though they recovered substantially in the first 2 months of 2006. (Footnote 2)

4. Gross official reserves stood at \$7.1 billion at end-2005 (equivalent to 37 months of imports of goods and services) while end-year foreign asset holdings of the National Fund of the Republic of Kazakhstan (NFRK), which saves a part of the Government's oil and mineral revenues for future generations, amounted to \$8.0 billion. During the year, the total of official reserves and fund assets strengthened by about \$684 million (about 1.2% of GDP) to \$15.1 billion. Outstanding public external debt was reduced by about \$1.0 billion to \$2.4 billion (about 4.2% of GDP) in the 9 months to end-September 2005. In this period, private sector external debt (excluding oil and gas intracompany debt) increased sharply by \$4.6 billion to \$16.6 billion (about 33% of GDP). The upsurge in private debt in recent years—mainly local bank borrowing for onlending—was largely a response to the differential between available foreign borrowing rates and domestic lending rates of about 15% for tenge loans and 11% for loans denominated in foreign currency. (Footnote 2)

5. The tenge continued to appreciate against the US dollar (2.9%) on an average annual basis, reflecting export earnings, foreign direct investment (FDI), and private external borrowing. However, tighter market conditions in the final months of 2005 resulted in a 2.2% depreciation on an end-of-year basis. As in the previous year, the real effective exchange rate rose by about 6% year on year, due to inflation differentials. Largely because of future substantial oil-related revenues, real appreciation may continue in 2006. (Footnote 2)

6. The medium-term outlook is positive, assuming buoyant oil prices, foreign direct investment inflows, continuation of economic diversification, good macroeconomic management, and political stability. In 2006, GDP growth is expected to be sustained at 8.5%. Moreover, macroeconomic stabilization should continue, with inflation estimated at about 6.5% in 2006. Despite recent substantial increases in wages and social spending, the Government of Kazakhstan has maintained sustainable fiscal and monetary policies, which have limited budget deficits and inflation. General government debt will continue to decrease in the next few years by about 1.0%–1.5% of GDP annually. Additionally, with the National Reserve Fund for excess oil earnings and tax revenues expected to reach about \$7.4 billion by year-end 2005, a substantial fiscal buffer has been created.³ Despite increased external borrowing by commercial banks, the overall external position remains strong.

7. A decomposition shows that overall growth in 2000–2004 was led by strong contributions from capital and total factor productivity (TFP). The contribution of labor accumulation declined continuously, suggesting that the economy is likely approaching full employment. According to government data, the contributions of capital accumulation, TFP, and labor growth to the average GDP rate of expansion of 10.4% in 2000–2004 were 6%, 3.2%, and 1.2%, respectively.⁴

³ The National Fund of Kazakhstan was created in 2001 to accumulate a part of the Government's oil and mineral revenues for stabilization purposes and to save for future generations.

⁴ ADB. 2006. *Asian Development Bank Outlook 2006*: 98–99.

8. The hydrocarbons sector has grown at an average of 16% a year since 2000, and will remain the locomotive of growth in the medium term. Its share in GDP, including production and related services, jumped from 11% in 2000 to almost 25% in 2005, and is expected to continue rising as production capacity increases. Sector growth has been fueled by large capital investments; oil and gas have received 60% of total investment, equivalent to 15% of GDP over the 2000–2005 period. Two thirds of the oil and gas investment came from the private sector. The share of hydrocarbons in GDP will increase over the medium term as large projects come on stream, though investment in the sector is expected to taper off as a share of total fixed investment. (Footnote 4)

9. Non-oil output has risen at an average of 7% a year since 2000 and has been sustained at the rate of 25% of total investment, representing 6.5% of GDP in 2000–2005. Within the non-oil sector, construction and services have been the most dynamic. Their combined share in GDP and total employment has increased to 65% and 60%, respectively. (Footnote 4)

10. In contrast, the share of manufacturing and agriculture in GDP has declined, reflecting low capital investment. Their investment rate stood at 3% of GDP a year on average over the period, with half of that from the public sector. If the investment rate in the non-oil sector keeps to its recent trend, non-oil growth could well stay at 7–8% a year in the medium term—and even higher if the Government manages to diversify the economy and stimulate the private sector. Removing impediments to regional trade and accession to the World Trade Organization would advance development of both the non-oil and private sectors. (Footnote 4)

11. Continuing growth, job creation in the private sector, and pro-poor growth have raised living standards. In 2004, real per capita incomes rose by 13%. The percentage of people living below the subsistence minimum⁵ fell from 19.8% in 2003 to 15.0% in 2004. Unemployment declined from 8.8% in 2003 to 8.4% in 2004.

B. Political and Regional Background

12. Kazakhstan became an independent sovereign state in 1991 as a result of the dissolution of the former Soviet Union. Since then, Kazakhstan has experienced significant change as it emerged from a single party political system and a centrally controlled command economy to a market-oriented, democratic model. The transition was initially marked by political uncertainty and tension, a recessionary economy marked by high inflation and instability of the local currency, and rapid but incomplete changes in the legal environment.

13. Since 1992, Kazakhstan has actively pursued a program of economic reform designed to establish a free-market economy through privatization of state enterprises and deregulation, and it is more advanced in this respect than some other countries of the CIS. However, as with any transition economy, there can be no assurance that such reforms and other reforms described elsewhere in this proposal will continue or that such reforms will achieve all or any of their intended aims.

14. Kazakhstan depends on neighboring states to access world markets for a number of its major exports, including oil, steel, copper, ferro-alloys, iron ore, aluminum, coal, lead, zinc, and wheat. Kazakhstan is thus dependent upon good relations with its neighbors to ensure its

⁵ The subsistence minimum is a measure of poverty. Calculated by the State Statistics Agency, it comprises the cost of a basket of 70% food items and 30% goods and services. The poverty line is established as a fixed percentage of the subsistence minimum, and it is used for determining households' social assistance allowances and eligibility for such assistance. In 2004, the subsistence minimum was T5,427 or equivalent to \$40 a month.

ability to export. In addition to taking various steps to promote regional economic integration among neighboring countries, Kazakhstan signed an agreement in September 2003 with Belarus, Russia, and Ukraine for creating a single economic zone, which is expected to result in common economic policies, harmonization of legislation implementing such policies, and the creation of a single commission on trade and tariffs. The aim of the single economic zone is to create a free customs area within which member countries would enjoy free movement of goods, services, capital, and labor. Another step toward integration is that the member countries also intend to look at ways to coordinate their fiscal policies, credit and currency policies, and government policies. These efforts will support further economic integration within the CIS, one of the aims of which is to assure continued access to export routes.

C. Macroeconomic Considerations and Exchange Rate Policies

15. Since Kazakhstan is heavily dependent upon export trade and commodity prices, it was particularly affected by the Asian financial crisis in early 1998 and by the Russian crisis later that year, both of which exacerbated the problems associated with falling commodity prices. Because Kazakhstan's economy is negatively affected by low commodity prices and economic instability elsewhere in the world, the Government has promoted economic reform, inward foreign investment, and diversification of the economy. Notwithstanding these efforts, however, low commodity prices and weak demand in its export markets may adversely affect Kazakhstan's economy in the future.

16. The Government began implementing market-based economic reforms in 1992, including to implement a significant privatization program, promote high levels of foreign direct investment (particularly in the oil and gas sectors), and introduce an extensive legal framework. Despite uneven progress in this regard, Kazakhstan has experienced extensive economic transformation over the last 12 years. Since mid-1994, the Government has adhered to a macroeconomic stabilization program aimed at curtailing inflation, reducing the fiscal deficit, and boosting international currency reserves. According to figures compiled by Kazakhstan's National Statistical Agency, GDP has continued to grow in real terms following the adoption of a floating exchange rate policy in April 1999. It rose by 13.5% in 2001, 9.8% in 2002, 9.2% in 2003, and 9.4% in 2004. However, there can be no assurance that GDP will continue to grow, and any decrease in GDP or in the rate of GDP growth in subsequent years could adversely affect Kazakhstan's development.

17. The tenge is convertible for current account transactions, although it is not a fully convertible currency outside Kazakhstan. Between 1991, when Kazakhstan began its transition to a market-based economy, and April 1999, the National Bank of Kazakhstan (NBK) maintained a managed exchange rate policy, which, although permitting the general trend in the exchange rate to reflect market conditions, involved official intervention aimed at limiting fluctuations. Depressed export markets in 1998 and early 1999, however, caused considerable pressure on Kazakhstan's managed exchange rate and resulting official intervention in the foreign exchange markets led to losses on foreign currency reserves. In response to these pressures, the authorities instituted a number of expenditure cuts, took revenue increasing measures and, in April 1999, the NBK floated the tenge. The tenge fell by 64.6% against the US dollar as of 31 December 1999, compared to a depreciation of 10.7% as of 31 December 1998. Following the adoption of a floating exchange rate policy in 1999, the tenge continued to depreciate against the US dollar, although at a much slower rate. It depreciated by 4.6% in 2000, by 3.8% in 2001, and 3.3% in 2002. The tenge subsequently appreciated against the US dollar by 7.3% during 2003 and by 9.9% during 2004. Then during the first 6 months of 2005, it depreciated against the dollar by 4.0%, to T135.26, as of 30 June

2005. Since then the tenge has gradually appreciated against the dollar and as of 11 May 2006, the official T/\$ exchange rate reported by the NBK was T122.87.

18. While the NBK has stated that it has no plans to resume a managed exchange rate policy, there can be no assurance that the NBK's policy will not change, and any subsequent decision to support the exchange rate could have an adverse impact on Kazakhstan's public finances and economy.

D. Regulation of the Banking Industry

19. In September 1995, the NBK introduced strict prudential requirements for the operations and the capital adequacy of banks. In addition, an institutional development plan was prepared for leading Kazakhstan banks. According to the plan, banks are required to prepare their accounts in accordance with International Financial Reporting Standards (IFRS) and to apply the Basel Committee norms within the period determined by the NBK on a case-to-case basis. These norms apply to ALB. Further, Kazakhstan banks are required to join a bank-funded deposit insurance scheme and be audited annually by a public accountancy firm approved by the NBK, which is likely to be one of the leading international firms. Following legislative changes in July 2003, the Financial Markets Supervisory Agency (FMSA) was formed, and, as of 1 January 2004, it took responsibility for most of the supervisory and regulatory functions in the financial sector, which had previously been performed by the NBK. The FMSA's main task is to regulate and supervise the financial markets and financial institutions in Kazakhstan.

E. Implementation of Further Market-Based Economic Reforms

20. The need for substantial investment in many enterprises has driven the Government's privatization program. The program has excluded certain enterprises deemed strategically significant by the Government, although major privatizations in key sectors have taken place, such as full or partial sales of certain large oil and gas producers, mining companies, and the national telecommunication company. However, there remains a need for substantial investment in many sectors of the Kazakhstan economy and there are areas in which economic performance in the private sector is still constrained by an inadequate business infrastructure. Furthermore, the extent of noncash transactions in the economy and the size of the shadow economy adversely affect implementation of reforms and hamper the efficient collection of taxes. The Government has stated that it intends to address these problems by improving bankruptcy procedures, the business infrastructure, and tax administration as well as by continuing the privatization process. Implementation of these measures in the short term has produced few positive results, however, and improved results may not materialize until the medium term, if at all.

DEVELOPMENT IMPACT FRAMEWORK

1. **Business Performance** (overall profitability and commercial viability of the financial institution)

Impact	Reported Measure
<ul style="list-style-type: none"> ▪ Overall performance of the financial institution 	<ul style="list-style-type: none"> ▪ Return on equity ▪ Return on assets ▪ Net interest margin ▪ Cost/income ratio ▪ Growth in assets

2. **Economic Sustainability** (allocation of resources and provision of financial services to viable private enterprises)

Impact	Reported Measure
<ul style="list-style-type: none"> ▪ Contribution to widening the access to finance 	<ul style="list-style-type: none"> ▪ Number of borrowers ▪ Increase of lending to business enterprises ▪ Disbursements to rural areas ▪ Training for staff ▪ Credit quality in lending ▪ Average size of loans ▪ No breach of domestic prudential norms (central bank regulations)

3. **Private Sector Development** (contribution to the growth of viable financial sector and financial markets development)

Impact	Reported Measure
<ul style="list-style-type: none"> ▪ Better technology in domestic financial sector ▪ Corporate governance ▪ Reform and stability of the financial sector 	<ul style="list-style-type: none"> ▪ Operational improvement (e.g., credit appraisal methods) ▪ Evidence of spillover effects (e.g., competitors adopting best practices of investee) ▪ Enhanced disclosure standards and/or accounting standards ▪ Contribution to financial strength of sector (e.g., better match of assets and liabilities) ▪ Increased private sector participation and/or control in investee ▪ Share in total financial sector assets of private sector financial institutions ▪ Increase in banking sector assets