

Kazakhstan Aiming for the top 30

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On the crossroads of Europe and Asia lies Kazakhstan, a vast nation spanning the two continents. Sharing borders with Russia in the north, China in the east, and Turkmenistan, Uzbekistan and Kyrgyzstan in the south, Kazakhstan is the world's largest landlocked country with an area of 2.7 million square kilometers, or about 7 times the size of Japan (Figure 1). Yet, it is only inhabited by 18 million people, ranking it among the most scarcely populated countries. Its sheer size struck me as I flew from Almaty to Astana on a recent business trip to Kazakhstan in November 2016. During the 90 minute plane ride, I was able to spot only a few settlements in the vast snow-covered Kazakh steppe.

Figure 1: Kazakhstan and its neighbors



Source: Google Maps

Kazakhstan is not only a giant in terms of land size; it also dwarfs its neighboring countries in the Central Asia region in economic size, accounting for about 60% of the region's GDP. The other Central Asian countries (Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) jointly make up the remaining 40%. Kazakhstan's per capita income,

\$11,390 in 2015, is the highest among the Central Asian countries.

The country has also set big ambitions for its future development. In 2015, its long-time President Nursultan Nazarbayev announced the target for Kazakhstan to join the top 30 most-developed countries in the world by the year 2050.

Economic transformation

During the Soviet era, Kazakhstan played an important industrial and agricultural role. Since then, it has also been home to Baikonur, the base of the Soviet and Russian space program.

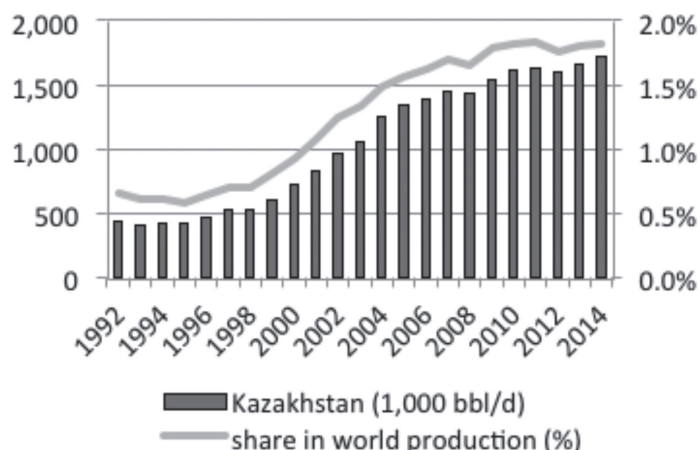
After the dissolution of the Soviet Union and Kazakhstan's independence in 1991, the economy underwent substantial structural changes as the country transitioned from a planned to a market economy. Between 1992 and 2015, the share of agriculture in the economy declined from 27% to 5%. Over the same period, services grew from 29% to 63%, while the share of industry shrank from 45% to 33%.

The country initially went through an adjustment period; the economy contracted by almost 40% over the first five years following its independence. Since then, the Kazakh economy has grown robustly at an average rate of 6% per year for the past two decades. As a result, the country progressed from lower-middle income status to upper-middle income status while per capita income grew 2.6 times in real terms between 1996 and 2015.

A well-oiled economy

A key driver underlying Kazakhstan's rapid economic expansion has been the oil and gas

Figure 2: Kazakhstan oil production



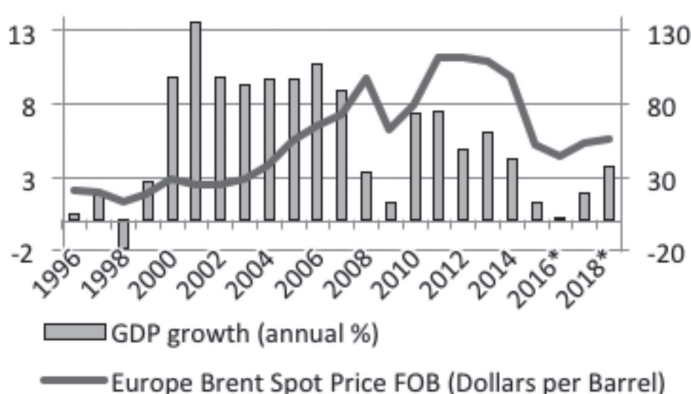
Source: Energy Information Administration (EIA)

industry. Kazakhstan's oil production almost quadrupled from less than 500,000 barrels per day in 1992 to 1.8 million barrels per day in 2015. Its share in global oil production increased correspondingly from 0.7% to 1.8% over the same period (Figure 2). In 2015, it was ranked the 18th largest oil producer.

Oil production is set to increase further. In 2000, the largest oil reserve found in decades was discovered in the Caspian sea off the coast of Kazakhstan. Its location of 4,200 meters below the seabed and other geographic challenges made it one of the most technically and logistically challenging projects to develop. The Kashagan oil field – named after the Kazakh poet Kashagan Kurzhimanuly – started production at the end of 2016. As oil production in the field gradually picks up, Kazakhstan is set to eventually produce more than 2 million barrels a day.

Given its reliance on oil, periods of increasing oil prices have translated into strong economic growth performance, while oil price drops resulted in growth slowdowns. The latter occurred in 1998, 2008-2009, and most recently in the wake of the oil price crash in 2014, which I will discuss in more detail below (Figure 3).

Figure 3: GDP growth and oil price



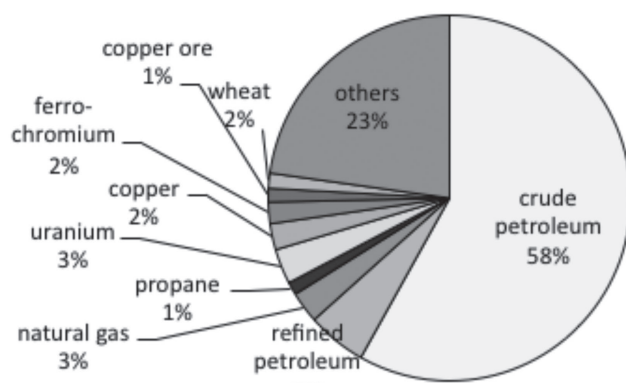
Sources: World Development Indicators and Global Economic Prospects (GDP) and Thomson Reuters and EIA (oil price)

Note: * indicates forecast

The oil sector accounts for about 15% of GDP. Oil and gas are by far the largest export commodity for Kazakhstan, generating \$47 billion in export revenue in 2014 (Figure 4).

With its roots both in Asia and Europe, Kazakhstan has adopted a so-called “multivector” foreign policy. It aims to balance relationships with the United States, Russia and China as well as with countries in (Central) Asia and Europe. It is a member of various regional organizations, including the Commonwealth of Independent States, Eurasian Economic Union, Central Asia Regional Economic Cooperation Program, and the Shanghai Cooperation Organization. This multipronged approach is also reflected in its trade relations; Kazakhstan's key trading partners include both Russia and

Figure 4: Kazakhstan's export composition in 2014



Source: <http://atlas.media.mit.edu/en/>

China as well as several European Union countries.

Kazakhstan is also strategically located to benefit from China's One Belt One Road plan, which aims to improve land and sea transport corridors connecting China, Central Asia, the Middle East, and Europe. The plan may result in substantial infrastructure investment to develop transport corridors in Kazakhstan.

Kazakhstan's natural resources have been an important source of tax revenues for the government. Taxes from oil and gas production and exports have allowed Kazakhstan to accumulate assets in a sovereign wealth fund, the National Fund of the Republic of Kazakhstan (NFRK). The NFRK was established in 2000 with the dual objective of stabilizing the economy in case of large fluctuations in the oil and gas price, and generating savings for future generations. At its peak in 2014, the NFRK had accumulated \$76 billion, equivalent to 36% of GDP.

In addition to the NFRK, the government also owns the Samryk-Kazyna fund. This fund manages the state-owned enterprises and is valued at about \$60 billion. Among the companies that the fund owns are the national rail and postal service, the state oil and gas company KazMunayGas, and Air Astana. At a meeting in Astana, Samryk-Kazyna executives explained that the fund is a key player in the government's efforts to privatize state-owned enterprises and diversify the economy.

Recent economic developments

The country underwent a substantial economic growth slowdown, resulting from the collapse in the oil price since mid-2014. This was compounded by the growth slowdown in two key trading partners of Kazakhstan; China and Russia. In China, growth had started decelerating gradually since 2011 from its earlier double digit levels as a result of the economic rebalancing from an investment and export-led growth model to a domestic consumption-driven model. This resulted in a sharp decline in the need for energy and raw materials, the two key export products of Kazakhstan to China. Shortly after, growth in Russia slowed down considerably resulting from the combined effect of

the oil price decrease and economic sanctions. Exports from Kazakhstan to China and Russia declined by more than 30% between 2011 and 2014 from a combined value of \$24.1 billion to \$16.6 billion.

As a result of these simultaneous external shocks, growth in Kazakhstan decelerated from 6.0% in 2013 to 4.2% in 2014, before plunging to 1.2% in 2015 (Figure 3). The economy was estimated to be stagnant in 2016. The drop in export revenue resulted in a negative current account balance in 2015, the first time since 2009.

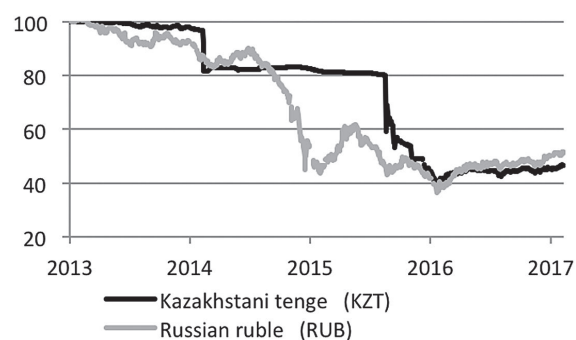
Countering the downturn

The government's response to mitigate the negative impact of the external shocks was twofold.

To counter the impact of the drop in private demand, the government introduced a fiscal stimulus package to support small and medium sized enterprises, develop infrastructure, and support the banking sector. To finance the budgetary shortfall, the government withdrew resources from the NFRK, consistent with its mandate to stabilize the economy. It also borrowed \$2 billion in countercyclical support from the Asian Development Bank and the World Bank. It is estimated that the fiscal deficit excluding transfers from the NFRK widened to about 10% in 2015. Recognizing that the oil price may not rebound rapidly, and wanting to protect the NFRK from rapid depletion, the government intends to pursue gradual fiscal consolidation over the next few years.

Monetary policy changes were even more drastic. In response to devaluation pressure on the Kazakhstani tenge, the central bank decided in mid-2015 to abandon pegging the tenge to a basket of foreign currencies, and introduced a floating exchange rate and an inflation-targeting monetary policy. This resulted in a depreciation of the tenge against the US dollar from 185 tenge in 2015 to 390 at its lowest point in early 2016. Since then the tenge has gradually recovered to about 330 tenge per US dollar. Interestingly, in floating the exchange rate, the tenge broadly followed the course of the Russian ruble against the US dollar (Figure 5).

Figure 5: Exchange rate movement in Russia and Kazakhstan (2 January 2013 = 100)



Source: IMF

The depreciation of the tenge in turn resulted in a sharp increase in the price of imported goods and the inflation rate, despite overall weaker demand. Inflation increased from 3.8%, year-on-year, in August 2015 to 16.7% in May 2016. As a result of the subsequent stabilization of the exchange rate, inflation pass-through had largely been completed by the end of 2016, and inflation had subsided within the target band set by the central bank. The depreciation of the tenge also helped in improving the fiscal balance of the government, by increasing the tenge value of the US dollar denominated receipts from the oil and gas sector.

While the situation was challenging, the government's efforts to stabilize the economy and reduce the impact of the drop in growth were largely successful. This is by no means a small accomplishment. Changing the exchange rate regime is a challenging task for any country even under normal circumstances let alone under the pressures of an economic downturn. The rocky monetary transitions in a number of other resource-rich economies in recent years have demonstrated the complexity of the task.

As a result of the successful stabilization efforts, Kazakhstan's growth is forecast to pick up to 1.9% in 2017 and 3.7% in 2018 (Figure 3). However, the speed of recovery will crucially depend on the evolution of the oil price, and full economic recovery is expected to stretch over several years.

The economic turmoil also impacted the banking sector. The sector, which was heavily affected by the 2008 financial crisis, has yet to fully recover from that episode. The financial

sector continues to be exposed to a substantial amount of non-performing loans. The depreciation of the tenge – which increased the repayment cost of US dollar-denominated borrowing – is anticipated to exacerbate this problem.

Kazakhstan's economic challenges did not go unnoticed with the international credit rating agencies. In quick succession they downgraded Kazakhstan's creditworthiness. However, despite the severity of the crisis, downgrades were limited to a modest one or two notches at most.

One of Kazakhstan's economic strengths quoted by the rating agencies is the very low levels of government debt by any standard. Even after expanding government borrowing to deal with the economic downturn, the debt level remained low at 22% of GDP in 2015.

Strategy 2050 – Preparing the economy for the future

While the country appears to have successfully weathered the economic downturn, it faces the far more complex and daunting challenge in the longer term of reducing its reliance on the oil and gas industry. To achieve this goal, and its vision of reaching the top 30 developed countries, the country must diversify and strengthen the economy.

The country's leadership recognizes this challenge, and has developed a number of strategies, programs and reform measures, which I describe in some detail below. However, successful implementation will be the key measure of success, and is by no means guaranteed. Especially in the current unfavorable economic environment, decisive action is needed more than ever to decouple the economy from swings in commodity prices. At the same time, the economic downturn makes undertaking reform measures more challenging, as it may inflict further hardship.

To address the challenge, Kazakhstan's "Strategy 2050" was developed in 2012. Economic diversification is a key pillar of the strategy. In addition to a number of traditional industries, diversification plans also focus on sectors with high domestic demand such as machine building, pharmaceuticals, construction, and building

materials; export-oriented sectors such as agribusiness, light industry, and tourism, and innovative sectors like information and communications technology, biotechnology, and alternative power engineering.

Complementing its long-term strategy, the government announced in 2014 the “Nurly Zhol” (bright path) modernization program. The program is a \$15 billion infrastructure investment program to be implemented over the period 2015-2020. The program aims to develop infrastructure for transport and logistics; industry and energy; modernize public utilities infrastructure including water and heat supply networks; and provide support for small and medium-sized businesses. Infrastructure development is deemed essential to improve connectivity in the landlocked country.

The need for increased infrastructure investment in Asia, if the region wants to maintain its growth momentum, is echoed in a recent study published by the Asian Development Bank entitled “Meeting Asia’s infrastructure needs”. The study estimates that infrastructure investment needs in Central Asia over the period 2016-2030 amount to almost \$500 billion or close to 7% of GDP. Central Asian countries would have to considerably step up investment to meet this target.

To finance its long-term development plans, the country has been tapping various financing sources. It works in close collaboration with various international organizations. For instance, the Asian Development Bank, one of Kazakhstan’s key development partners, has provided over \$4.4 billion in loans since 1994, with a focus on developing transport routes, fostering the private sector, supporting social equality, and improving energy security.

One hundred steps

A broader set of institutional reform measures was launched in 2015 under the slogan “One Hundred Concrete Steps, a Modern State for All”. The reform measures cover a wide range of areas, including steps to professionalize public administration, strengthen the regulatory framework, improve public financial management and accountability, and enhance the management

of state-owned enterprises.

The government also intends to reduce its role in the economy through privatization of state-owned enterprises. Currently state involvement in the economy is widespread in various sectors. To promote efficiency and private sector participation, the government aims to gradually dispose of state-owned enterprises over the period 2016-2020. The objective is to reduce the share of state participation in the economy to 15% of GDP. A priority list of the 65 largest state-controlled companies has been identified, including railways, the postal service, Air Astana, and various airports.

To provide a more investment-friendly climate, Kazakhstan has been taken steps to improve the business environment. As a result, it most recently substantially improved its ranking in the annual Doing Business survey. It jumped from 51st place in 2016 to 35th place in 2017 out of 190 countries ranked. Reforms improved areas such as starting a business, getting electricity, dealing with construction permits, protecting minority investors, trading across borders and resolving insolvency.

On the annual Worldwide Governance Indicators, Kazakhstan was ranked in the fiftieth percentile worldwide on regulatory quality and government effectiveness. It ranked in the fortieth percentile for rule of law and political stability, with lower scores for control of corruption and voice and accountability.

On the political front, the country is also readying itself for a potential change. President Nursultan Nazarbayev, who is currently 76 years old, has ruled Kazakhstan since 1990. In January 2017, he announced constitutional changes that would transfer some of his authority to the cabinet and parliament. These changes, while decentralizing the decision-making, are also said to be paving the way for the president’s eventual succession.

The country has also been active in raising its international profile by organizing various international events. In January 2017, it hosted the 28th Winter Universiade in Almaty. Later this year, Astana will host the Expo 2017. Astana also prominently featured in the news recently as the venue for Syrian peace talks.

Perhaps one of the most tangible ways in which Kazakhstan demonstrates its vision towards

the future is the futuristic architectural design of the capital Astana. The new city, which became the capital in 1997 after the seat of the government was moved from Almaty, was built from the ground up in the steppes of northern Kazakhstan. Its urban masterplan was designed by Japanese architect Kisho Kurokawa. Even when braving arctic temperatures of minus 30 degrees Celsius—Astana is ranked as the second coldest capital in the world—I could only marvel at the progressive design of numerous buildings (Figure 6). On the architectural front, the country has certainly already earned its spot in the top 30.

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Figure 6: Baiterek Tower in Astana