

Republic of Kazakhstan

Country Economic Memorandum

**Getting Competitive, Staying Competitive:
The Challenge of Managing Kazakhstan's Oil Boom***

Background Paper No. 1:
**The Role of a Public Investment Fund in
Promoting Diversification in Kazakhstan**

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Key Messages

1. Overall Assessment:

- There are few public investment funds (PIF) in the world (i.e., institutions devoted to provide equity to SMEs, assist in their overall strengthening, and rip substantial gains when the SMEs become listed). The few existing ones work in an intensive (privately-led) competitive environment, have a marginal impact on financial intermediation, and have survived by focusing on highly selected niches that would take years to replicate in Kazakhstan.
- From a pure cost-benefit analysis, the effort (financial and human) that will need to go into setting up a PIF properly is significant, and the potential payoff not likely to be significant. International experience suggests that the impact of a PIF on overall financial intermediation, economy diversification, productivity, and diversification is likely to be (at best) small.
- The existing private conglomerates in Kazakhstan (and particularly their financial arms) are already acting as quasi-investment funds (or quasi-venture funds) even though the legal framework for these instruments do not exist. Some donor programs (e.g., IFC's SEAF) are also moving in that direction.

2. Options:

- Develop the framework for formal entry of (foreign and domestic) private equity funds, venture funds, and other forms to pool and manage money from investors seeking private equity stakes in small and medium enterprises.
- Develop an "industrial policy" along the basis of: (1) modern "business promotion" initiatives that provide assistance with the sole objective of increasing the productivity and competitiveness of domestically based firms; (2) good macroeconomic management (interest rates, taxation, and conservative management of the oil fund proceeds), and improved infrastructure. (See examples in Table below.)
- Modern "business promotion" initiatives are likely to be intensive in design and would need answers to such questions as: (1) what form should the coordinating agency take, a PIU, a new Agency, an agency under an existing Ministry, a council of key ministries with a secretariat, an "investment fund"?; (2) should the interventions be on a self-selection basis, or should the government spell out the key sectors to be targeted (i.e., a positive or a negative list)?; (3) How 'lean' should the coordination agency be (i.e., subcontract all services, or provide directly some of them)?
- Modern "business promotion" initiatives should be relatively cheap (if appropriately monitored and supervised during the implementation phase), allowing the government to carry out the complementary measures that are needed for an overall "industrial policy": (1) reduce taxes; (2) increase spending on infrastructure (following strict Economic Rate of Return analysis), education (with some specific initiatives to match skills with labor demand), health, and social protection; and (3) safeguard macroeconomic stability by maintaining its conservative approach to fiscal management, the management of oil revenues, and the regulation of pension funds.

Factor Affecting Competitiveness Of non-oil sectors	Policy Instrument
1. Real exchange appreciation reduce the costs of imported goods relative to domestically produced goods (Dutch disease).	<ul style="list-style-type: none"> ▪ Reduce taxation on capital and labor (modalities needs to be discussed more specifically) ▪ Focus monetary policy on reducing real interest rates ▪ Set up a program to systematically reduce red tape imposed by government institutions on businesses. Of all the usual suspects, focus first on worse offenders (e.g., tax and custom administration, standards department, sanitation)
2. Lack of qualified personnel (skills in Kazakhstan are well behind what its economy needs)	<ul style="list-style-type: none"> ▪ Provide matching funds to compensate individual firms initiatives to their workers (including the cost of internships in similar firms abroad) ▪ Sponsor after-graduation internships in local/foreign enterprise (here or abroad) ▪ Facilitate temporary hiring of foreign experts by domestic firms ▪ Relax immigration policies for highly qualified workers ▪ Allow tax deduction on "human capital" investments
3. Inability of enterprises to reap the benefits of large economies of scale due to the small size of the Kazak market	<ul style="list-style-type: none"> ▪ Switch from 'import' substitution to export promotion policies ▪ Provide financial assistance for "market opening" activities (using existing banks). ▪ Develop credit insurance schemes to protect exporter against both the commercial and political risk of a foreign buyer defaulting on payments ▪ Simplify import-export related taxation (tax refund, drawback and temporal admission schemes) ▪ Provide incentives for the creation (or entry) of trading companies ▪ Provide non-financial services to exporters (e.g., information, expedite customs processes). ▪ Promote FDI into non-extractive sectors (specific modalities of promotion require greater elaboration)
4. SMEs unable to formulate business plans, assess markets, detect business opportunities in the domestic market.	<ul style="list-style-type: none"> ▪ Increase (demand and supply) for business advisory services building on programs piloted by donors ▪ Sponsor (multiple) programs (financial and TA) to help micro- small- and medium-sized enterprises detect and use opportunities to act as suppliers for: 1) large enterprises in extractive sectors; and 2) the government
5. Slow technological modernization in key non-extractive sectors	<ul style="list-style-type: none"> ▪ Promote Research and Development by private firms through competitive allocated grants, or credits and tax incentives for tangible innovations. ▪ Strengthen cooperation between public research institutions and private firms ▪ Create or strengthening the informational infrastructure for R&D by firms.
6. High transportation cost	<ul style="list-style-type: none"> ▪ Invest in infrastructure (following strict Economic Rate of Return analysis) ▪ Invest in trade facilitation ▪ Subcontract custom procedures

SUMMARY

Available savings and the level of financial intermediation in Kazakhstan have both improved significantly over the last few years. However, investments in non-extractive industries, which are essential to reduce the volatility associated with oil prices and to spread the benefits of growth to the population, remains stagnant. Rightly, the authorities objective is to accelerate the pace of economic diversification. In this context, the World Bank has received a request to prepare recommendations on other countries' experience with public investment funds. This note addresses this request.

There are few public investment funds (PIF) in the world outside second-tier development banks, and the few existing ones work in an intensive (privately-led) competitive environment. There are even fewer examples of governments setting up investment funds nowadays—indeed, Russia has just recently closed its State Investment Corporation. While remaining skeptical about the ability of a public investment fund to intermediate (well) any meaningful amount of financial resources, this note offers possible safeguards in the event that the government chooses to pursue this option. The note also contrasts this option with the more challenging, but also more sustainable, alternative of promoting the establishment of foreign and domestically owned private investment funds. The note also summarizes modern industrial policies (i.e., business promotion policies), which focuses on issues (i.e., promoting steady gains in productivity and competitiveness in the non-extractive sectors) rather than sectors.

- Reduce costs for enterprises through policies, such as trade, trade-facilitation, taxation, and real interest rates. At the same time assist enterprises to adequately use these opportunities:
 - Assist micro- small- and medium-sized enterprises (MSMEs) to detect and use opportunities to act as suppliers for: 1) large enterprises in extractive sectors; and 2) the government.
 - Foster the creation of market-based avenues to make credit and knowledge available to MSMEs (micro-finance institutions that provide a mixture of financing and technical assistance, Foreign Direct Investments)
 - Promote research and development and human capital investments by private firms.
- Use the Country's liquidity primarily to back up macroeconomic stability statements, to reduce and simplify taxes, and to improve the economic and social infrastructure.

The proposed framework represents a first attempt at pinning down specific government interventions. In moving forward with this framework, greater understanding is needed on the reasons why credit and capital markets are not channeling greater amounts of resources to non-extractive industries and, what is most important, to outline and rank the most significant (non-financial) bottlenecks faced by non-extractive sectors. For brevity, the note does not discuss in detail the most obvious policy intervention to promote competitiveness (or offset the potential loss of it that could come from Dutch disease type of developments), namely reducing inflation and the cost of capital (through monetary and fiscal policies), and the cost of doing business (through reductions in taxes and red tape).

The World Bank Group is ready to further support government's diversification objectives by expanding the above framework o outlined in this note.

THE ROLE OF A PUBLIC INVESTMENT FUND IN PROMOTING DIVERSIFICATION IN KAZAKHSTAN: ISSUES AND OPTIONS

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THE ROLE OF A PUBLIC INVESTMENT FUND IN PROMOTING DIVERSIFICATION IN KAZAKHSTAN: ISSUES AND OPTIONS

I. STRATEGIC CONTEXT

Resource mobilization has improved, but the authorities expect stronger financial intermediation towards non-extractive industries.

1. A key policy objective in Kazakhstan is to promote the diversification of the economy, particularly given its extensive natural endowments (pasture and agricultural land, minerals), and the initial signs of a growing food and light industries sector. This is viewed as the only sustainable way to reduce exposure to oil and other world price fluctuations, and to ensure that the benefits of growth and increasing oil revenues are spread over a large part of the population.ⁱ Although debate in the broadest sense is about possible government interventions to promote greater economic diversification (i.e., about policies), the debate often focuses on how to channel increasingly available domestic savings to non-extractive industrial sectors. As illustrated in Table 1, investment in non extractive industries have been marginal—with some exemptions that are driven by a few enterprises within a given sector—while at the same time domestic saving rates have increased substantially.

2. Since some of the savings are been generated in the public sector (i.e., the oil fund has accumulated US\$1.9 billion by the end of 2002), the authorities are making efforts to understand world experiences on the role that the government can play in channeling funds towards non-extractive industries. In this context, the World Bank has received a request to prepare recommendations on other countries' experience with public investment funds, i.e., sources and forms of

	1998	1999	2000	2001
I. Gross Domestic Savings	11.3	20.1	25.9	24.0
II. Total investments in Fixed Capital, o.w.	15.7	18.3	22.9	29.0
1. <i>Non-Extractive sectors, o.w.:</i>	...	6.3	7.4	9.6
- Agriculture	...	0.1	0.3	0.4
- Manufacturing	...	2.2	2.8	3.2
- Trade	...	1.1	0.8	1.0
- Hotel, restaurants	...	0.2	0.1	0.1
- Financial activities	...	0.3	0.4	0.4
- Construction	...	0.7	0.8	1.3
- Real state	...	1.6	2.2	3.3
2. <i>Mining and infrastructure, o.w.</i>	...	10.0	14.3	16.9
- Mining	...	7.7	11.4	12.9
- Transport and communications*	...	1.4	2.2	3.2
- Power sector	...	1.0	0.7	0.9
3. <i>Public services, o.w.</i>	...	2.0	1.3	2.5
- Government services	...	1.4	0.7	1.9
- Education	...	0.1	0.2	0.2
- Health	...	0.2	0.1	0.1
- Public utilities	...	0.4	0.3	0.2

Source: Agency of Statistics, National Accounts for 1998 and Investment Activities in the Republic of Kazakhstan, 2002 for 1999-2001. * Includes investments in CPC pipeline

capital, scope of investments, and consistency with an industrial policy. This note addresses this request. The first section discusses the international experience on public investment funds; it offers a few basic principles to follow in the event that the authorities decide to pursue this course and compares this option with the more difficult but also more sustainable route of promoting the creation of private investment funds. The second section outlines a three-pronged approach to promote steady gains in productivity of the non-oil sectors, combining both policy actions with selective interventions. Such three-pronged approach would require substantial further developed

for which the World Bank could provide further assistance. The third section summarizes the recent international experience on industrial policy.

II. INVESTMENTS FUNDS

A. Public investment funds¹

Not many public investment funds exist outside second-tier development banks, and the few existing ones work in an intensive (privately-led) competitive environment.

3. There are not many worldwide examples of using substantial amounts of stateⁱⁱ money to finance industrial activities, and--what is more--not many of them are successful in the long run. There are even fewer examples in the world of governments actually setting up investment funds. Countries that already have public-sector financial corporations (or development banks) provide small investment facilities, and countries which do not have them (e.g., Argentina), use a second tier private sector intermediary with some government participation.

4. According to Melo (2001)ⁱⁱⁱ, public corporations in 15 Latin American countries provide mainly medium-term loans to finance working capital or investment projects (including discrete purchase of fixed assets). Equity investments are only now being tested in a few of those public corporations. In the typical case, the stated policy is to take equity positions only as a minority shareholder, and on a temporary and selective basis, in profitable companies or projects. In the case of Brazil, a company must meet several explicit criteria if the Banco Nacional de Desenvolvimento Economico e Social (BNDES) is to participate in a share subscription operation: 1) it must have tangible competitive advantages in the market where it operates; 2) it must be profitable; 3) the company's management must be apt, professional and efficient; 4) the

¹ The discussion focuses on a proposed public investment fund to provide equity to SMEs. There is of course reasons for considering the establishment of public "Social Investment Funds" or a "Infrastructure Fund," dealing with fundamental infrastructure, such as roadways, bridges, ports, public irrigation systems, etc., that are essential for private sector development and that otherwise would not be carried out by the private sector, including commercial banks. In order to avoid bottlenecks in such fundamental infrastructures, the Government could well establish a PIF, but the PIF might be based on the principles that: (i) its loans would not be for working capital, and would be made in such a way so as to not crowd out the development of the nascent commercial banking sector; (ii) its loans would only go to "public works" (fundamental infrastructure projects), where private capital is unlikely to be invested but where there are large social benefits; (iii) it probably should provide for co-financing investments only if the private sector, including foreign investors, are willing to participate, hence providing a market test of project viability; (iv) perhaps it should not lend to state-owned enterprises, including those that are commercially unviable (which should either be competitively restructured or enter into bankruptcy proceedings); (v) its loans would generally be made at competitive rates consistent with the long term opportunity cost of capital and risk management methods common in commercial banking practice; (vi) supported projects should/would entail cost-sharing and collateralized lending with the project beneficiary; (vii) any project would be chosen in a competitive and transparent manner, based on the soundness of project business plans; (viii) the PIF would be governed by a board of directors that would have non-state representatives and other outsiders, including international experts; (ix) its financial accounts would fully comply with IAS, be subject to independent audits based on ISA carried out by international reputable accountants, and be published; and (x) it would be an autonomous and independent entity, with its own charter, which would provide safeguards from political interference.

company's shares must be publicly traded or, if that is not the case, it must make a commitment to go public.²

5. BNDES is, in fact, the leading institution in equity investments in the entire Latin America Region. It carries out equity investment operations through a subsidiary BNDESPAR. As a specialized equity branch, BNDESPAR operates through two main credit facilities (one that organizes its participation in share subscription operations and one that specializes in the granting of guarantees), and six special programs:

- 1) The Program for the Capitalization of Technologically-Based Companies;
- 2) The Program for the Capitalization of Small Enterprises;
- 3) The Mutual Fund for Investments in Emerging Enterprises;
- 4) The Mutual Fund for Investment in Pre-Market Enterprises (which in the BNSDES' terminology are medium-size firms that are preparing themselves to issue shares in the stock market);
- 5) The Program to Support New Corporations; and
- 6) The Investment Program in Quotas of Stock Investment Funds.

6. It should, however, be mentioned that BNDES is but a small player in the supply of investments finance instruments in Brazil, where companies have significant access to foreign markets, and where the presence of private investment funds of all types (both domestic and foreign) is widespread.³

7. Since the Latin America experience with public equity investments is still new, its success or failure has not been assessed. However, a public investment fund in the Andhra Pradesh region of India (where competition from other investment instruments was not present) had disastrous results. More recently, during the post Asia crisis, the Korean government hired reputable investment banks (e.g., Templeton, Scudder, Rexiter) and listed managers to do private equity, but the results were mixed (and marginal in the overall spectrum of policies and financing options). Perhaps the most recent example of failure is the State Investment Corporation in Russia, Gosinkor, which was closed last 7th of February. Gosinkor was closed after accusations that the US\$1.25 billion in authorized capital was used to build a conglomerate through two commercial banks, and that at least half a billion of dollars has been squandered.

8. Risks and inefficiencies of the state run financial institutions are all too well known to repeat; thus the remainder of this section focuses on possible safeguards applicable in Kazakhstan, in the event that the government chooses to pursue the option of setting up an investment fund.

The critical issues to consider are: (1) corporate governance of the PIF (including sources of capital); (2) client base (scope of investment); (3) connections to the (industrial) policy; and (4) simplicity.

(1) Corporate governance of a PIF

9. The question of the PIF's day-to-day management is, at least conceptually, relatively easy to answer. Management of the PIF would have to have all characteristics and prerogatives of

² The issue of whether similar criteria can be enforced in present day Kazakhstan is to be explored, given the weaknesses in corporate governance related institutions.

³ Brazil is a US\$500 billion economy, even though its per capita GDP is around US\$3,000.

management of any commercially run private fund: professionalism, fiduciary responsibilities of an agent for someone's else money, arm's length relations with supervisory bodies and owners, clearly defined incentives and performance benchmarks.⁴

10. Professionalism can be achieved by a well-defined management contract with a management company. IFC would be an obvious source of advice in designing the PIF and possibly could participate in managing the PIF. The IFC has already accumulated experience in this regard with the setting up of the Central Asia Small Enterprise Fund—but this fund is truly privately run, though with some bilateral and multilateral financing (see below).⁵

11. Fiduciary responsibilities are more complicated. State run financial institutions have typically poorly defined institutional and personal accountability for the state money. The poor definition of accountabilities is not that much a result of lack of knowledge but, first of all, because of inherently contradictory nature of the task.

12. Another practiced mechanism is to mix state money with private capital. Private investors then act as a proxy for the state in imposing the lending discipline. The downside of this solution may be that private investors, when not correctly supervised, could abuse their position for their own gains. The use of IFIs resources (including IFC or the WB) underwritten by a government proved to be a workable solution. Market borrowing from pension funds, and giving them a supervisory role, is a proven way of bringing long-term capital with social responsibility. For Kazakhstan, with its fully funded pension system and an active market for corporate long-term debt instruments, it would be a particularly interesting venue to further investigate.

(2) Client Base (Scope of Investment)

13. Defining a potential pool of clients of the PIF poses a perennial dilemma of the Catch 22. If the PIF is expected to act 'as if' a commercial financial institution, i.e. evaluating the risks and pricing them according to the market criteria, then it is a redundant institution (the market would take care of these clients). If the PIF does not follow market criteria and prices, it has to apply some form of non-price rationing of the access to its funds, with all the risks of corruption and moral hazard involved. A constructive way out of this dilemma could consist of the following elements:

1. The price of the funds made available to clients (interest rates) cannot go below the costs of the PIF's capital plus reasonable margin to cover the costs of its operations. Margins charged by commercial financial institutions working in Kazakhstan would be a good benchmark. In other words, the PIF does not have to make profits "as if" a commercial financier but it should not bleed its capital either.
2. Potential clients should not be the ones who were refused financing, otherwise available, from the commercial financial institutions. They should be "niche" clients for whom there are no alternative financial services developed by the financial markets. For example, in developing economies, there is often no medium and longer time financing

⁴ We do not discuss the possibility of creating a small and carefully crafted investment facility in the Kazakhstan Development Bank, which is an option to consider—in which case some of the safeguards suggested by a previous informal note from the World Bank would need to be reassessed together with the discussion on Corporate governance in this note. See Kazakhstan: A Note on the State Owned Development Bank. World Bank Quick Response 12/2001.

⁵ See the Web Site of the Central Asia Small Enterprise Fund www.seaf.com. The IFC has pioneered the setting up of private investment funds with a variety of purposes all over the world (See Annex 1 for some examples.)

available because of the term mismatch between deposits and assets of commercial banks. In addition, banks are often unwilling or unable to provide financing to companies in distress, though otherwise sound in the long run. The PIF could fill these gaps.

3. Potential clients should be self-selected by a real (material), up-front commitment to cope with their problems. The material commitment can take the form of the internal financing by selling assets, shedding redundant labor, securing new contracts, reaching a workout agreement with creditors. The World Bank has a rich experience in designing and implementing this type of self-selection mechanisms. To mention ECA only, the experience of the Bank-designed approaches for Turkey, Moldova, Georgia, Ukraine, and Russia have proved that the up-front commitment makes enterprises more prudent and responsible clients of any financial institution. What is important, this behavior does not depend much on the form of the ownership: SOEs, privatized, or private (SMEs) react much alike.

(3) Connections to Industrial Policy

14. One of the weaknesses of state run financial institutions is that often they are driven by ad hoc political pressures. Realistically, no financial institutions in developing countries, including private ones, can be completely free from the political interference. Proper corporate governance can, as described before, limit this impact. Another important way to reduce political pressures may be a well-articulated policy framework for the PIF priorities and its lending policy. International experience shows that it may work for PIF's management as an efficient weapon for standing up to political pressures.⁶ Although experience shows that state investment policies have a natural tendency to erode (priorities are overcome by super-priorities, etc.), it is still better than nothing. In Kazakhstan, balancing growth through support to non-extractive industries, or support to high value-added (knowledge rich) industries could be a good backbone for this type of policies. The Bank could offer its experience in these areas, including the analytical capacity and the knowledge economy assessment.

(4) Simplicity

15. Last but not least, in the developing economies only simple solutions work. Complexity of proposed solutions, although often driven by good intentions, increases the risks of failure exponentially. It regards multiple objectives, processes of project evaluation and decision-making, the management and staff skills, and wishful thinking regarding business and legislative environment the PIF is supposed to work in. The PIF cannot be thought of as a panacea for all problems of Kazakhstani enterprises. For example, it is a legitimate objective to provide longer-term financing, not available from the markets, to structurally sound ventures in non-extractive industries, or to innovative start-ups. It is not, however, wise to use the state money to rescue apparent losers to maintain jobs and to provide social services by enterprises to their employees. Also, the PIF should not be considered as a vehicle for building the financial markets or for supporting objectives that require different instruments or specialization (i.e., both the development of infrastructure as well as the non-extractive sector).

(5) Conclusions

⁶ International experience shows that these pressures are very rarely coming from the top echelons of power. Most often, these are attempts of lower level officials, and not too strongly defended when challenged. The main objective is to limit the cases of the collusion between vested interests and managers of the PIF.

16. The problems of Kazakhstani enterprises and entrepreneurs are real and not all of them can be, at the moment, efficiently addressed by an existing financial system. There is a chance to achieve some gains by creating a Public Investment Funds, although the experience of similar solutions implemented all around the world is not very encouraging and if successfully set up, the impact on the economy may be marginal overall. The main lessons from other countries (mostly what did not work rather what did) are the following:

- PIF should be managed by professional managers, who should work by rules clearly defining benchmarks, accountabilities, and incentives.
- Activities of the PIF should, at least, not lead to the decrease of the PIF's capital.
- Activities of the PIF should take place within a framework of a well-defined governmental program.
- The PIF should not compete with commercial financial institutions.
- Clients of the PIF should commit themselves to be prudent borrowers, by a series of up-front measures improving their chances to survive.
- PIF should have simple objectives, realistically measured against available skills, existing financial markets, and the legal and regulatory environment.

B. Private Investment Funds^{iv}

There is a need to foster competition, and to provide different equity finance options for different needs.

17. Competition is perhaps the most essential safeguard to ensure that a PIF will perform. As was mentioned earlier, most of the development banks (including the Brazilian equity investment fund in BNDNS) operate in a highly competitive environment coming from both domestic and external players.

18. There are various types of private investment funds all of which can be considered financial structures for pooling and managing the monies of multiple investors—with the government possibly been one of such investors. The sectoral, geographical and structural diversity of funds is extensive and growing. Four broad categories of investment purposes can also be identified:

1. Private equity funds (PEFs) (also called direct investment funds) buy significant minority equity stakes in unlisted companies. Investors aim for high capital gains, especially if a firm becomes listed. Funds manager may sit on the boards of investee firms. Often the investing focus of private equity funds requires a joint effort between the fund's management (which possesses financial and general management expertise) and professionals with specific industry expertise.
2. Venture Capital Funds (VCFs) pool and manage money from investors seeking private equity stakes in small and medium enterprises (SMEs), generally newer enterprises. VCFs historically have been quite small. The average VC fund sponsored by the IFC has been US\$30 million, although some recent funds have ranged up to US\$100 million. VCFs buy significant minority stakes (sometimes majority stakes) in companies and often provide management input. Ultimately, VCF managers aim for high capital gains. Nevertheless, a VCF typically has a negative cash flow in the early years, as management

fees and some failed investments eat into capital. Cash flows turn positive as the fund sells profitable investments. As a result, VCFs tend to be long term and relatively illiquid.

3. Domestic Mutual Funds (DMFs) (also called unit trusts) raise money from local investors and buy securities listed on the domestic stock market.
4. International Portfolio Investment Fund (IPIF) (also called country funds) mainly buys securities listed on local stock exchange. They may also buy stocks of emerging markets companies listed in international money centers, such as American Depository Receipts. They buy minority stakes in companies and do not seek a management role.

19. The Korea and Mexico Funds (of the PEFs type), started in the early 1980's, marked the beginning of the portfolio equity industry in emerging markets. Interest was quickly kindled in other countries, and initial funds quickly drew in others. For example, two years after the Malaysia Fund's launch in 1987, the country had attracted eight other funds, which raised US\$600 million. At the end of 1991, just seven years after the launch of the Korea Fund, there were nearly 300 funds—managing US\$20 billion—targeting emerging markets.

20. Initially, some government were persuaded to open up to closed-end country funds, because these funds seemed to overcome the two main concerns of host governments: foreign control of domestic firms and destabilizing, "hot" money flows. Closed-end funds raise a fixed sum and then close the shareholder group. Structured as a finite pool owned by multiple investors and aiming for diverse portfolio, these closed-end portfolio country funds seemed to pose little threat. Before long, most policy makers in emerging markets had relaxed their attitudes and were keen to move beyond the closed-end vehicles and attract a variety of portfolio funds.⁷

21. The speed at which investment funds grew caught many observers by surprise. Several currents happened to coincide. Privatization increased the supply of assets for investors to buy. A few governments started to promote private pension funds and domestic mutual funds to raise national savings rates. In transition economies (mainly in Eastern Europe), the combination of many new private firms, distressed banking sectors, and voucher privatization led to big opportunities for portfolio funds. Improved telecommunications and financial innovation made it easier to invest.

22. Although the Asian Crisis in 1997, the following Russian crisis in 1998, and the most recent difficulties experience by emerging markets such as Turkey and Argentina have changed the appetite for investing in emerging markets, Kazakhstan (with its advanced level of financial development relative to other CIS countries, its advanced policy and institutional framework for private pension funds, and its recently achieved investment grade) could indeed benefit substantially from the setting up a framework for attracting VCF and/or PEFs. Small infusions of foreign capital through funds can successfully stimulate the further development of Kazakhstan capital market through two parallel virtuous cycles:

1. Institutional development is fostered as international investors—and by proxy the management of their funds—demand high standards in regulation and information. Spurred by the prospect of new investment, market regulators often undertake reforms as part of the opening-up process. In addition, fund managers require local services, such as

⁷ The Central Asia Small Enterprise Fund (www.seaf.com) has a first closing at US\$8.6 million from the IFC and the Swiss government, but expect to raise additional capital from other investors interested in participating in the economic development of the region in the future. Its focuses initially on Kazakhstan, Uzbekistan and the Kyrgyz Republic.

- brokers, custody and transfer agents, and information on local companies. In response to this demand, local providers spring up, competition increases, and standards improve. Although these changes are driven initially by foreign investment, the benefits of more market intermediaries and a more transparent, efficient market accrue to all players.
2. Financial broadening and deepening are fostered even though foreign inflows are usually small relative to the market. This is because the institutional reforms they promote have a significant effect on trading activity. Stock prices rise in response to the extra demand. Higher price-earnings ratio reduces firms' cost of raising equity with dramatic effects. The higher ratios encourage listed firms to raise more capital from the market, and new firms to enter the market through initial public offerings. The larger, more liquid market attracts more foreign and domestic investors. New investors emerge—domestic insurance companies, pension funds, mutual funds, and individuals. More intermediaries—brokers, underwriters, custodians—enter the market to meet the demand from the larger number of investors and firms. As market liquidity and efficiency increase, more firms issue stock, including 'second-tier' companies that previously would not have considered a public listing.
23. There are, however, some safeguards to be taken when opening up to international capital markets and investors. The first and most importance is the avoidance of 'bubbles,' namely the increased valuation of a few set of firms that would attract most of the capital, inflate the value of their shares, an ultimately consuming rather than investing the newly available liquidity. Since the enterprise sector in Kazakhstan is relatively small, rapid creation of VCFs and PCFs could potentially lead to excess liquidity and 'bubbles.' A related issue is how fast should the regulatory authorities allow domestic institutional investors (e.g., private pension funds) to invest domestically under the umbrella of VCFs or PCFs.
24. One of the most important lessons from the past is that the quality of fund management is the most important factor in a funds' performance. VCF managers need to be close to the companies they invest in, but finding experienced, high-quality capital fund managers willing to manage relatively small funds in difficult environments has proved a major challenge. Size and structure of the fund also matters, as they help define the incentives for managers to perform and for fund shareholders to remain interested. Funds under US\$10 million have tended to perform worse than larger funds, as they generally have been unable to hold onto good managers or to spread risks adequately. Other important issues in structuring a fund typically include tax efficiency, legal form and domicile, the legal status of investors, management incentives, and the investment strategy and exposure guidelines. Structuring is often complex, as in the case of a potential US\$50 million venture capital fund in Indonesia. The proposed fund faced two difficulties: foreign investors needed government permission each time they invested in an unlisted company, and the tax treatment of sale of stakes in locally incorporated companies was unclear.
25. Finally, there is the risk of harming the development of the banking (and broader financial sector), in the event that investment funds are structured in such a way that they compete for the same customers. On the other hand, in most countries investment funds has created another business opportunities for commercial banks.

III. PROMOTING PRODUCTIVITY AND COMPETITIVENESS

26. Governments affect the costs of production of firms (and thus their competitiveness) through various channels. These include monetary policies (which affect the cost of borrowing, present and expected), exchange rate policies (which may affect real exchange rate transitorily⁸), fiscal policies (which also affect interest rates), taxation policies, the regulatory framework (inspections, licensing, etc.), and through the provision of infrastructure. Over the medium-term Kazakhstan is likely to experience some degree of real exchange appreciation, given the strong amount of capital inflows that are expected to come as a result of the successful exploitation in the oil and other mineral sectors. To avoid the loss of competitiveness that the non-oil sector (and more specifically those engaged in the production of tradable goods) is likely to suffer, the natural course of action is to work on reducing the cost that monetary, fiscal, and regulatory policies imposed on the private sector. Some more specific interventions may be warranted (to address externalities or remove specific bottlenecks), but these will need to be carefully designed. This and the following sections offer ways to go about designing such interventions. These interventions are not alternatives to the establishment of a public investment fund, they are essentially what should be done in any case to create an overarching framework to improve productivity and competitiveness.

A. Initial Assessment of Strengths and Weaknesses of the Kazakh Economy

International experience, although useful as a starting point, has to be molded to the local Kazakh's conditions.

27. The structure of the economy in Kazakhstan has a number of peculiarities that are to be taken into account before embarking on the creation of public investment funds, or any other industrial program. Key features include:

- Strong dominance of most economic activities by a few conglomerates.
- Highly industrialized production arrangements living side by side with incipient forms of exploitation in key non-extractive sectors, such as in agriculture and agri-industries.
- An extractive sector (oil and minerals) that functions in many ways like an 'enclave' with little linkages to domestic supplier or distribution chains, and large enterprises that remind highly integrated as a legacy from the Soviet Union.
- Weak governance and oversight arrangements (e.g., disclosure, accounting, transparency for most but a few enterprises) and weak state institutions (e.g., judiciary, customs).
- An uneven level field playing and a very poor climate for small and medium-size enterprises and foreign investors—particularly those in industries whose rates of return, and bargaining power, are well below that of extractive industries.⁹
- A banking and payment sectors that while relatively developed still focused mainly on trade credits, provides little credit opportunities to small enterprises and, in general, the cost of capital is high (although some of the situation in this regard is now changing).

⁸ It is however not clear whether government interventions can affect the real exchange rate over the long-run, which in fact is determined by the underlying forces of the economy such as the overall productivity rates, permanent capital flows, etc.

⁹ According the EBRD's 2002 Transition report, the bulk of the improvements in the business environment in Kazakhstan can almost entirely be attributed to the recent strong economic recovery, rather than to reform efforts. Earlier World Bank work has also highlighted that registration procedures are not particularly burdensome in Kazakhstan, but that there are numerous barriers associated with harassment by inspectors, and renewal of operation licensing. A recent World Bank survey of household, enterprises and government officials pointed specifically at the weaknesses of customs and the judiciary system (*Governance and Service Delivery: A Diagnostic Report*).

- Likelihood of a Dutch-type of disease, which may result in a loss of competitiveness in the non-oil sector as the price of imports falls.

28. Perhaps the most important factor is that production in the majority of industries in Kazakhstan, other than perhaps some agriculture and related activities, have to be developed from a very low base in most sectors (starting with basic, low-tech, activities such as construction materials). A subset of this issue is the need to build supplier chains around the oil and mineral sectors, which has only been pursued systematically around the steel sector.^y

29. At the same time, Kazakhstan has strengths that many economies with similar or higher income would envy:

- The recently acquired investment-level rating for government securities, which is higher than in most emerging economies, including slightly higher than Russia's.¹⁰
- A strong macroeconomic outlook (based on the good perspectives for oil revenues, and a reputation for sound fiscal and monetary management).
- A relatively sound banking and payment system.
- Limited social tensions and unrest and low crime rates, which allow key resources (human and financial) to focus on development issues.
- Extensive endowments of natural resources, including minerals as well as pastures and agricultural lands
- An initial good start in the creation of a private sector-led light and food industries.

30. These strengths offer options to promote competitiveness and diversification not available to many middle-income economies, such as the potential to attract foreign direct investment and expertise to areas other than extractive incomes, and a potential to expand the access to financial markets by promising non-extractive enterprises (like China). Initial progress made in diversification also suggest that further improving the macroeconomic environment (reduction in inflation, interest rates, and taxes) is crucial to maintain the initial momentum that has been gained in some sectors and offset the effects of a possible real exchange appreciation.

B. Options

There is a need for a multi-pronged approach to promote competitiveness in the non-oil sector backed by a cohesive framework:

(i) foster opportunities by improving business environment and trade policies, while at the same time develop an infrastructure to assist MSMEs to adequately use these opportunities.

31. Structural policies to substantially improve the trade regime, facilitate border trade, reduce the taxation burden on capital and labor, facilitate tax compliance, and improve the business environment will create substantial business opportunities at the micro level if appropriately implemented. Once opportunities are created, a supply response may however not come about automatically, in part because the reforms may generate strains in the productive sector, but most likely because other bottlenecks may preclude business growth or start-ups. A

¹⁰ S&P sovereign credit rating for Kazakhstan is BB+/positive in local currency and BB/positive in foreign currency. Its local currency rating is similar to Bulgaria's, but slightly better than the ratings for Russia, Costa Rica, and Peru (BB+/stable), and much better than the ratings for India, Guatemala (BB+/negative), Romania (BB-/positive), Brazil (BB/negative) and Turkey (B-/stable).

small set of well-selected interventions to assist with the growth of businesses, may well then be warranted.

32. The subset of proactive policies that appears most relevant for Kazakhstan's present conditions (see Section IV) are related to promoting:

- 1) The creation, integration and strengthening of production chains (starting, but not limited, to oil and other extractive industries and government procurement);
- 2) Technological modernization (equipment and know how);
- 3) Private sector investments in human capital and research and development (R&D); and
- 4) Assistance to collective arrangements of MSMEs, such as policies to support including integration of production chains, clustering, and network of enterprises (groups of firms using combined resources to cooperate on joint projects).

33. Given that the non-oil industries in Kazakhstan are dominated by a few conglomerates, and key other sectors are still based on highly integrated industries it also appears to consider the need to promote and protect competition through:

- Strengthening the institutional arrangements to enforce anticompetitive provisions
- Promoting spinning offs in private conglomerates

34. While there is no strong evidence in the world that a growth strategy based on small and medium-size enterprises (e.g., Taiwan) is better than one led by conglomerates (Korea), there is sufficient evidence in Kazakhstan that the presence of public and private conglomerates are affecting the level play field in a substantial manner—and therefore acting as a deterrent of diversification, productivity and growth.

35. In the Europe and Central Asia Region, the ARIA program is regarded as one of the best comprehensive approaches to tackle key issues of private sector development in Moldova (e.g., facilitate reorganization and liquidation bankruptcies; promote small and medium enterprise spin-offs and new start-ups; promote new learning at the enterprise level, both in the form of “Marshall Plan” programs with more advanced post-socialist countries, as well as continuous improvement programs such as those adapted from Japanese programs).^{vi} While the specific interventions promoted under the ARIA program may not be relevant for Kazakhstan, the integrated framework certainly is.

36. A key issue to discuss regarding public intervention in Kazakhstan is whether or not to target specific sectors (like in Korea and Japan). In this context, it is noteworthy that targeting of specific industries nowadays takes place under the umbrella of “production chains”, rather than under the umbrella of investment and credit policies. For instance, and as would be sketched in greater detail in section IV below, Mexico targets the production chains of eight sectors: 1) high-technology industries; 2) the automotive industry; 3) light manufacturing; 4) the petrochemical industry; 5) mining; 6) agribusinesses; 7) forestry; and 8) public sector providers.

37. Another leading country on this in Latin America, i.e., Colombia, differentiates between existing production chains that require strengthening and the promotion of new production chains. The first category is, in turn, broken in two sub-categories:

- Significant non-traditional exporters that are threatened by external competition. Here the targeted production chains are: 1) cotton-fibers-textile-apparel, 2) leather-leather manufactures-footwear, 3) automotive parts-cars, 4) sugar cane-sugar-confectionery-chocolates, 5) oleaginous seeds-cooking oil-fats-soap, 6) aquaculture, 7) tuna production, 8) toiletries, cleaning products and cosmetics; and 8) potatoes and their industrial processing.
- Those that generate important linkages and are significant in the country's internal trade. These are associated with the following goods and sectors: petrochemicals and plastics; steel; electric and electronic appliances; forestry, wood products, and furniture; vegetables; fruits and their industrial transformation; cocoa and chocolates; beans; rice; shrimp; fish; cereals; dietetic foods; poultry farming; porcine production; dairy farming; medical services; engineering services; consulting services; software; tourism; jewelry; and crafts.

38. The category of new production chains includes information technology and software; microelectronics; biotechnology and biomedicine; new materials; fine chemistry; capital goods; and communications.

39. It is worth for the Kazak authorities to examine more closely both the Colombian and Mexican strategies and in particular the fact that credit has not been the main instrument offered to the targeted industries (or in the Colombian case “production chains”).¹¹ The general guidelines of the Colombian strategy includes elements, such as the need to improve both the country's general physical infrastructure and the specialized infrastructure needed to support specific production chains; and the need to maintain legal, policy, and regulatory frameworks favorable to investments, particularly foreign direct investment. Specific actions include: 1) to help develop cooperative relationships between firms in a given production chain that can result in projects of mutual benefits¹²; 2) actions in the field of technological innovation; 3) actions in the area of human capital formation; and 4) implementation of Sector Competitiveness Agreements with firms in the targeted production chains.

(ii) Develop new avenues to increase the access of MSMEs to credit and know how including fostering FDI to non-extractive sectors and, as mentioned earlier, by evaluating options to foster R&D and human capital investments by private firms.

40. *A public equity investment fund will take time and effort to be created before it works well—i.e., effectively channel resources to promising MSMEs—and the world experience suggests that it may never get to work well.* Thus effectively, even if a PIF is created tomorrow, it will be a marginal player in the financial intermediation of resources, and is likely to stay that way. Hence, multiple channels to increase the availability of funds for micro- small- and medium-size enterprises are needed, for which the authorities are advised to explore options (and world

¹¹ In 2001, the per capita GDP in Mexico was US\$ 6214 (at market exchange rates), and Colombia US\$1938. Per capita GDP in Kazakhstan was US\$1526 the same year.

¹² A World Bank project in the Kyrgyz Republic improved substantially once it was restructured to assist the creation of farmers cooperatives that became the primary exporters of wool and meat. While the project provided working capital to the farmer's associations, its true value was that of assisting farmers to organized themselves, understand neighboring and world markets, and deepen their knowledge about actions that rapidly translated into better quality of wool or meat.

experiences). A subset of issues relevant to the Republic of Kazakhstan is the appropriate vehicles to strengthen micro-lending institutions.¹³

41. *Diversification requires both capital and expertise, making FDI the perfect instrument for accelerating it.* To attract FDI to non-extractive sectors, the authorities should consider promoting private equity funds, private venture funds and institutional investors as described above. In essence, this action amounts to taking a decision of “importing” financial intermediation services to some extent: the country would accumulate funds in the rest of the world, and at the same time will be borrowing from the rest of the world. It should be noted that most East Asian economies have ‘imported’ financial intermediation. This is also the strategy that China—given the incipient state of development of its domestic banking sector—has successfully been following.

42. *Even with an investment grade, attracting FDI and private capital flows towards non-extractive sectors will not be easy, particularly because most of the investment funds that came into Kazakhstan were disenchanted with its investment climate even prior to the regional financial crisis in 1998.* For that reason, efforts should be made to attract one or two visible foreign investors to the non-extractive sector in the immediate term, that would send a strong signal to international markets and investors that Kazakhstan is serious about playing a key role as a regional base for Asia and Europe. Focusing on attracting on one or two companies is perhaps the best strategy (e.g., Microsoft or Dell in the high-tech industry), and a different one of that been pursued during the past few years (in which broad investor conferences were organized without targeting specifically a few firms and ensure a deal is concluded). Such strategy, if successful¹⁴, will provide international visibility to the FDI efforts, while simultaneously facilitating access to the particular technology by local companies. Efforts should nonetheless be made to genuinely improve the investment climate for (domestic and foreign) investors of all scales in non-extractive sectors, and to promote their expansion of markets towards neighboring countries.

43. It is noteworthy to mention that the economic literature has attributed Malaysia’s success in diversifying its oil economy (and attaining economy-wide productivity gains) more to policies that encouraged the flow of foreign direct investment and to better access to imported capital goods rather than to its efforts to set up public investment funds.^{vii} Malaysia’s openness is remarkable, with a ratio of exports and imports to GDP of 190% in 1997, higher than in most other countries (33% in Mexico, 49% in Chile, and 77% in Korea). Its ratio of FDI to GDP was also high, above 5% for most of the 1990s. Similar considerations apply to the United Arab Emirates, with the exception that the track record of good trade and FDI policies in this country has been created even before the discovery of oil in the late 1960s. In Mexico, non-oil exports grew fourfold over the 1980s—almost entirely explaining the diversification that occurred during those years in Mexico.

(iii) Use the Country’s liquidity to back up stability statements, and for improvements in economic and social infrastructure; temper expectations on the amounts of public resources to be devoted to industrial development.

¹³ As part of its regional initiatives for Central Asia, the Bank is both preparing region-wide study on micro-finance, and co-hosting with partners such as EBRD a conference in April 2003 (in Almaty) to consider how to move this agenda forward.

¹⁴ For a company like Microsoft to set up some of its development in Central Asia, the market and immediate sales opportunities would need to be enlarged, something that perhaps can be achieved if the government commits to purchase certain amount of products for its government institutions over the next 5-10 years.

44. *Maintaining an overall macroeconomic stability is a task that can be derailed any moment, particularly given the vulnerability of the Kazak economy to international prices.* In this regard, there is nothing inherently wrong with building up international assets to back up macroeconomic stability claims and, indirectly, help the private sector attract financing from the international markets. At the same time, actions that the authorities are already taken (such as retiring external and domestic public debt, and savings the proceedings of oil windfalls in an stabilization type of fund) are all sound policies. Distributing some of the additional resources to consumers (e.g., the recent cuts in VAT and other profit taxes) were also appropriate—and further reductions in the taxation of labor and capital should follow.

45. *Part of the recently acquired liquidity must also be used to finance serious and systematic improvements of the infrastructure needed by the private sector (following strict cost-benefit analysis).* It is not necessary to elaborate here in the need of modernizing key infrastructure, including selective roads, airports, and water and sewerage.¹⁵ In all cases, public investment decisions should be guided by strict economic rate of return (ERR) criteria. Similarly, serious and systematic institutional investments are needed—similar to those made into the initial phase of treasury modernization—to improve key government services, such as the judiciary system and the custom administration and to build the cost-benefit analysis capacity of the public sector. Finally, there is also a major need for sound investments in health and education.

46. *Against these vast needs of legitimate public interventions, there appears to be a need to temper the expectations about the amounts of resources that the government of the Republic of Kazakhstan can in reality devote to actively promoting industrial policies.* This is the most relevant given the fact that the oil industry is just beginning to generate fiscal resources and its transport infrastructure is still vulnerable to technical or other shocks that in the ‘worst case scenario’ of technical or organization failure could paralyze exports rapidly.

47. International experience offers a number of historical “development” models, which the Kazak authorities could more credibly promote. In particular, claims that the government of the Republic of Kazakhstan will be able to afford (and stage) the type of direct initial “push” in industry that countries such as Japan, Korea and Taiwan carried out should be tempered in favor of a commitment to:

- Free trade and FDI promotion almost from the start (like Hong-Kong, Singapore and Dubai), or to an initial openness based on export promotion (most South East Asian countries), with import liberalization staged in phases.
- A long-term policy to develop natural resources with forward linkages to activities with higher value added (based on the experience of Denmark, Sweden, Australia, and Finland in the past; and Thailand, Malaysia and Indonesia at present).

48. Certainly, Kazakhstan abundance of natural resources (oil, minerals, and rich steppe) makes it less comparable with Korea and Japan than with Denmark, Sweden, Australia and

¹⁵ The authorities very preliminary work on the water sector strategy suggests investment needs over the next 5-10 years to the tune of : (1) US\$1.1 billion for urban water infrastructure, the bulk of which is near its productive life span; (2) US\$250-400 million for urgent investments in rural water infrastructure; (3) agricultural water supply investments are estimated at US\$600 million; and (4) industries will need to undertake clean up investments for an unknown amount—some of which may need to be actively supported. See http://www.worldbank.org.kz/content/water_study_eng.html

Malaysia and Indonesia. There are however many examples of natural resource rich countries that have been unable to increase the value added and develop (especially most of the resource rich countries in Latin America).^{viii} This literature points out at the inability of some countries to move from a rent-based exploitation of mineral or other natural resources to an innovation phase, despite the fact that mining is intensive in knowledge and very dynamic and, at least at the initial stages, productivity growth tends to be higher in agriculture than manufacturing.

IV. REVIEW OF INDUSTRIAL POLICIES IN THE 1990s¹⁶

A. A Typology of Market-Friendly Policies to Promote Competitiveness

Kazakhstan is not alone on the search for a government's role in promoting modernization, diversification and competitiveness.

49. The round of comprehensive structural reforms during the 1980s—which in most countries included trade liberalization, privatization, domestic market liberalization and deregulation—have brought profound changes to the productive structures of many middle income economies. Despite the difficulties experienced in East Asia after 1997, Russia after 1998, and most recently by Argentina (and, to a much lesser extent, Brazil and Turkey), there seems little doubts that policies such as a more open economy and private sector-led initiatives are here to stay. Partly as a follow up to the effects of the liberalization policies, and partly as a follow up to the crisis, options for industrial (business promotion) policies are being explored in many regions of the world. This search can also be interpreted as a follow up to the liberalization and structural policies since, like the transition that took place in previously centrally-commanded economies, they trigger strains, imbalances, and significant industrial restructuring processes.

50. In the case of Latin America, various countries adopted almost simultaneously industrial programs. In 1995, the Brazilian government formulated a strategy on “Industrial, Technological and External Trade Policy.” The goal was to create the conditions that would enable Brazilian firms to make the transition from the defensive strategies dominant in the initial phase of trade liberalization to more assertive strategies based on increased productivity and technological innovation. This latter point includes the following guidelines: 1) modernization and expansion of infrastructure; 2) greater private sector participation in total investments; 3) strengthening of productive sectors having the potential for international insertion, and incentives to technological innovation and productive restructuring; 4) improvement of education; and 5) modernization of labor-market relations. For its part, Mexico launched an “Industrial and External Trade Program” in 1996 to address the need to: 1) rebuild production chains that were dislocated as a consequence of trade liberalization; 2) continue attracting foreign direct investment; 3) overcome the obstacles faced by SME and micro enterprises in the areas of technology and management; 4) shift the emphasis from being competitive in markets for labor-intensive goods to being competitive in the markets of advanced-technology goods and services; and 5) promote regional decentralization of the manufacturing industry. The Costa Rican government approved the Strategy for the Industrial Modernization of the SME sector to enable them to acquire and maintain a dynamic competitive advantage.

51. The most specific interventions emerging from these IP, as well as those in 11 other countries are summarized in Table 2. The resulting interventions from IP statements have been generally market friendly (e.g., few, if any, countries subsidize credit these days, subsidies from

¹⁶ It should be clarified that most of the “industrial policies” fall under the most modern denomination of “business promotion policies” even though governments generally include the word “industrial” in the title of official programs.

the budget to firms are implemented only during calamities, and a vast number of countries use horizontal tax refunds or expeditious procedures for tax and custom procedures). The interventions are also mainly demand-driven (e.g., self-selection of firms is promoted rather than state identification of winners). Credit interventions—while still prevalent—are only a small part of the menu of intervention, are delivery through second-tier or even third-tier banking institutions (i.e., micro-lending), and are targeted toward deficiencies in the banking sector. Increasingly, governments are playing a “facilitator” role (promoting business associations, securing basic infrastructure). Most of the credit interventions are mainly targeted at carefully analyzed market failures (e.g., financing for the cost that a firm may incur in opening up a new export market, offering insurance against non-payments by foreign purchasers).

Table 2: A Typology of Policies to Promote Competitiveness in 14 Latin American Countries

Export Promotion	Investment Promotion	Promotion of Productivity and Competitiveness	Micro and SMEs Development
<p>1. Availability and/or cost of credit (almost always following market principles for pricing of loans, and generally targeted to non-traditional exporters):</p> <ul style="list-style-type: none"> ▪ Credit: 1) Special export credit agencies working as second tier financial institutions; 2) Credit facilities for the exporters of capital goods; 3) Financial assistance for market opening activities. ▪ Credit Insurance schemes to protect the exporter against both the commercial and political risk of a foreign buyer defaulting on payments ▪ Grants (on a cost-sharing basis) to enhance export firms' competitiveness (only in the Caribbean). <p>2. Fiscal incentives (direct subsidies, or budget lines of credits, play no role these days):</p> <ul style="list-style-type: none"> ▪ Tax refund schemes (some of these are incompatible with WTO rules) ▪ Drawback schemes ▪ Temporal admission schemes ▪ Export processing zones ▪ Incentives for the creation of trading companies ▪ Exemption from import duties or internal taxes <p>3. Provision of non-financial services to exporters (e.g., information, expedite customs processes).</p>	<p>1. Horizontal (i.e. across sectors) loans for working capital, mainly through development banks that operate as 2nd tier institutions and charge market determined interest rates.</p> <p>2. Loans to particular sectors (usually a very limited set of sectors, such as mining, transport or even motion picture)</p> <p>3. Loans for Human Capital (i.e. for undergraduate and graduate university studies at home or abroad) through development banks (rather than the education Ministry or other government agency).</p> <p>4. Credit line to promote productive alliances between groups of companies so that they can jointly solve management and commercialization problems in the execution of a shared productive projects</p> <p>5. Loans aimed at strengthening companies that supply unfinished, intermediate goods to a large manufacturing company (i.e., to stimulate the development of supplier networks.</p> <p>6. Horizontal tax incentives (mainly a very minor phenomenon) or tax incentives to specific sectors</p>	<p>1. Policies to foster the integration and strengthening of <u>production chains</u>:</p> <ul style="list-style-type: none"> ▪ Supporting private sector efforts to form clusters of firms around a particular production chain** ▪ Strengthening existing transport 'corridors.' ▪ Helping firms detect opportunities to act as suppliers to other firms (e.g., business conventions). ▪ Helping develop cooperative relationship between firms in a given production chain <p>2. Policies to promote <u>technological modernization</u>:</p> <ul style="list-style-type: none"> ▪ Promoting R&D by private firms through competitive allocated grants, or credits and tax incentives for tangible innovations. ▪ Strengthening cooperation between public research institutions and private firms ▪ Creating or strengthening the informational infrastructure for R&D by firms. <p>3. Policies to promote and protect competition:</p> <ul style="list-style-type: none"> ▪ Modern competition laws (similar to those in OECD countries). ▪ Independent agencies to enforce anticompetitive provisions. <p>4. explicit policies to promote private-sector investment in human capital, including financial or actual assistance to individual firms to train or retrain their workers in general or high-quality personnel for strategic activities.</p>	<p>Generally policies are built on the basis of a thorough assessment of the key constraints faced by MSMEs, which tend to fall within the following categories:</p> <ul style="list-style-type: none"> ▪ Factor-market ▪ Final-product market ▪ Regulatory ▪ Management ▪ Institutional. <p>Two types of interventions:</p> <p>1. Assistance to <u>individual MSMEs</u> through demand driven support services (e.g., financial services, access to technology, training, infrastructure, information, non-financial support)</p> <p>2. Assistance to <u>collective arrangements of MSMEs</u>, such as policies to support:</p> <ul style="list-style-type: none"> ▪ Integration of production chains ▪ Clustering ▪ Network of enterprises (groups of firms using combined resources to cooperate on joint projects)

Note: Excludes actions in the areas of Foreign Investment Promotion, Trade policy, and Banking Sector Reform, most of which are relevant to Kazakhstan. The table summarizes the interventions reported in Melo (2001).

** Targeting specific industries (high tech industries, automotive, light manufacturing, the petrochemical industry, mining, agribusiness, forestry and public-sector providers) or issues (non-traditional exporters that are threatened by external competition; production chains that generate important linkages for the countries internal trade). Key instruments are those in which the government plays an integration role (material incentives are minimal).

The role of the government is being redefined for an era of greater worldwide commercial and financial integration, rather than attempting to return to the past

52. The thrust of these policy statements and the interventions that have emerged from them have been inherently market-oriented. Based on the assessment carried out by Melo (2001), no Latin American government suggested to returned to the import substitution policies they advocated in the 1950s, nor do these industrial programs aim at interfering with the market mechanism through a systematic and generalized use of arbitrary subsidies (including subsidized credit). Similarly based on Choi and Kang (2000),^{ix} the mainstream interventions in Korea can no longer be described as active promotion policies to alter the sectoral structure of production towards sectors they believed offered greater prospects for accelerated growth. The Korean government provided, among other things, financial support to MSMEs and venture business to spur exporting efforts and corporate restructuring, mergers and acquisitions, technology developments, and employment, but there are sufficiently large qualitative differences between these policies and those that were used to promote the development of certain industries in the past.¹⁷ In Japan, successive stimulus packages have focused mainly on infrastructure and on addressing the problems of the banking sector.

53. Thus, a remarkable feature of industrial policies (IP) of the late 1990s in both Latin America and East Asia is that they aim to address issues such as productivity, efficiency, product-quality, and skills. These issues revolve around the central question of how to raise the countries' competitiveness.

54. The underlying assumption in most middle-income economies is that trade liberalization and private sector participation is here to stay, but that government nonetheless has a role to play in improving the countries position on exports and production. More importantly, the prevailing notion behind IP of the late 1990s appears to be that some degree of *concerted effort by the public and private sectors is necessary, to jointly outline technological, productive, trade, and infrastructure strategies that make it possible to increase and efficiently utilize productive resources and generate sustainable comparative advantages.*

B. Recent Assessments on the Success of East Asia Model of Intervention

Such breakaway from state-led-only policies is, in part, the result of an ample body of empirical evidence that such interventions have failed

55. For instance, most of the recent research suggests that publicly owned banks are less efficient than privately-held ones, so countries that do not have state banks are not rushing to set them up, and those which have them are transforming them into second-tier privatizable ones, or limiting sharply the scope of their operation (by replacing general lines of credits more selective interventions).^{x xi} More broadly, there is an extensive body of literature evaluating the role of IP in the development of the East Asian Countries. Noland and Pack (2002)^{xii} recently review this body of literature aiming at answering two questions:

- Was industrial policy “the” source of growth in Japan, Korean and Taiwan or only a mild accelerant/deterrent?

¹⁷ In fact, the World Bank and the Asian Development Bank made available to the Korean government about \$1billion each in support of these policies.

- Are any of the problems encountered in Japan since 1990 and in Korea since 1997 partly the legacy of one aspect or another of industrial policy?^{xiii}

56. They conclude that, at most, IP made a minor contribution to the growth of East Asia. Rather, a large part of the “Asian Miracle” was attributable to non-miraculous good macro- and micro-economic policies. These latter included a significant government role other than macroeconomic management in stimulating economic growth. Growth enhancing measures that did not differentiate among sectors included: 1) large expenditures on primary and secondary education, 2) the building of large and efficient social infrastructure, 3) a favorable attitude towards international technology transfer including both technology licensing and direct foreign investments, and 4) a substantial investment in public technology institutions. The credible commitment to rapid development may itself have a positive effect on risk taking in the private sector and have led firms to choose product or processes that promised greater return.

57. There is of course a large body of economic theory justifying state intervention to increase productivity by fostering goods that exhibit economies of scale or whose production process is associated with learning by doing. Moreover, the case of stimulating research and development activities of private firms—as well as stimulating investment in human capital by both private firms and households—have been well made, as these activities generate positive externalities for the economy as a whole. Thus, the search for government interventions to promote productivity is well warranted in the Republic of Kazakhstan.

ANNEX I: THE EXPERIENCE OF THE IFC

58. The International Financial Corporation (IFC), the private lending arm of the World Bank Group, has played a catalytic role in the conformation of numerous VCF as well as PEF:

- VCFs. IFC has undertaken activities ranging from advising governments, to structuring, investing in, underwriting, and placing funds, to identifying fund managers, to sitting on boards. Between 1978 and June 1995, IFC invested US\$196 million in forty nine VCF whose total size at inception was US\$1.5 billion (see Table 1 in the attached View Point Note No. 90, September 1996). The average fund size has been US\$30 million, although recent funds have ranged up to US\$100 million. As international investment banks and asset managers became willing to enter the emerging market funds business, IFC scaled back its activities, shifting to the promotion of funds targeting stock markets untouched by foreign portfolio investment—especially in Africa and the Middle East. In the Europe and Central Asia region, IFC sponsored the first Easter European fund in Hungary in 1989. In June 1995, IFC invested in eighteen funds in the region (five in Russia alone).
- PEFs. The IFC has played a key role in creating the portfolio funds industry in emerging markets (see table 1 and Box 1 in the IFC View Point Note no. 89, September 1996), beginning in the late 1970s when IFC began to work with a few interested governments to amend these regulations and identify potential investors and fund managers.

59. IFC's recent support to equity funds includes:

- **New Africa Investment Fund**. A US\$5 million contribution was made to a private – equity funds whose goal is to foster mining activities and empowerment in South Africa and the rest of Africa—especially in the area of junior mining. Junior mining involves small and medium sized projects whose capital needs cannot be satisfied through normal financing channels
- **Turkey Private Equity Fund**. The Turkish Private Equity Fund I received a US\$10 million contribution from IFC (contributing to a total first closing of US\$41 million). The Fund will be managed by Turk Venture Partner Limited (“Turkvent”), the exclusive Turkish affiliate of global private equity investment firm Advent International. The other institutional investors include the National Bank of Greece, European Investment Bank, the Netherlands Development Finance Company, and the German Investment and Development Company. The Fund will focus on the numerous small and medium sized companies with good fundamental that face capital constraints. The Fund is one of the first of its kind in Turkey and is expected to create a diversified portfolio of growth companies in a broad range of industries.

IFC has also experience in building supply and distribution chains in nearby countries, particularly Russia, as the following link to their website suggest.

Supply and Distribution Chains

Building Supply and Distribution Chains: Investment-Linked Technical Assistance

The Challenge

Direct investment can have a powerful impact on post-Soviet economies. It is an important source of capital, and it brings with it new technologies, new management techniques, and greater access to markets. While the former Soviet Union can be an attractive market for investors, local companies lack modern management and production know-how and access to new technologies needed to partner with outside investors.

The Partnership Solution

Forging Business Ties through Technical Assistance

To promote increased investment in post-Soviet markets and to bring the benefits of direct investment to local communities, the Partnership builds local companies into competitive and reliable business partners and links them into the supply and distribution chains of major investors. We:

- Identify existing or potential large investors and examine their needs.
- Survey local companies to identify those best positioned to become reliable business partners to outside investors.
- Conduct thorough reviews of the business and management practices of selected local companies to diagnose their weaknesses and the principal constraints to their growth.
- Introduce modern technologies and management know-how to bring quality and productivity in line with investors' needs.
- Broker long-term contracts between investors and local businesses.
- Train local companies in financial management, business planning, and investment proposal writing to help them access financing and link them to financial institutions.
- Develop financing mechanisms and establish financial intermediaries to fund new production technologies and working capital for local suppliers and distributors.
- Work with local government authorities to remove constraints to business development and investment.

The Result

Since the Partnership was created, its program to build local supply and distribution chains has transformed local businesses into successful enterprises and helped them access financing, laid the foundation for increased investment, and brought economic benefits to local communities. For example, the Partnership has:

Facilitated Investment

The Partnership worked with 18 Russian farms to help them introduce modern technical and management know-how to boost the quality and quantity of their milk production. The improvements in the farms' operations laid the groundwork for a \$50 million investment in a dairy plant south of Moscow, operated by Campina, a Dutch dairy processor. IFC helped finance the plant with a EUR 9.4 million loan. This new factory created dozens of jobs, and Russian farmers concluded long-term supply contracts with Campina and other dairy processors.

Increased Access to Financing for Local Enterprises

Thanks to the long-term supply contracts the Partnership brokered between Campina and Russian farms, the farms became credit-worthy, attracting \$2.1 million of capital investment (\$1.4 from Campina and \$700,000 from Western equipment suppliers). With the new equipment, the farms were able to double their production, boost the quality of milk, and increase their revenue by 60 percent. The competition among foreign and domestic dairy processors for the supply of high quality milk boosted milk prices and doubled the farmers' earnings.

In Ukraine, we have trained local banks to assess agricultural credit risk and worked with farmers to improve their financial management and business planning skills. As a result, the number and size of agricultural loans has increased significantly in the region where we are

Current Projects

- [Russia: Agribusiness Development Program](#)
- [Russia: Business Development in Russia's Far East](#)
- [Russia: Development of Furniture Manufacturers](#)
- [Russia: Northwest Russia Forest Investment Project](#)
- [Russia: Sustainable Wood Harvesting in Leningrad Oblast](#)
- [Russia: Development of Automotive Component Suppliers](#)
- [Russia: Dmitrov Potato and Dairy Production Project](#)
- [Ukraine: Agribusiness Development Program](#)
- [Tajikistan: Farmer Ownership Model](#)

Other program areas

- [Improving Corporate Governance Practices and Regulations](#)
- [Building and Developing Financial Markets](#)
- [Developing SME Business Support Services and Improving Regulatory Environment for MSMEs.](#)

working. While virtually no financial institution loaned to farmers at the outset of the program, the Partnership helped some of the leading Ukrainian banks build or expand their rural credit programs. In the first year of the Partnership's program in Southern Ukraine, about 80 farmers we trained obtained loans of \$600 to \$20,000 from local banks.

Established a Financial Intermediary to Fund Local Companies

The Partnership provided technical assistance to create the Agro-industrial Finance Company (AFC) - a financial intermediary that will finance Russian suppliers to major processors of agricultural products. The company is established and financed by IFC, Rabobank, and the Netherlands Development Finance Company (FMO).

Matched Local Companies with Business Partners

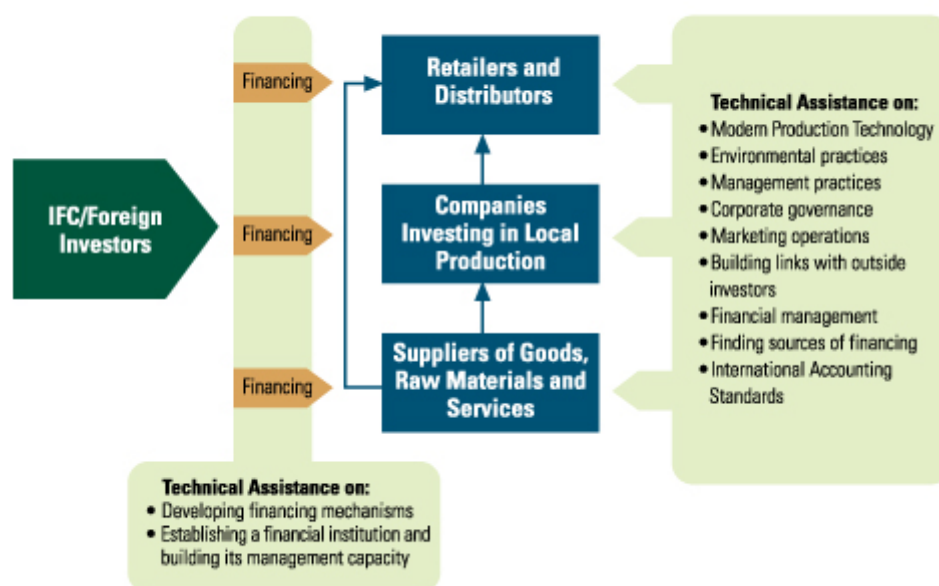
In the forestry sector, we have worked with a dozen wood harvesting companies in Northwest Russia to introduce sustainable and environmentally sound production practices, help them develop business plans and investment proposals, and match them with European investors. A major Finnish forest industry group has acquired significant stakes in two of the participating companies and provided them with financing to increase the companies' harvesting capacity. The group plans to invest in other Russian harvesting companies and build a large wood processing facility together with these new partners. Others Russian forestry companies we worked with have established direct partnerships with the leading forest industry companies in Finland and Sweden.

In Ukraine, the Partnership has set up demonstration fields and provides hands-on training to about 1,500 family farms a year in growing new crops and employing modern agricultural production technologies. The Partnership facilitates links between these farms and food processors.

In the automotive, furniture manufacturing, and mining sectors, we are building up Russian small and medium-sized enterprises in order to link them to the supply chains of IFC-supported projects.

Currently IFC's Partnership is working with suppliers in the agribusiness, mining, forestry, furniture manufacturing sectors in Russia, Ukraine and Central Asia. These programs are supported by [Canada \(CIDA\)](#), [Finland, the Netherlands \(Senter\)](#), [Norway](#), [Sweden \(Sida\)](#) and [Switzerland \(seco\)](#).

Building Supply and Distribution Chains Model



End Notes

ⁱ See Government Resolution #1370 of 26 Dec. 2002 on major economic and social policies in 2003. In this Resolution, industries such as processing of oil, gas, ferrous and non-ferrous metals, production of modern construction materials, food and non-food consumer goods are perceived to have a good potential.

ⁱⁱ We use the term “state” money to avoid confusion with “public” money as in IPOs.

ⁱⁱⁱ Summary of Melo, Alberto (2001): Industrial Policy in Latin America and the Caribbean at the Turn of the Century; Interamerican Development Bank Working Paper No. 459.

^{iv} This section borrows Carter Laurence (1996): Investment Funds in Emerging Markets. IFC Lessons of Experience Series, and from various presentations on Issues in Private Investment Funds by Teresa Barger.

^v Ispat Karmet and the International Financial Corporation have set up an “Investment Fund” to provide financial, technical, and business assistance to SMEs located in Karaganda Oblast. The program is primarily, but not exclusively, targeted at SMEs that have a good potential to become suppliers to Ispat Karmet (the largest steel producer).

^{vi} Ellerman, David; Kreacic, Vladimir. Transforming the old into a foundation for the new - lessons of the Moldova ARIA Project. World Bank Policy Research Working Paper, WPS2866.

^{vii} Ghani and Suri; *Productivity Growth, Capital Accumulation and the Banking Sector: Lessons from Malaysia*; Policy Research Working Paper 2252.

^{viii} See W. Maloney: Missed Opportunities: Innovation and Resource-Based Growth in Latin America. Office of the Chief Economist, Latin America and Caribbean Region, The World Bank.

^{ix} For a summary of government support programs in Korea see: Choi and Kang (2000): A study on the Crisis, Recovery, and Industrial Upgrading in the Republic of Korea. Chapter 11 in Dwor-Frecaut et al “Asian Corporate Recovery”, published by the World Bank, April 2000.

^x A useful recent paper on this issue, which examined the degree of efficient allocation of public and private banks in 34 countries is that of Galindo and Micco (2003)

^{xi} Galindo and A. Micco (2003). Do State-Owned Banks promote Growth? Cross Country Evidence for Manufacturing Industries. Inter-american Development Bank, Research Department Working Papers No. 483.

^{xii} Marcus Noland (Institute for International Economics) and Howard Pack (Wharton School, The University of Pennsylvania, Industrial policies and growth: Lessons from international experience. Paper presented at the Fifth Annual Conference of the Central Bank of Chile on the Challenges of Economic Growth (co-sponsored by the World Bank). <http://www.bcentral.cl/Estudios/Conferencias/2001/i2001.htm>

^{xiii} The first question is relevant to the extent that these countries had many of the conventional growth-fundamentals well in place (e.g., high growth of capital, high education achievements, large total factor productivity gains from adopting foreign technology, stable macroeconomic frameworks, predictable exchange rates). Thus, the actual contribution of IP to growth might have been marginal to the overall equation growth. The second question is also relevant to the extent that there is agreement that the principal causes of the Asian crisis include inadequate corporate and financial institutions whose development was, in fact, undermined by IP.