I. CONTEXT: A TASTE OF THE FUTURE

A. TRANSFORMING KAZAKHSTAN WITHIN A DECADE

1. **A difficult transition.** From 1991 to 1995 real GDP fell by 39 percent and exports collapsed (Figure 1). Fiscal and external imbalances led to hyperinflation which peaked in 1994, and there were widespread arrears in pensions and wages. Production ties with the Commonwealth of Independent States (CIS) were severed, which created massive underemployment – particularly in defense-related industries where those ties were strongest. Livestock became the main safety net for the rural population. Its exports – among the highest in the CIS – collapsed (World Bank 2004b).

2. **The government focused on the most obvious comparative advantages.** Aggressive efforts were made by the government to attract investments into mineral and energy resources, and to provide opportunities for the country’s relatively well-educated population (Figure 2). Between 1994 and 1996 the country liberalized most prices, imposed hard budget constraints on enterprises and banks, reduced trade distortions, and privatized all small and most medium-scale enterprises. Vigorous banking and pension reforms followed, together with liberalization and unbundling in the electricity sector. Late in the 1990s, the government began to concentrate its efforts on institutions. The framework for public resource and civil service management was introduced; and, in mid-2001, the National Fund of the Republic of Kazakhstan (NFRK) was set up—an important, albeit initial, step towards oil revenue management and transparency.

3. **Strong supply response after the regional financial crisis.** A vigorous recovery started in 2000 and has continued through 2004, led mainly by the oil sector (Figure 3). Oil production increased from 0.5 million barrels per day (mbd) during the 1997-99 period to one mbd in 2003, with substantially more to come in the future. This and the global increase in commodity prices (e.g., grain, steel, copper and gold) had important spillovers into the non-oil sectors. The food and construction industries and financial and business services sectors experienced true development, even if from a very small base.

4. **Stability was achieved, but pressures from capital inflows began.** Since 2001, inflation has been below ten percent. Between 2000 and 2003 the real exchange rate index depreciated against the euro and the ruble, and appreciated against the US dollar. This stability was underpinned by a cautious fiscal stance, during which about half of oil revenues were saved in the NFRK abroad, and government’s spending levels were kept to approximately 22.5% of GDP (Figure 4). A sharp real appreciation vis à vis the US dollar has occurred over the past year, despite interventions by the National Bank of the Republic of Kazakhstan (NBK). If defined as the relative price of tradable to non-tradable goods, the real exchange rate has followed a trend similar to that of the tenge/dollar although not as accentuated (Figure 5). The pressure on the exchange rate, due to ongoing capital inflows, continued as of end-2004.

5. **Increase in savings.** The savings rate, driven by fiscal surpluses, has more than doubled since 1997 (Figure 6). The government accounted for one-quarter of the country’s savings in 2003, and its assets in the NFRK reached US$5.0 billion by last year (12 percent of projected GDP), an amount similar to the country’s total (external and domestic) public external debt.
Private savings have also increased, with deposits in commercial banks and pension assets reaching 23 percent and 9 percent of GDP, respectively, last year. Given this pace of asset accumulation, credit rating agencies have continuously upgraded Kazakhstan’s sovereign-bond ratings (Moody’s:Baa3; Fitch:BBB-; S&P:BBB-). Investments are also up, but this increase has been driven by oil and the state investment programs (Figure 6).

6. **Simple recipe for success.** First, the overall macro-economic framework was put in place through hard budget constraints and a fiscal policy that restrained aggregate demand. Second, opportunities for private (domestic and foreign) investors were quickly created in all sectors, including strategically important ones, such as electricity generation. Finally, key government institutions were strengthened. Maintaining these three policies is a precondition for continued success. But as will be discussed later, the road ahead requires efforts in other areas as well.

B. **2004: The Two Faces of Kazakhstan**

7. **Financial indicators are strong, but the country’s manufacturing base remains weak.** While Kazakhstan is modernizing its extractive industries—a process helped along by high commodity prices—there is significantly less economic activity outside of mining and metals. Construction, trade, commerce, transport, and financial services are all increasing, but these trends are likely to be the result—directly or indirectly—of the demand generated from high oil investments and spending. This poses the question of whether growth in these sectors can be sustained when the oil boom recedes, as one day it must. Naturally, the country’s economy is now heavily dominated by oil and gas, mining, and metals, which directly accounted for thirty percent of GDP (Figure 7), nearly 80 percent of industrial output, and more than 80 percent of exports. But exports in all other industries have been stagnant at approximately US$2 billion dollars since 1997 (Figure 8). This weak manufacturing base hampers illustrate the magnitude of challenge to diversify the economy.

8. **Social indicators.** While the percent of the population that can not afford a minimum amount of food has fallen from 18% to 12% between 2001 and 2003 (although mainly in urban areas); nearly 27% of the population lives in crowded conditions with less than 6 square meters per person. Also, an estimated 11% of the population is poorly educated—defined as those persons 15 years or older who at most have completed primary school (World Bank 2004a). The trend for income inequality is unclear, but since oil is the driving force of the economy authorities should expect it to worsen and prepare to mitigate its effects through human capital policies (e.g., health and education) and by strengthening the taxation of property (housing and vehicles).
Sources: Annex Tables 5, 6, 7, and 8.
9. **Health indicators are not good either.** Life expectancy at birth is lower than the average for the CIS, while adult mortality rates are higher. Part of the health problem results from low access to safe water, particularly in rural areas where only 6.4% of households have access to piped water (44% of the population lives in rural areas). The country also faces major health threatening environmental challenges, related to water availability, water and air pollution, and a legacy of mismanagement of natural resources. Problems in the water and sanitation sector are already at critical levels as suggested by the multiple hepatitis outbreaks during last summer.

10. **Negative consequences.** Were these health and social trends to continue, it is likely that labor productivity will stagnate or fall over time, affecting the overall level of competitiveness in Kazakhstan. Oil inflows will clearly lead to real exchange rate appreciation over time, which in turn will push wages costs up in sectors that have no direct or indirect link to the oil industry. Thus, unless labor productivity increases, it will be too costly to produce goods without link to the oil industry in Kazakhstan.