

## 1. Sovereign Wealth Funds in resource-rich countries

Various resource-rich countries have placed some of their export revenues in Sovereign Wealth Funds (SWFs); by the end of 2007 these were worth perhaps \$2,500 billion.<sup>1</sup> They serve two main purposes:

- **Consumption smoothing**, e.g. Norway's Government Pension Fund invests oil revenues to provide returns for future generations of Norwegians who may no longer have large oil revenues.
- **Stabilization**, e.g. Chile's Economic and Social Stabilization Fund, which accumulates funds when copper prices are high and disburses them when prices are low.

The first goal implies long-term investment, but raises issues of what yields the best return (investing domestically in education, health, infrastructure, etc or diversifying by investing abroad?), while the second goal requires greater liquidity.<sup>2</sup> In practice, SWFs vary according to their emphasis on these two primary goals and whether they have other goals.

### Alaska

The Alaska Permanent Fund was established in 1976 when oil exports became important for the state.<sup>3</sup> An amendment to the state constitution guaranteed that at least a quarter of all oil revenues received by the state be invested permanently on behalf of the state's residents, transforming non-renewable oil wealth into a renewable source of wealth for future generations of Alaskans. In 1980 the State Legislature created the Permanent Fund Dividend Program, retroactive to January 1, 1979, to distribute a portion of the income of the Permanent Fund each year to eligible Alaskans as a dividend payment: the 2008 dividend is \$3,269.<sup>4</sup>

The Alaska Permanent Fund is a pioneering model of a fair and effective way to secure common heritage wealth benefits for the people as a whole. The APF is a well-managed, transparent and democratic institution, built on a concept of individual

<sup>1</sup> Nobody knows the SWFs' combined asset value. There is not even agreement on the definition. The number cited is from *The Economist* (6 September, 2008); other sources include SWFs run by non-resource-exporting countries.

<sup>2</sup> Although even holding illiquid assets in an oil fund may give a country greater collateral to borrow when faced with a sudden fall in revenues (J. Davis et al. *Stabilization and Savings Funds for Non-renewable Resources*, *IMF Occasional Paper No.205*, 2001). The literature on oil funds and stabilization is reviewed by Ghiath Shabsigh and Nadeem Ilahi, *Looking beyond the Fiscal: Do oil funds bring macroeconomic stability?* *IMF Working Paper 07/96*, April 2007.

<sup>3</sup> Under the Alaska Constitution all the natural resources of Alaska belong to the state to be used, developed and conserved for the maximum benefit of the people. In 1969 the first Prudhoe Bay oil lease sale yielded \$900 million from oil companies for the right to drill oil on 164 tracts of state-owned land. Compared to the 1968 total state budget of \$112 million, this was a huge windfall. By legislative consensus, the original \$900 million was spent to provide for basic community needs such as water and sewer systems, schools, airports, health and other social services, although many voters subsequently thought it was spent too quickly and without sufficient oversight.

<sup>4</sup> This is taxable income. The annual dividend and procedures for obtaining it are set out on the website <https://www.pfd.state.ak.us/>. More details on the APF are in Jonathan Anderson, *The Alaska Permanent Fund: Politics and Trust*. *Public Budgeting and Finance*, 22, 2002, pp. 57-68 (abstract at <http://ssrn.com/abstract=320697>).

ownership and intended to spur demand and consumption. Under the policy guidance of the Fund's six trustees and the executive director and staff selected to execute it, there has developed an extensive accountability program and open meetings with opportunity for citizen participation. The Alaska Permanent Fund Corporation website ([www.apfc.org](http://www.apfc.org)) keeps current all investment and distribution activities of the Fund. Earnings of the Fund undergo special public scrutiny since any expenditure of such earnings must be subject to the legislative appropriation process. An Annual Report is distributed each year.

Crucial to the democratic oversight is strong citizen interest in the Fund's operation and investment activities. The desire to retain the fund's principal for future generations was illustrated in 1999 when, with oil prices at \$9 per barrel, the State government put an advisory vote before Alaskans requesting authorization to use part of the Permanent Fund for current government expenditure. Although the Governor and many other elected officials urged a "yes" vote and campaign spending greatly favoured the "yes" side, the proposal was voted down by over 80% of the voters. This vote may, however, reflect distrust of allowing politicians to exert discretionary control over APF money, rather than concern for future generations. Any measure negatively impacting on dividend payouts is considered politically suicidal because perceived support of the dividend program is so universally strong; this may ensure the dividend's continuity, even in years when there may be better uses of APF money.

## **Norway**

Norway's emergence as a major oil and gas producer in the mid-1970s transformed the economy. Large sums of investment capital poured into the offshore oil sector, leading to greater increases in Norwegian production costs and wages than in the rest of Western Europe. A Petroleum Fund was established in 1990 to counter the disrupting effects of fluctuating oil prices and to invest the petroleum sector's surplus for the benefit of future generations. The Norwegian fund, like Alaska's, converts petrodollars into stocks and bonds, but instead of paying dividends it uses revenues and appreciation to ensure the equitable distribution of wealth across generations. It is closely controlled by the Ministry of Finance which has exerted discretionary power in changing the rules about allowable assets (i.e. the shares of stocks and bonds and the need for ethical investing) and has the authority to use Petroleum Fund assets for current government expenditures.

The surplus is generated mainly from taxes of companies, but also payment for licences to explore as well as dividends from the 81% state-owned company, Statoil. The fund is managed by Norges Bank Investment Management (NBIM), a part of the central bank, which reports to the Minister of Finance. The initial investment strategy was cautious, with most of the funds in bonds, but this meant that the fund missed opportunities to benefit from buoyant stock markets. In 1998 the fund was allowed to invest up to 40% of its portfolio in international stocks, and in 2007 the Ministry raised the maximum stock portion to 60%. The fund's assets exceeded \$388 billion by the end of December 2007.

Norway's citizens are protected against sudden falls in oil prices or against the eventual decline in oil exports, and they will not have to alter spending habits dramatically if oil revenues decline. When the government runs deficits, it is allowed to transfer cash out of the funds. In a land of high taxes, the fund functions as a

substitute for national savings.<sup>5</sup> Although the fund is commonly referred to as the Petroleum Fund (*Oljefondet* in Norwegian), in January 2006 its name was changed to the Government Pension Fund – Global, although it is not actually a pension fund (as it derives its financial backing from oil profits and not pension contributions) and is distinct from the Government Pension Fund - Norway which was established in 1967 as the National Insurance Scheme Fund. The change in name reflects a social protection view of the fund.

Due to the large size of the fund relative to the population of Norway (just under five million people), the Petroleum Fund has been a political issue. Three main issues have dominated:

- should the country use more of the petroleum revenues for the current state budget instead of saving the funds for the future?
- should the fund seek to maximize returns by aggressive investment in global stocks or should it place greater weight on avoiding risk?
- is the investment policy of the Petroleum Fund ethical?

After the discovery of several cases of investment by the Petroleum Fund in companies involved in arms and tobacco production, the Petroleum Fund's Advisory Council on Ethics was established in 2004 and new regulations on the management of the Petroleum Fund included ethical guidelines.

In Norway, the sudden increase in oil prices has meant larger inflows to the fund and enhanced long-term welfare for its citizens. The Norwegian economy remains heavily dependent on oil (petroleum industries account for about 17 percent of Norwegian GDP and 45 percent of exports), but the rapid growth of the fund means Norway does not suffer massively when oil prices suddenly drop or if production begins to dwindle.

## Assessment

Despite the differences between the Alaskan and Norwegian funds, both have functioned well as consumption smoothing mechanisms. The exceptional oil price increases in the early and mid-2000s allowed Alaska to make larger dividend payments to citizens and allowed Norway to use the fund for social goals (eschewing revenue by ethical investing and transferring funds to the state budget for social programs). Indirectly the funds may be influencing economic structure (by private investment of the dividend in Alaska or by public policy financed by oil revenues in Norway), but in neither case is the fund involved directly in changing the economic structure. Both funds have high levels of accountability, achieved in Alaska by transparency and voter activism and in Norway by an incorrupt representative government.

The opposite extreme is represented by countries where oil revenues flow into the bank accounts of the royal family (Saudi Arabia) or corrupt politicians or soldiers (Nigeria). In Central Asia, Turkmenistan had the least transparent system, with most of the revenues from cotton and gas exports going into off-budget accounts, which ended up in foreign accounts in the president's name or were used for ostentatious construction projects. The revenues which went to the people (e.g. as subsidies for

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<sup>5</sup> Daniel Gross (on Slate <http://www.slate.com/id/2108873/>) sees the Fund as the means by which Norway has been able to continue socialist policies which other Western European countries have had to rein in due to the budget constraint.

heating, lighting, water and basic foodstuffs) or in investment in import-substituting manufacturing projects made little or no provision for future living standards.

The stimulus for establishing oil funds was the realization that many oil-rich countries wasted the windfall benefits from the oil price increases of the 1970s. Nevertheless, there are some positive lessons from that decade. Indonesia used its oil windfall to finance an ambitious program of investment in primary education, which contributed to rapid growth in the following decades. This was a better use of the added revenues than if they had been put into a fund under the control of the corrupt ruling family. On the other hand, Kuwait invested large part of its revenues overseas, which provided good insurance against invasion (as happened in 1980).

These examples highlight that:

- There may be domestic investments with high social return (such as rural schools) which will be underprovided by pure market forces
- An oil fund is likely to be socially beneficial only if it is well-managed

The examples of Alaska and Norway may only be useful for countries with well-functioning domestic financial and fiscal systems (so that all worthwhile projects are being financed by the private sector) and with transparent and incorrupt governance.

## Azerbaijan

Although Azerbaijan was the centre of the world oil industry a hundred years ago, output stagnated in the second half of the 1900s. The revival of oil production dates from the Deal of the Century signed 20 September 1994 with a consortium of foreign oil companies who committed to invest \$7.4 billion in three major offshore oil fields over thirty years, projecting an increase in Azerbaijan's daily output from 160,000 barrels per day in 1994 to 700,000 bpd in a decade. A National Oil Strategy was articulated with four components:

1. major oil companies provide technology
2. multiple transport routes
3. accumulation of managerial expertise
4. investment in sustainable development

The State Oil Fund of Azerbaijan (SOFAZ) was established in 1999, and became operational in 2001, as oil revenues began a rapid increase.

	Oil Production	Oil exports		Share of total exports	GDP per capita (USD)
	(million barrels)	Quantity (mb)	Value (\$m.)		
<b>1998</b>	83.4	32.1	450	66%	554
<b>2002</b>	150.8	85.6	2,046	89%	752

Oil revenues accrue to SOFAZ, which transfers a portion to the government budget and invests the remainder overseas to mitigate Dutch Disease effects:

- in 2003 the Fund was used to finance resettlement and other assistance to people displaced by the Nagorno Karabakh conflict (\$24m), to contribute to Azerbaijan's share of the cost of the Baku-Tbilisi-Ceyhan pipeline (\$133m), and \$115m was transferred to the state budget for other purposes.<sup>6</sup>
- the investment strategy so far has been fairly conservative (liquid fixed-income assets), but may become more aggressive and forward-looking as funds (and expertise) build up.

<sup>6</sup> IMF *Staff Country Report 04/322*, 2004, p.14.

The Fund has an oversight board, an independent auditor (Ernst and Young) and a website. In July 2004 Azerbaijan became a pilot country for the Extractive Industries Transparency Initiative (EITI), which sent a positive signal about transparency and accountability, even though the EITI only relates to how revenues are collected, not to how they are spent.<sup>7</sup>

## **Kazakhstan**

Kazakhstan has the Caspian Sea region's largest recoverable crude oil reserves, and it accounts for over half of the 2.8 million barrels per day currently being produced in the region (including regional oil producers Azerbaijan, Uzbekistan, and Turkmenistan). Kazakhstan's petroleum industry accounts for roughly 30 percent of the country's GDP and over half of its export revenues. Oil exports have ensured that average real GDP growth has stayed above 9 percent for the last 6 years.

The National Fund for the Republic of Kazakhstan (NFRK), established in August 2000, explicitly has both stabilization and a savings function.

Extra revenues from oil and three large minerals producers are transferred to the NFRK when prices exceed reference prices for oil, gas, copper, lead, zinc and chrome (mainly implemented by triggering higher tax rates). The NFRK must keep at least a fifth of its assets in the stabilization portfolio, which has specific criteria requiring investment in liquid foreign financial instruments. When market prices are below the reference price then the fund provides revenue to the government for its operations. The stabilization role has been inactive so far, in part because of low reference prices relative to today's levels (e.g. \$19 per barrel for oil), but more fundamentally because Kazakhstan's resource exports enjoyed almost continuously increasing prices from 2000 to 2008 so that stabilization was not an issue.

The savings portfolio appears to be conservatively managed, but actual criteria are non-transparent. In 2007 reports indicated that 75% was in fixed income and 25% in equities, essentially tracking a basket of stock market indices.<sup>8</sup> President Nazarbayev has the authority to request special transfers from the NFBK to state or local budgets for purposes defined by the President, although to date no such transfers have occurred.

A sign of improved transparency is that Kazakhstan became an EITI candidate country in 2007 and published its first EITI report in January 2008, although the report came under some criticism for omission of some energy companies.

Both SOFAZ and the NFRK were established by presidential decree rather than by legislation which passed through parliament, thus leaving both funds subject to presidential discretion. The NFRK is generally considered less transparent than SOFAZ, due to the weaker independent oversight and greater discretionary power of the President. Not only does President Nazarbayev have the authority to request special transfers from the NFBK, but he also appears to have closer control over

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<sup>7</sup> In April 2008 the World Bank proposed a new initiative (EITI++) focusing on the generation, management and distribution of revenues, rather than just on the relationship between companies and governments as in the original EITI.

<sup>8</sup> These shares were reported in a book by Medet Sartbayev (Deputy Governor of the Central bank) and Anuar Izbasarov (senior analyst at the Treasury). The assets are distributed across fifteen currencies, e.g. the fixed income assets are 45% US Treasury paper, 30% eurozone government bonds, 10% UK gilts, 10% Japanese government bonds, and 5% Australian government bonds.

appointments to the oversight board, which includes members of the Presidential family, than President Aliyev enjoys in Azerbaijan. Limits on media independence and civil society in both countries restrict the kinds of oversight existing in Alaska or Norway.

A criticism of both funds is their lack of concern for poverty alleviation. The Azeri fund has been used to help internally dispersed persons, but there is no general mandate for either fund to address poverty. This may be a mistake given the ongoing inequality of income distribution in both countries and potentially high social return to many investments (e.g. in education, health or infrastructure, especially in rural areas). The Indonesian example cited above shows the potential for such uses, although there are many other examples of windfalls being frittered away in supposedly productive current projects.

Evaluation of SOFAZ and the NFRK should be in the broader context of fiscal policy and how governments finance their budget. Between 2003 and 2006 Azerbaijan's government borrowed abroad an amount equal to about 4% of 2006 GDP, which made little financial sense when SOFAZ funds were being invested internationally to fetch 3-4% in nominal dollar terms. This was a counterpart to a huge non-oil fiscal deficit (equal to 30% of GDP).<sup>9</sup> Thus, Azerbaijan was using its oil windfall to finance public expenditure, including poverty alleviation through water and irrigation projects, but it was doing so in an inefficient, and to some extent non-transparent, way. By contrast Kazakhstan was paying off external debts to reduce future obligations.

## 2. Production Sharing Agreements and State Equity Positions

The dominant contractual form for exploiting oil and gas resources in the Caspian Basin and minerals elsewhere in Central Asia (such as the Kumtor goldmine in the Kyrgyz Republic) has been Production Sharing Agreements (PSAs) between foreign companies and the state. PSAs reflect the need to draw on firm-specific technical expertise, the high initial costs (and risks) to the foreign companies of exploring and developing a new oil or gas field, and the right of the state to residual returns. Typically PSAs are front-loaded so that the foreign investor retrieves much of the pre-production costs before revenue from the flow of oil or gas or gold is shared in agreed proportions. Under a PSA the state cedes some sovereign immunity by entering into a detailed arrangement in which contractual disputes are subject to international arbitration.

PSAs address a time inconsistency problem: the host government needs the foreign companies to develop the resources, but once output is flowing the foreign firms are less necessary.<sup>10</sup> To commit the financial and human resources to developing resources, the foreign companies need credible commitments that they will not be expropriated once resources are being profitably exploited – or at least an arrangement whereby they can recoup their investment quickly and thereby reduce the cost and risk of expropriation. This picture was further complicated in the post-Soviet space by:

- the rapid increase in energy prices once oil and gas projects began to come online in the late 1990s

<sup>9</sup> Norio Usui, How effective are Oil Funds? Managing resource windfalls in Azerbaijan and Kazakhstan, *ERD Policy Brief Series No.50*, Asian Development Bank, December 2007.

<sup>10</sup> This is an old pattern. Many of the large producing nations in the Middle East nationalized oil production in the 1950s or early 1960s.

and

- by the new independent states' negotiating inexperience.

The latter was used as an excuse for renegotiation which was really driven by the former (or by a simple wish to renegotiate the contract in the host country's favour once exploitation was under way). The danger for the host country is that any one-sided renegotiation of contracts might deter future foreign investment.

The most hard-line reaction came from Russia, which effectively scrapped PSAs in a 2003 amendment to the law governing PSAs, which would henceforth only be permissible if development of the resource under the licensing procedure defined in Russia's Subsoil Law could be proven to be implausible. At the same time the Russian government used various pressures to terminate existing PSAs. After cancellation of environmental permits for the largest project, Sakhalin-2, the foreign operators sold 50 percent of shares plus one share to Gazprom for \$7.5 billion in 2006. Similar pressures were placed on Exxon, operator of Sakhalin-1.

## **Kazakhstan**

The modern Caspian oil industry dates from the Tengiz agreement signed between Chevron and the USSR in 1990; the largest foreign investment deal in Soviet history. After the dissolution of the Soviet Union, the project was inherited by Kazakhstan. The 1990s in Kazakhstan were characterized by a series of deals between the President and the oil majors to revise the shareholdings in Tengiz and for the development of other large energy projects such as the Kashagan offshore oilfield and the Karachaganak gasfield which were to be developed by consortia. The process was extremely opaque, leading to drawn out legal proceedings in New York and elsewhere (dubbed *Kazakhgate* by the media) and the imprisonment in the USA of a Mobil Vice-President for failing to declare a "commission" in his tax return. Despite the corruption, the PSAs succeeded in involving the foreign companies and developing the energy resources.

Since 1997 there has been concern in Kazakhstan that PSAs have given too much to foreign partners at the expense of Kazakhstan. When such concerns were first voiced, and explained by the inexperience of Kazakh lawyers in the early post-independence years, foreign investors protested strongly and President Nazarbayev guaranteed that no existing PSAs would be amended without consensus. In 1999 amendments to the Oil and Gas Law strengthened local content requirements, and subsequent PSAs specified local sourcing elements. There has been a growing tendency to favour domestic partners, and the 2005 PSA Law mandated a minimum fifty percent participation of *Kazmunaigas*.

*Kazmunaigas* was created in November 2002 by merging state corporations with a variety of oil and gas operations to form a 100% state-owned vertically integrated company. Its operations include exploration and production, transportation, oil refining, petrochemicals and marketing of oil and gas, as well as being the government's negotiating arm in PSA contracts. The company is also required to supply subsidised fuel to domestic markets and to provide some social services, reflecting its close connection to government and role in policy implementation. This role also includes increasing rent extraction for the government. In this aggressive intent *Kazmunaigas* has some resemblance to Russian state-owned companies, *Gazprom* and *Rosneft*, although unlike the latter *Kazmunaigas* has acquired larger shares of energy projects in a straightforward and transparent manner by purchase or the transfer of state-held licences.

In 2004 Kazakhstan began to revise the tax and other laws pertaining to PSAs. The government also began to demand a larger share for the national oil company, *Kazmunaigas*, in energy projects. A flashpoint arose when the development of the Kashagan megafield ran into technical difficulties, cost overruns and revised projections of when oil exports would begin. The dispute which began in mid-2007 was settled in January 2008 when ENI and other foreign participants agreed to reduce their shares in order to permit *Kazmunaigas*, to increase its share to 16.7% (the same as that of other lead shareholders).<sup>11</sup>

### **Turkmenistan**

In Turkmenistan under President Niyazov (or Turkmenbashi the Great as he preferred to be known) the initial involvement of ExxonMobil and Monument in the energy sector was changed in favour of smaller companies such as Burren Energy (purchased by ENI in November 2007), Dragon Oil and Petronas. Two onshore (Khazar and Nebitdag) and three offshore projects are being developed under PSAs.<sup>12</sup>

### **Azerbaijan**

The state energy company SOCAR, established in 1994 by the merger of two pre-existing state oil companies, has signed 25 PSAs with consortia of foreign oil companies, including the 1994 “Deal of the Century”, and two major pipeline agreements (the Baku-Tbilis-Ceyhan and Southern Caucasus Pipelines). It has a minority stake in all 13 PSAs currently operational in Azerbaijan.

Development of Azerbaijan’s oil industry in the 1990s was hampered by opposition from Russia (whose Lukoil only had a 10% share in the Deal, which it sold to Inpex of Japan in 2003) and Iran, which disputed the demarcation of the South Caspian Sea and was upset that Caspian oil was not being routed southwards to Indian Ocean ports. On the other hand, coherence was given by the dominant position of the lead foreign company, BP, which took the lead in organizing the Baku-Ceyhan pipeline when oil prices began to rise.

In January 2003 SOCAR’s charter was revised by presidential decree so that the company retained ownership over oil it produces (previously it relinquished ownership once the oil went to be processed). SOCAR also relinquished some of its non-oil businesses. However, with increasing output of oil and gas and increasing energy prices, SOCAR’s financial position strengthened after 2003. SOCAR operates about forty older oilfields, which are generally high cost due to depletion and aging equipment. Its payroll of 50-70,000 employees is considered bloated. After the 2003 reform there were rumours of SOCAR being floated as a joint stock company, although the company’s accounts had never been independently audited before this year.

In 2007-8 SOCAR initiated international expansion. Beginning with acquisition and renovation of Georgia’s Kulevi oil terminal on the Black Sea, followed by opening offices in the UK, Romania, Switzerland and Turkey

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<sup>11</sup> It was also reported that ENI and its partners would make an additional payment to Kazakhstan of \$5 billion in compensation for lost revenue due to the delays.

<sup>12</sup> As reported by Yelena Kalyuzhnova and Christian Nygaard (State Governance Evolution in Resource-rich Transition Economies: An application to Russia and Kazakhstan, *Energy Policy* 36, 2008, pp.1829-42), p. 1835.

(potentially to establish a refinery network) and planning to open twenty petrol stations in Georgia.

In 2007 there were reports that Azerbaijan planned to renegotiate the terms of the largest PSAs to increase the tax take and to increase SOCAR's share.

### 3. Macroeconomic Policy in Kazakhstan 1998-2008 and the Banking Crisis<sup>13</sup>

Since May 1999 the central bank has adopted a *de facto* exchange-rate anchor. Although there had been fluctuations, the exchange rate in February 2006 was 130/\$, the same as at the end of May 1999, despite pressures for currency appreciation. The central bank accumulated foreign exchange reserves, including oil fund assets, amounting to over twelve months of imports by the end of 2006. A move away from *de facto* exchange rate targeting began in the first half of 2006 and the dollar exchange rate was allowed to appreciate, reaching 120/\$ in January 2008, but the net exchange rate effect was unclear; between January 2006 and January 2008 the tenge depreciated against the euro (from 161 to 188), and to a lesser extent against the ruble (from 4.7 to 4.9).

Meanwhile, since 2003 the economy had been exhibiting signs of overheating due to demand pressure from large FDI-financed oil investments, fiscal and public sector expansion, and a credit-fuelled private boom. With the expectation that there was little exchange rate risk, by 2006 Kazakhstan's banks were raising large amounts of capital abroad, where the cost of capital was less than the double-digit interest rates that they could charge borrowers at home. In the first half of 2007 medium- and long-term debt-creating capital inflows more than doubled, largely due to external borrowing by the banking sector.<sup>14</sup>

In 2007 banks started to compete in making domestic deposits more attractive and at the same time they substantially increased the interest rates on loans, which by the start of 2008 had reached about 20%, double the rates of two years' earlier. In November 2007 the government provided support of around \$4 billion, targeted at construction projects in danger of being abandoned half-finished, and the central bank raised the official refinancing rate, which had been unchanged at 9% since July 2006, to 11%. Among the consequences of the financial sector's problems were an acceleration of inflation, which had been fairly stable around 7% in 2000-5 rising to 9% in 2006. Official year to December 2007 change in the consumer price index was 18%, but many consumers believed this to be an understatement. Particularly visible in 2007 were the doubling of bread prices and the over 50% increase in average house prices in Almaty, but the former was related to world wheat prices and the latter was a symptom of the asset bubble not a consequence. Nevertheless, the government

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<sup>13</sup> Based on Richard Pomfret, "Kazakhstan's Banking Problems", *Central Asia Caucasus Analyst*, 20 February 2008 – e journal available at <http://www.cacianalyst.org/?q=issuearchive>

<sup>14</sup> The banks lent to borrowers eager not to miss out in the property market, and problems arose because banks borrowed in international markets at shorter maturities to those on their loan portfolios. In important aspects the situation resembled that underlying previous crises, such as the 1997 Thai crisis when Bangkok, like Almaty and Astana in the mid-2000s, experienced a real estate boom. The full amount owed by Kazakhstan's banks to foreign creditors is unclear; according to the *Financial Times*, in October 2007 Kazakh banks' international borrowings totalled \$40 billion, and conservative estimates put the banks' foreign debt due in 2008 at around \$12 billion. International rating agencies began to downgrade the banks' creditworthiness in late 2007, and Standard and Poor's downgraded Kazakhstan's sovereign debt to BBB-.

pumped \$4 billion into the economy in November; the issue is not whether that was inflationary, but by how much.

An indirect consequence is the increased pressure to accept higher tariffs on utilities. Energy generators, for example, need continuous borrowing to upgrade facilities, but with higher interest rates they need to have tariff structures that reflect their costs. As with the higher inflation, higher utility prices will undermine poverty alleviation efforts.

Kazakhstan's banks, and the government, still have cards to play. Some banks are looking for a white knight to help resolve the liquidity crisis or to take an equity stake. The first substantial foreign investment in the banking sector was in November 2007 when the Italian bank UniCredit paid \$2.1 billion for a 91.8% stake in ATF Bank, Kazakhstan's fifth largest bank. However, with the global credit crisis in 2008, such hopes seem mistimed.

Potential domestic sources of financing include the pension funds, the oil fund and the central bank's foreign reserves. The pension funds have accumulated some \$20 billion since the introduction of individual accounts in Kazakhstan's 1997 pension reform. At present these funds are not allowed to have more than 20% of their assets in any one company, but there is pressure to raise the ceiling to 30% so that the funds can take a larger stake in individual banks. The National Oil Fund also has assets in excess of what is needed to resolve the banks' problems; by September 2008 it had accumulated over \$31 billion.<sup>15</sup> However, even more than with the pension funds, the oil fund is supposed to invest for the future, mainly taking foreign equity positions, and was not designed to bail-out companies in trouble. Despite rising oil production and prices, Kazakhstan's official reserves fell by over a fifth during 2007, from \$23 to \$18 billion, and these may have been used to assist the commercial banks' foreign obligations.<sup>16</sup>

As with many financial crises, the ultimate question is whether the banks have a liquidity or a solvency problem. If it is a liquidity problem, sufficient options are available to avoid a crisis, perhaps at the cost of an inflation spike if the government becomes too involved in providing liquidity. Depending on the solutions adopted, other potential costs include undermining of the integrity of pension funds or the oil fund. On the other hand, a brief liquidity crisis which imposed some costs on banks would be a positive reminder that they had lacked sufficient prudence in lending to fuel a property boom; that should result in a healthier banking sector in the long-run.

If, however, too many of the banks' loans become non-performing and the banks face a solvency crisis, then the outlook is bleaker. That outcome most likely depends upon exogenous factors, above all the price of oil, which will determine the extent to which Kazakhstan's high growth can continue despite blips. With high growth the many building projects in Astana and Almaty, both commercial and residential, will find tenants; the banks' loans based on optimistic projections will be repaid and the banks will be profitable, with cash to lend for future investment. Without high growth many borrowers will be unable to meet their payments; the banks will foreclose on assets of diminishing value, and that will be a financial crisis.

Integration into global markets offers large benefits but also brings risks, of which one is the increased volatility associate with liberalized financial sectors having access to global capital markets. In Kazakhstan financial integration exacerbated the problems of a mis-aligned and inappropriately fixed exchange rate.

<sup>15</sup> [http://www.nationalbank.kz/cont/publish190760\\_4813.pdf](http://www.nationalbank.kz/cont/publish190760_4813.pdf) In April 2008, however, the president committed to not using oil fund money to ease the credit crunch.

<sup>16</sup> They had increased to \$22 billion by the end of September 2008.