THE TRANSITION IN KAZAKHSTAN

FROM COMMAND TO MARKET ECONOMY

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Abstract

In the wake of the dissolution of the Soviet Union the newly independent state of Kazakhstan launched reforms aiming at dismantling the command economy and developing a market economy integrated into the world economy. The reform programme was relatively rapid and comprehensive and inspired by the 'shock therapy' philosophy that dominated in the early 1990s. Initially the reforms succeeded in liberalising and privatising the economy, but not stabilising it. The first years of independence were characterised by a steep decline in output and hyperinflation. The economic situation changed in 1995 and except for an economic downturn connected to the Russian financial crisis in 1998 the economy has steadily improved ever since. Kazakhstan has experienced an impressive growth based on a surge in export of natural resources since 2000. The transition has been a success in terms of privatisation and macroeconomic development and the radical consequent path had positive economic effects with time. However, it is hazardous to directly connect the growth of the 21st century to the reform programme. The exploration of newly discovered oil and gas fields as well as high world-market prices of these commodities might have been more determinant factors. Furthermore, the social outcome has been negative, although improving since 2000, and no democracy has evolved. Despite improvements the heavy reliance on natural resources still makes the economy vulnerable to exogenous shocks.

Keywords: command economy, former Soviet Union, J-curve, Kazakhstan, privatisation, shock therapy, transition economy

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Preface

This Minor Field Study included a two-month stay in Kazakhstan the summer of 2008 and was financed by SIDA, to whom I am grateful. During the stay in Kazakhstan I met many helpful people, in particular my interviewees at the European Commission, the World Bank and within the UN agencies; the friendly staff at the UNESCO Almaty Cluster Office; and the students, professors and staff at KIMEP – thank you all! Furthermore, I would like to thank my supervisor Yves Bourdet in Lund for patience and brilliant advice.

List of acronyms and abbreviations

ADB	Asian Development Bank
CIS	Commonwealth of Independent States
COMECON	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
IPF	Investment Privatisation Fund
KIMEP	Kazakhstan Institute of Management, Economics and Strategic Research
SIDA	Swedish International Development Cooperation Agency
SOE	State-owned Enterprise
UNCTAD	United Nation's Conference on Trade and Development
UNESCO	United Nation's Educational, Scientific and Cultural Organisation
USSR	Union of Soviet Socialist Republics
VAT	Value-added Tax
WHO	World Health Organisation

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1 Introduction

The breakdown of the Soviet empire initiated the largest transition from a socialist economy to a market economy. Kazakhstan is larger than Western Europe and with its 16.4 million inhabitants (2009) it has a low population density. The country has huge metallurgical reserves and one of the largest untapped oil fields found during the last 30 years.

Since independence in 1991, Kazakhstan has been undertaking comprehensive reforms aimed at dismantling the command economy and creating a market economy. After an initial economic recession in the 1990s Kazakhstan has experienced an economic boom since 2000. Till 2006, annual GDP growth was between 9 and 13 percent, which made Kazakhstan one of the fastest growing economies in the world. This extraordinary growth can be explained to a large extent by the surge in export of natural resources. This paper focuses on the measures taken in the early days of transition and to what extent the economic boom of the 21st century can be related to these.

Countries in the former socialist blocs have gone through the transition process with varied success. Among economists there is a consensus on the reforms needed to transform socialist economies to market economies with stable and sound macroeconomic development. However, there is no agreement about the timing and sequencing of these reforms (Bourdet 1995:30). Similarly, there are different opinions about how rapidly these measures should be implemented, to what extent they should be directed by the government, and how freely the market should be allowed to act. Now, almost two decades afterwards, it is possible to evaluate the transition process.

1.1 Statement of purpose

The purpose of the paper is to describe and evaluate the Kazakh economic transition towards a market economy. The study of the Kazakh reform programme focuses on comprehensiveness, timing and sequencing of the reform programme. The assessment of the economic impact of the reforms focuses on macroeconomic development, in particular on growth, private sector development and macroeconomic balances, as well as social outcome. This study focuses on, but is not limited to, the initial phase of the transition programme and its consequences for the economic development.

1.2 Organisation of the paper

The paper is organised as follows: Chapter two scrutinises the theoretical framework which is the basis of the analysis. In chapter three the economic reform programme of Kazakhstan is presented, divided into areas of systemic reforms, stabilisation policy, and trade and exchange rate policy. Chapter four contains an evaluation of the economic transition programme in Kazakhstan as well as a comparison and discussion about the assumed and actual effects of the reforms. It focuses on growth and development of the private sector, internal and external balance, and social outcome. Chapter five summarises and concludes the paper.

2 Transition - theoretical framework

The fall of the Berlin wall in 1989 and the collapse of the Soviet Union in 1991 were among the greatest societal transformations in history, implying the end not only of the cold war, but also of a political and economic system that had governed more than 400 million people. The breakdown of the Soviet Union was the end of an era of the world divided between two ideological and economic systems that had fought a cold war: capitalism and communism. Since then the former socialist bloc has developed from command economies towards a capitalistic economic system based on market mechanisms. This has implied an entire shift in the economic structure. Prices have to be set by supply and demand rather than by a bureaucrat in the administration, and private interests and property have replaced huge parts of the economy characterised by state ownership.

In a command economy the central administration takes the decisions concerning the production of goods and services. The nationalisation of the means of production is a fundamental communist and Marxist principle. The collective ownership of land and means of production is expected to guarantee social justice and put an end to the exploitation of labour. In the former command economies of the Soviet bloc, enterprises became state property; industry, transport, banking and infrastructure were nationalised; while agriculture as well as some services became collectivised, although in many cases nationalised at a later stage.

The central economic planning included domestic prices, which hence were delinked from world market prices. The state had a monopoly on foreign trade. There was no single exchange rate but rather one for each good, as the domestic prices were not based on the world prices. The production data was often impressive, but exaggerated for propaganda reasons (Landes 1998:496). The quality of the products of the USSR was seldom high, and apart from caviar and other special commodities the production could not compete on the world market.

For a few simple products, the socialist economies worked pretty well. These included steel, which became one of the propaganda symbols of the strength of the communist economic system. This, together with the possibility of fast mobilisation of labour and production, made the Soviet economy suitable for war times. However, in times of peace it was less suitable, and as production, economics and trade grew in terms of complexity, the socialist system turned out to be very difficult to manage.

At an initial stage several command economies achieved high growth and modernisation of the economic structure as well as low (almost no) unemployment. The social price was high though, and with time the economic weaknesses were obvious. Growth decreased and in the late 1980s many socialist countries experienced serious stagnation and suffered from high inflation. The shortage of commodities and services remained and even increased. Due to uncertain statistics from the Soviet Union and arbitrary exchange rates, it was difficult to compare the performance of communist command economies with Western market economies. The centralised economic structure, focused on dense industry, had difficulties modernising and adapting to new technology, and the living standard increased slowly while the ecological situation worsened markedly (Åslund 1993:11-13).

2.1 Reformation of the socialist economies

As the communist governments in Eastern Europe fell one after the other and finally the Soviet Union also broke down, it was time to hand over the economy to the market and Adam Smith's invisible hand. In the wake of the fall of the Berlin wall an abundance of ideas, advice, and theories on how the socialist countries would transform to capitalism emerged.

> *"Understanding transition requires a comprehensive understanding of the constitutive elements of capitalism and of their interactions. Moreover, it requires also an understanding of the dynamics of large-scale institutional change, an even more difficult objective."* (Roland 2001:30)

Technically, a reform process can be rather easy since the main goal is to abolish regulations rather than create new ones. The road is tricky, bumpy and full of challenges.

2.1.1 Systemic reforms

Price liberalisation

Letting the market set the prices of goods and services is a fundamental principle of a market economy and a major step in the transition process. In theory, price liberalisation is one of the easier reforms to launch since only an abolishment of the regulations is needed. The producers are free to set the prices according to their own profit-maximising models. This has significant efficiency gains and is a necessity for a decentralisation of domestic and foreign trade.

Nevertheless, price liberalisation is politically risky for a number of reasons, and furthermore the economic effect of the reform is a debated issue. First, a rapid price liberalisation is often followed by high inflation or hyperinflation. High inflation is hard to handle and deteriorates the predictability of the economy. The prices of some commodities that used to be the objects of heavy subsidies may increase by hundreds of percent. These include basic products such as bread, milk etc. where a significant increase in prices has large impact on the population and thereby may create public dissatisfaction and political unrest. Second, empirical studies of the socialist transition processes have showed that a rapid and comprehensive price liberalisation is often followed by a fall in output. Even though it is difficult to specifically link the output fall to the price liberalisation, it was an unexpected effect of the reforms (Roland 2001:44). Third, price liberalisation has often been followed by increased income disparities (cf. Doyle 1996). In the chaotic turmoil of the wake of price liberalisation some might gain high profits while for the masses the purchasing power might decrease significantly. Naturally, such a development may upset the population, and the reform is hence politically delicate.

An initial downward-sloping output curve can be part of a so called J-curve effect, i.e. that transition programmes initially imply a decline in output and macroeconomic destabilisation before a stable growth and macroeconomic situation evolves, which improves the economy from the point of departure (cf. Brada & King 1992:38). The J-curve effect is a widely spread hypothesis among scholars on the effect of a command economy dismantling regulations and liberalising the economy.

Enterprise reforms and privatisation

Since the means of production and the companies were owned by the state in the socialist economies it was necessary to privatise a significant part of the state-owned enterprises (SOEs) and reform all of them. Being a key aspect of the transition process, privatisation of SOEs and state properties such as real estate and infrastructure is one of the most difficult tasks of economic transition, economically, politically, juridically, and practically. It is a very complex process to divide the ownership in a country where everything was owned by the state, and the tradition of private ownership was limited.

There are different variants of handling privatisation of state property and the speed of the process has varied greatly between countries. Several obstacles occurred, such as valuation problems, restitution to former owners, lack of private capital needed for purchasing, massive bureaucracy resulting in delays etc. In addition, problems with so called "nomenklatura privatisation" (privatisation that benefited the nomenklatura[1] that took advantage of their key positions in the administration) as well as "the mafia" and foreign buyers further complicated the privatisation process (Nove 1995:238). The privatisation process in a country with poor institutions is ideal for corruption to occur. Corruption is associated with lower investment, lower economic growth, misallocation of resources, and increased income inequality and poverty (IMF 1999:74). Hence, transparency is a crucial key.

Most of the post communist countries used voucher privatisation to some extent in their reform programme. The method is based on vouchers that are distributed among the citizens who can trade them for shares in SOEs at auctions. The system has several

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[1] Russian term literally meaning a list of names, but became the name of the elite of the Communist Party having key administrative positions in the society.

economically and politically appealing features: It is relatively easy and fast to launch, the equal distribution of the vouchers benefits the entire population, and it solves the problem of lack of domestic demand for property (Åslund 2002:272).

There were, however, also negative sides in such a system. The ownership of enterprises became very dispersed, which to a certain extent had negative effects on the efficiency of management. Furthermore, it is important to point out that voucher privatisation cannot be counted as an investment since it is just a distribution of already existing entities (Nove 1995:239). Many of the most valuable enterprises were withheld from voucher auctions and therefore did not take part in the mass privatisation (Åslund 2002:273). Furthermore, many enterprises were given or sold directly to managers and workers cheaply instead of at the auctions. Lack of knowledge as well as the miserable economic conditions in many cases made the voucher system favourable for frauds. Intangible but valuable shares in companies could in some cases be bought for vodka. In addition, the system of distributed vouchers may have decreased the incentives of entrepreneurship.

Privatisation is often seen as a way to increase efficiency as old style monopolies develop into a flowering market of competition. But as Nove points out, the public monopolies at least in theory serve the interests of the people and have some kind of commitment towards them (Nove 1995:240). Furthermore, the private enterprises often avoided taxes, which harmed the economy. Hence, privatisation can be a complicated matter with possible undesirable effects on the economy.

The process was unprepared and chaotic in most post-Soviet countries. In many cases the privatisation was ideological rather than rational, and the result was a fall in output and investment. Nishimura points out that the transfer of enterprises from the public to the private sector only represents the first step of the privatisation process, and that it has to be well managed in the private ownership in order to survive. This requires training of managers and a sound business environment, something that might be harder to achieve than to sell the companies (Nishimura 2001:7).

Foreign investments and reform of the financial sector

In the command economies, foreign direct investment was the subject of major regulations. Foreign investments are important for growth and tend to have positive spill-over effects such as spread of technical know-how. Hence, the regulations constraining foreign investments should be removed, or at least decreased. Furthermore, the state should strive to create an environment attracting foreign investments. This includes well functioning financial institutions, macroeconomic stability, favourable tax conditions, well educated workforce etc.

A market economy requires an effective financial sector. Private banks, created through privatisation of state owned banks, as well as encouraging the emergence of new banks and establishment of foreign banks, are necessary for investments and important for the privatisation process in general (Gros & Steinherr 1995:297).

Legal reforms

Most of the reforms necessary for a successful economic transition process are complex and very political. Strong and reliable institutions and juridical set of rules are crucial and did not exist at the breakdown of the Soviet Union. Such institutions take a long time to build up. Furthermore, property rights as well as copyright and other immaterial laws are fundamental in market economies. Private property, physical as well as intellectual, has to be defended by the state in order to promote innovation and entrepreneurship.

2.1.2 Stabilisation policy

Fiscal policy

The government has to take new conditions into consideration in the fiscal policy. The expenditure often escalates uncontrollably, but the goal should be a balance between expenditures and revenues. Inflation often increases as result of soft budget constraints, lack of control of the state owned enterprises and monetary overhang (Gros & Steinherr 2004:83). Keeping the inflation down is important in order to stabilise the economy and attract investments.

Keeping fiscal control and balancing expenditures and revenues are delicate issues. The countries are in a phase of huge costs and necessary investments and are facing social and economical problems. Thus, it is difficult and politically sensitive to keep expenditures down, especially since the long-term gain of the policy might not be seen immediately. Hard budget constraints are politically unpopular but very positive for the transition process. Furthermore, a comprehensive reform of the tax system is needed. It often includes the introduction of value-added taxes (VAT) and the removal of the confiscatory tax rates. (Gros & Steinherr 1995:179).

Monetary policy

Economic uncertainty is expensive and harmful for the transition process and monetary stability is therefore crucial. It aims at a low and stable inflation as well as credible currency and current account. The preconditions are often difficult however. Price liberalization is often followed by high inflation in the short and medium term, and the currency generally suffers from low credibility. If price liberalisation is not accompanied by a strict monetary policy, hyperinflation is likely to occur.

2.1.3 Trade and exchange rate policy

Exchange rate policy

The Soviet economic system did not include a single exchange rate as trade could not be pursued by any other than the state. Instead, there was a complicated system of different exchange rates according to different commodities. Reformation of the exchange rate policy was hence of major importance in order to facilitate internal and external trade.

The reform of exchange rate policy may be done in several steps. Newly independent countries might introduce an independent currency, as in the case of Kazakhstan. The exchange rate is supposed to be unified, but in some cases it may be partly controlled initially in order to avoid negative effects of speculative flows (Gros & Steinherr 1995:145). Many argue for a fully flexible exchange rate, but the lack of macroeconomic stability and financial institutions may imply harmful effects on the transition.

Foreign trade

A huge step for the socialist economies was to change the trade that mainly was pursued with other socialist countries (e.g. through COMECON) and to enter the world trading system. The reform process must primarily break down the state monopoly on trade in order to let enterprises trade freely. The process promotes price liberalisation and improves the allocation of resources. The shortages of consumer products in these countries implied strong public support for liberalising trade.

A removal or reduction of trade obstacles such as quantitative restrictions on imports, import tariffs and export taxes is necessary in order to promote trade. However, the import tariffs and export taxes generate revenues to the state, something which is much needed during the transition. Furthermore, some trade barriers may protect the domestic companies in a transitional phase while adjusting to international competition. IMF suggested an import tariff on 10 percent to the former Soviet Union (FSU) states, mainly in order to secure government revenues (Åslund 2002:172). A complete free trade might create chaos as entire sectors collapse. This has to be compared to the inefficiency and trade distortion that high tariffs might imply.

2.1.4 Sequencing and timing of reforms

Most economists agree upon which reforms are necessary for socialist economies to go through in order to move towards a market economy. However, there is less consensus on the timing and sequencing for the measures (Bourdet 1995:29-30). Different socialist economies have taken different paths in this regard. Some have followed a rapid path where the reforms came simultaneously, while other have chosen a more gradual approach. In the latter case the sequencing of the different elements of the reform program is subject to discussion.

The dissolution of the socialist bloc was followed by an enormous economic experiment. The breakdown was unexpected, and there were no pre-existing theories on how a transformation towards capitalism should be made. Nobody knew what effects price liberalisation would have when no functioning market existed, or the results of privatisation of huge state owned enterprises (Roland 2001:29). Two visions appeared. One advocated radical reforms for a fast liberalisation – shock therapy – while the other supported a more gradual transformation.

Despite the general discussion between these two reform plans, some scholars argue that the importance of the strategy should not be exaggerated. Popov does not pay much attention to gradualism or shock therapy in his analysis of the modest success of transformation of Central Asian economies, but rather suggests three other groups of factors that were most determinant in causing the recession: First, the distortions in the industrial structure as well as the external trade pattern before the collapse of the Soviet union; second, the collapse of state bureaucracy and institutions, resulting in poor crisis management; and third, the poor economic policies (Popov 2004:101). Thus, the effect of the choice between a gradual or rather radical path should not be exaggerated.

Shock therapy

Advocates of a radical reform programme emphasise a rapid reformation of the market. The market economy of the industrialised countries is the model, and transition countries should develop such an economic system through rapid and comprehensive liberalisation, stabilisation and privatisation in order to "shock" the market. Theoretically the arguments were rooted in neo-classical price theory (Roland 2001:32). Supporters of the radical model suggest that the weak state and institutions of the post-communist countries should have limited influence initially and that emphasis instead should be on a free market (Åslund 1993:32).

This policy package is often referred to as the Washington Consensus,[2] and has been a well-used reform package in several countries in Latin America and in former socialist states. The Washington consensus was based on classical market economy

[2] The term was coined by the economist John Williamson and refers to the fact that these ideas were promoted by several institutions with headquarters close to each other in Washington DC, such as the International Monetary Foundation, the World Bank, and the US Treasury Department.

principles and consisted of ten broad recommendations concerning fiscal policy discipline, broadening tax base and adopting moderate marginal tax rates, low interest rates, competitive exchange rates, low import tariffs, privatisation, property rights, social policies etc. (Williamson 1989).

Advocates of radical reforms emphasise the necessity of rapid and comprehensive price liberalisation. They fear that a gradual liberalisation of the massively distorted prices would create confusion and not send accurate signals about fundamentals of market economy, i.e. demand, supply and prices (Åslund 2002:81). Speed of reforms is considered necessary since a partial reform might benefit a certain group which then will counteract further reforms (Roland 2001:33).

The Washington Consensus inspired view on rapid and comprehensive reforms was dominant in the early 1900s in policy circles as well as among scholars. It shaped the recommendations from the international financial organisations and had huge impact on the economic policy in most countries of the former socialist bloc (Roland 2001:32). However, the shock therapy has also been the subject of growing criticism from some economists, politicians and the civil society.

Evolutionary approach

Despite the assurances of those who advocated shock therapy in the early 1990s, some effects of liberalisation were unexpected to most scholars: (i) the huge output fall after price liberalisation, (ii) the significant occurrence of insider privatisation, and (iii) the emergence of the "Mafia" in many of the countries (Roland 2001:30).

This points out the difficulties of prediction in this case and has resulted in a more gradual approach to economic transition gaining support. This approach emphasises the need of hard budget constraints and the importance of well functioning institutions in transforming and developing the economy and the political system. Experience from the former Soviet bloc has showed that in countries where the institutions are not well functioning it is difficult to get the desired economic effects from liberalisation, stabilisation and privatisation. The economic rules valid in well developed capitalistic democracies with strong institutions, and a rigid legislative, executive, and juridical system, are not necessarily applicable to developing countries or transitional states where the preconditions are not the same. Hence, it is difficult to generalise amongst economic policies and when they are applicable, since every country or region has its own particular history, conditions, and path dependency.

The idea is therefore that liberalisation and privatisation not should be hurried, but progressive. The country might not be ready for such a change at once. Roland, himself being an advocate of this school, calls it the evolutionary-institutionalist perspective. This since it stresses the importance of functioning institutions. “Transition has forced us to think about institutions not in a static way but in a dynamic way” (Roland 2001:31).

An important difference between the two approaches is the view on privatisation. Instead of a rapid mass privatisation, the evolutionary approach suggests a gradual downsizing of the public sector and the encouragement of private entrepreneurship. SOEs can be sold to foreigners in order to ensure efficient ownership and management from the start (Roland 2001:35). Institutional infrastructure and proper legal framework and law enforcement are underlined. The initial conditions and the specific path-dependency of the country have to be taken into account in the reform package.

China and Vietnam are examples of socialist countries in a transition phase that have adopted more gradual reforms. These countries have also been used as examples of advocates of the evolutionary school for promoting sound, long-term growth.

2.2 Summary

Command economies face great challenges and obstacles in the development towards a market economy. Reforms focus on liberalisation, stabilisation and privatisation. Legal reforms aiming at securing property rights and new institutional settings are necessary. Liberalisation of trade and prices provides efficiency. Some of the main goals of the transition are to achieve macroeconomic stability, encourage entrepreneurship, and reallocate resources to their most efficient use. In the reform process there are different directions to embark on: a radical one characterised by speed, comprehensiveness and simultaneous reforms and a gradual one emphasising the role of institutions and the path-dependency of every country.

3 The Kazakh reform programme

3.1 Background and initial conditions

The economic transition of Kazakhstan coincided with independence and the set-up of new institutions and legal framework. Hence, the transition process did not only result in a *change* of institutions etc., but in some cases a *creation* of these.

Kazakhstan was the last state to declare its independence from the USSR and stayed close to Russia during the initial phase of independence – in many respects Kazakhstan followed the Russian transition process. This implied a relatively radical reform programme, which dominated the agenda in the wake of the collapse of the Soviet Union. The goal was to create a well functioning market economy through a range of measures aiming at liberalising, stabilising and privatising the economy.

Kazakhstan inherited an economic system from the Soviet Union with major problems. The capital stock was old-fashioned as a result of decades of low investment, production was concentrated to industries and agriculture while the service sector was underdeveloped. Poor infrastructure generated inefficient production. In all, the centralisation and heavy bureaucracy were prime obstacles to an effective economic environment. During the Soviet era there was a strong centralised domination from Moscow, i.e. most individuals with economic experience and knowledge were stationed in Russia, not in Central Asia. Thus, most companies were directed and governed centrally. In addition, there was a paucity of experience and know-how about working in a market economy.

Kazakhstan and the rest of the former Soviet Union further suffered from huge ecological problems, e.g. the catastrophic drying up of the Aral Sea, nuclear pollution in the military testing zones, and pollution and bad water in industrial areas (Akhanoc & Buranbayeva 1996:138).

At independence, the economic structure of Kazakhstan was much more like that of a developing country, such as Thailand (table 3.1). In 1991 agriculture represented 29 percent of the GDP, employing an even larger part of the population. At the same time, agriculture accounted for 14 percent of Russia's economy and only 3 percent of France's (1989). Meanwhile, industry represented 28 percent and services 43 percent of the Kazakh economy.

Table 3.1 Sector share of GDP (%), 1991/1989

	Agriculture	Industry	Services
Kazakhstan (1991)	29	28	43
Russia (1991)	14	39	47
United States (1989)	2	29	69
France (1989)	3	29	67
Thailand (1989)	15	38	47

Source: Åslund 2002:37

The economic conditions at the outset implied major challenges in the transition towards a sound market economy. However, the point of departure was better than for most of its Central Asian neighbours. Kazakhstan possessed huge natural resources and the main fields of oil and gas were not explored before independence (Kalyuzhova et. al. 2004:249). Furthermore, Kazakhstan also possessed vast fertile agricultural land, as well as forests and minerals. The country has approximately one third of the world's deposits of chromium and manganese and significant reserves of tungsten, lead, zinc, copper, bauxite and phosphorus, as well as reserves of coal and iron (Gleason 2003:48). In 1991, the GNP per capita was almost 100 percent higher than some of the other newly independent Central Asian states (World Bank, World Development Report, 1993:239).

3.2 The reform programme

The Kazakh reform programme is illustrated below as divided into systemic reforms, stabilisation policy, and trade and exchange rate policy. This is followed by a discussion of the comprehensiveness, timing and sequencing of the reforms.

Table 3.2 Summary of the Kazakh reform programme

Policy Area	Introduction	Implementation
Systemic Reforms		
Liberalisation of internal trade	1992	Internal trade restriction removed
Price liberalisation	1992	Followed Russia's radical reforms, more than 80% of the prices were decontrolled.
Privatisation of SOEs	1991	First Privatisation Act passed in 1991, the privatisation seriously started in 1992-1993, second wave in 1995-1996, slowed since 1997.
Foreign investments	1991	"One-stop" State Investment Committee was introduced in 1996.
Labour Market	1992	Introduction of wage flexibility and tax-based wage policy.
Financial liberalisation	1991	Restrictions on private and independent banking and financial institutions eliminated.
Legal reforms	1991-1992	Property and commercial law
Constitutional reform	1991-1992	Independence and new constitution
Stabilisation Policy		
Fiscal Policy		
- Tax reform	1992-1995	1992: Taxes for enterprises, personal income and VAT replaced old system. 1995: New tax code based on international standards enacted.
- Public expenditure control	1992-1994	Fiscal deficit diminished significantly
Monetary policy		
- Money supply	1994	Control from 1995
- Credit to the public sector	1993-1994	Control, hard budget constraints for SOEs,
- Central bank independence	1993-1995	Independence and increased autonomy
Trade and exchange rate policy		
Liberalisation of foreign trade	1992-1996	State monopoly abolished, simplified regulation, unified exchange rate
Import tariff	1991-1992	Initially removed, later reintroduced at a low level
Export taxes	1992	Reduced but later augmented
Currency	1993	National currency introduced

3.2.1 Systemic reforms

Price liberalisation

In January 1992 Kazakhstan liberalised internal prices. This reform had just been carried out in Russia. Indeed, already in 1991 some administrated prices were increased in the USSR, before the independence in December. The reform involved liberalisation of about 80 percent of wholesale prices and 85 percent of retail prices. The remaining controlled prices were increased several times. In some cases consumer price increased by as much as 350 percent.

Price liberalisation of heavily subsidised basic food, such as milk, bread and meat, was a sensitive issue because of possible foreseeable unrest among the population. Bread was among the products that still were regulated in 1993, probably for this reason. Other sectors where retail prices were not yet decontrolled included transport, communication and energy.

However, price differences occurred between state and private trade as well as between official and informal trade (Åslund 2002:166). Non-tradable goods needed a longer time to adjust their prices than tradable goods.

Privatisation

Following the reforms of Russia, Kazakhstan started the privatization process at an early stage. Already in January 1991 the Kazakh State Property Committee was founded with the mission to privatise state enterprises (estimated to about 37,000 (Pomfret 1995:90)), as well as to encourage the creation of new private firms.

In 1992 a coupon scheme was launched to privatise housing, and for most households the coupons were enough to purchase the house or apartment where they lived. Many small-scale service business, such as laundries, small restaurants etc., were sold by auctions, often to the operators at the time since they were offered lower prices than other prospective buyers.

Initially the privatisation was slow and mainly concerned small companies. The privatisation process accelerated in 1993 as the government introduced a program to facilitate the reforms. Vouchers became the dominant form of privatisation. In

Kazakhstan vouchers were provided to every Kazakh resident[3] from July 1993. Small companies (less than 200 employees) were sold at open auctions or by housing vouchers where the employed enjoyed a reduction in price. Larger companies (up to 5000 employees) were converted into joint stock companies that mainly were bid to Investment Privatisation Funds (Gleason 2003:47). Shares in IPFs could be bought by vouchers. The second wave of reforms started in 1995 as a new, extended privatization law was adopted. Within two years the private sector rose from 25 percent to 55 percent of GDP (EBRD 2001), and included virtually all sectors of the economy. After 1997 the privatisation process slowed down.

The main decentralisation came after the mass privatisation of larger SOEs in 1995. The decentralisation of the economy is important in promoting efficient allocation of resources. Furthermore, the decentralisation of the economic management system was pursued in order to encourage establishment of new firms.

Natural resources and land continued to be owned by the state although they could be rented out for up to 99 years. Later, in 2000, a law on land ownership was passed, recognising permanent and completely private ownership and use of land. This also implied that foreign companies and citizens may own (land designated for farming and dacha[4] construction excluded) and rent all kinds of land (Pomfret 2006:43).

Labour market reforms

In the early reform process the government tried to keep unemployment low, and used subsidised credits meanwhile in order to make the transition smooth for the labour force. More flexibility in wages was allowed from 1992 through the *Law on Collective Bargaining Agreements*, providing free bargaining between employer and employee. This implied that the minimum wage, that previously affected most of the salaries, lost it significance and impact.

In 1992 the minimum wage was almost tripled to 900 roubles, which due to hyper inflation in reality meant a decrease in purchasing power by more than 90 percent.

[3] Urban residents received 100 vouchers while rural residents received 120, which favoured the ethnic Kazakh part of the population since they were disproportionally rural (Pomfret 1995:90).
[4] Russian/Soviet traditional country house or cottage.

However, the average wage increased from 452 to 13,359 roubles, meaning an average increase in purchasing power by 10 percent. The minimum wage was then just relevant for pensions, civil servants' salaries etc. (Pomfret 1995:93). Hence, the differences in wages, that used to be modest, grew significantly.

In 1996 the *Law of Labour Disputes and Strikes* was adopted, allowing strikes in order to achieve wage increases etc. The unions are however weak in Kazakhstan and they were further weakened by the 1999 *Law on Labour*. This law replaced collective agreements previously negotiated by unions with individual contracts negotiated between employers and employees. The reforms liberalised the labour market and the wages were to be determined by market forces.

The Kazakh government had already established regional and local labour market employment offices all over the country in 1991 (Verme 1998:25). In general this was a reformation of the Soviet placement offices. A wide range of labour market policy measures were adopted. Job creation schemes and programmes to facilitate mobility of labour were launched. Poor areas such as rural regions and ecological disaster zones got special attention.

Financial sector reform

As early as during Perestroika the centralised banking system was slowly changed, and smaller, specialised banks could take over some functions, although still being dependent on the USSR State Bank. In 1991, no really independent banking and financial institutions existed in Kazakhstan.

The Kazakh State Bank was renamed National Bank of Kazakhstan after independence and restrictions on private independent banking and financial institutions were lifted. New commercial banks were created, both private and state-owned (often as part of a SOE), and within a few years there were hundreds of them. Often the customers consisted of one single enterprise. Also foreign banks were establishing on the Kazakh financial market, e.g. Citibank, HSBC and UniCredit.

The early reforms of commercial banking had huge problems with lack of confidence in the new system. This was partly a result of the hyperinflation that made economic predictions difficult. As inflation stabilised in the early 2000s, the commercial banks faced a more stable market environment.

3.2.2 Stabilisation policy

The independent state of Kazakhstan started with a significant budget deficit. In 1991 the budget deficit was 8 percent of GDP (EBRD Transition Report 2007:29). This, together with modest state revenues, called for cuts in public expenditure, a politically sensitive measure. An abolishment of consumer price subsidies was effected as part of the price reform. The military expenditure was reduced compared to the USSR time despite the fact that an independent national army was built up.

Taxes used to be paid by a small number of state enterprises and collected through the state bank system. Kazakhstan had established an own system with a new tax agency, which was rather complicated. Different agencies competed with each other and there was initially no monopoly on taxation (EBRD 1999:120). In 1992 the old tax system was replaced by a new tax system based on VAT, an enterprise profits tax and a personal income tax. The initial rate of the VAT was 28 percent, but within a year it was decreased to 20 percent. In 1995 a new tax code was enacted, based on international standards. Stressing equity, simplicity and economic neutrality, it included taxation on central, province and local levels. The new taxes were 30 percent for corporations and a progressive one between 5 and 40 percent for personal income. The pension system was completely reorganised with the outcome that citizens could choose whether to invest in private or state funds (Olcott 2005:31).

During the command economy of the Soviet Union the prices were extremely distorted. Therefore, price liberalization had severe effects and resulted in hyperinflation. In order to fight inflation after the national currency was introduced, the National Bank of Kazakhstan launched a stabilisation programme in 1994 with tight monetary policy (de Broeck & Kostial 1998:31). Monetary aggregate targets as well as fiscal adjustments were the basis of the programme, that turned out not to be very successful. From 1995 onwards the National Bank of Kazakhstan began pursuing specific policies targeting low inflation and a stable exchange rate. These objectives were identified to be important to promote sustainable growth.

3.2.3 Trade and exchange rate policy

At independence a significant amount of domestic trade became foreign trade with Russia, a country that Kazakhstan's economy was, and still is, tightly integrated with. The *Commonwealth of Independent States* (CIS) was established as the Soviet Union collapsed in December 1991. The main feature of this loose organisation was the common currency, the ruble.

Payments for inter-Soviet republics' trade were settled through the balances of the national banks of the republics and the *Gosbank* – the central bank of the Soviet Union. The central bank of Kazakhstan and other FSU republics banks retained the right to issue non-cash credits in rubles. The implication was that the states could diminish their fiscal deficit by issuing ruble credits while mainly other states within the ruble zone had to take the inflation effect of this manoeuvre.

It turned out to be impossible to coordinate the new central banks and maintain monetary discipline. The countries left the ruble zone one by one and the Russian central bank started to change the banknotes in Russian territory. In November 1993 Kazakhstan introduced the tenge as the ruble zone collapsed. Thereby Kazakhstan could pursue an independent monetary and exchange rate policy. Hyperinflation however continued, and the tenge had to float freely. The central bank began to target a stable exchange rate as well as low inflation.

Initially the newly independent government tried to preserve the production and trade patterns inherited from the Soviet time. Bilateral trade agreements with CIS states were settled (de Broeck and Kostial 1998:17). The system however had problems, e.g. it was financed by credits linked to Russia's central bank due to the ruble zone, and a new system was negotiated in 1993. This also fell however as Kazakhstan left the ruble area.

Kazakhstan initially kept the common import tariff of USSR on trade with non-FSU states. Import was subject to more deregulation than export. Along with Russia, Kazakhstan initially abolished import tariffs, but later introduced them at a low rate (10 percent) after recommendations from the IMF, mainly as a means to increase state revenue (interview, senior official, World Bank).

In January 1995 a *Partnership and Cooperation Agreement* was reached with the EU and hence enhanced the trade partnership outside FSU. The vast natural resources and untapped agricultural potential were a promising point of departure for export promotion policies.

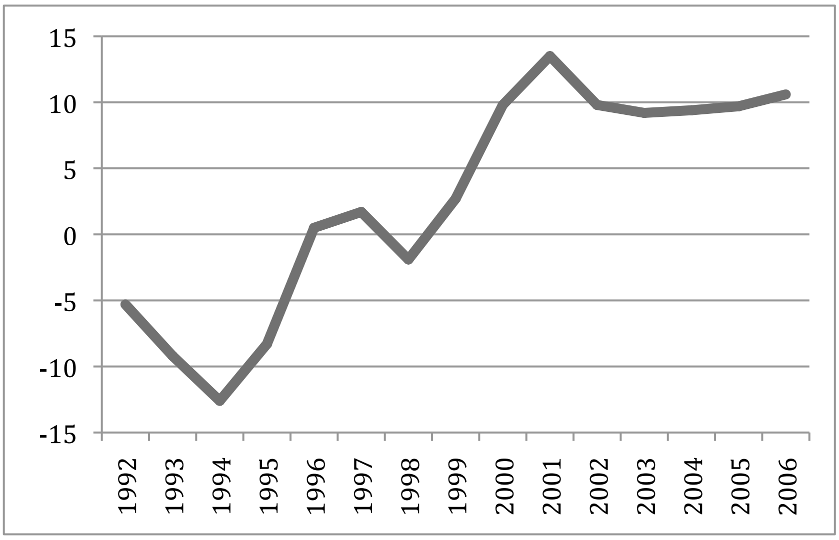
4 Evaluation of the reform programme

The evaluation of a transition programme towards a market economy can focus on different aspects. Most often evaluations focus on macroeconomic issues, in particular growth, private sector development and fiscal trade balances. This chapter scrutinises these aspects in order to understand to what extent the economic performance of Kazakhstan can be traced back to the reform programme.

4.1 Growth and private sector development

Independence was followed by a severe recession. Kazakhstan experienced a decline in output, GDP, real wages and investments. In 1995, real GDP was only 59 percent of the level of 1990 and 45 percent of the level of 1989 (IMF 1999:10; EBRD 1997:9). Real GDP growth was negative and worsened dramatically to a grave recession (figure 4.1). From 1988 to 1993 Kazakhstan's real per capita GDP decreased 26 percent, and the real per capita income fell 57 percent (de Broeck & Kostial 1998:6). The decline concerned all sectors but was particularly important in construction as well as in transport and communication.

Fig. 4.1 Real GDP growth (%) 1992-2006



Source: IMF 2000

Why a decline in output?

Why did Kazakhstan, just like other countries in transition, experience such a steep decline in output? This was an unexpected implication of the transition programme. To some extent it can be explained by the fall in productivity as a result of decline of inputs of capital and labour (de Broeck & Kostial 1998:17). There were also other causes behind this decline that can be traced back to the command economy. It is often argued that the statistics of the Soviet Union were not accurate, which would imply that the statistical decline in output partly was a statistical artifact. An important element is the chaos that followed the disintegration of the Soviet Union and its economic mechanisms. It was a time of disorganisation and confusion.

In the late 1980s, Kazakhstan was heavily dependent on inter-USSR-state trade since a high degree of specialisation in agriculture and raw material production had been a result of the central planning. If these specialisations were the result of a comparative advantage in these sectors, this would not directly create a decline in output at independence. However, the traditional channels of trade were disrupted, including the trade organisation COMECON. Intra-Soviet trade became foreign trade and several obstacles resulted in decline in the deliveries of material necessary for the production, as well as other products. This had negative effects on the output.

As the centralised financing of firms by the official banking system was torn down, the credits did not mirror the planned economy (de Broeck & Kostial 1998:31). This is also a reason for the recession since a credit contraction occurred with liquidity shortages and output decline as results.

The tightened credit policy that SOEs encountered had severe impact on the total output since SOEs completely dominated the economy. A cut in input was in many cases the only way for the companies to reach budget balance. Industry accounted for 28 percent of GDP at independence and experienced a sharp decline in output. Also the agricultural sector, accounting for 29 percent of GDP in 1991, experienced a steep turn down but not to the same extent.

Another factor is the institutional disruption. Institutions and the entire bureaucracy met a new situation with a set of uncertain rules they were not familiar with. An economic system based on a market was something completely new and required a new way of thinking. The managers of companies and banks also lacked experience and education in market economic principles and business.

The J-curve outcome

Kazakhstan's reform programme was rapid and comprehensive, but the economic situation continued to worsen until 1995 and it took another few years before the economy recovered and improved from the initial level of 1990. Depending on the time perspective this can either support or reject the J-curve thesis. The "J" was very deep and long lasting. The output curve rather seemed like a "U" before the economic boom of the 2000s took off. This implies that rapid reforms are not always guarantees for a rapid growth.

Economic boom in 21st century

After the economic turning point in 1995 Kazakhstan experienced another shock in 1998 as a result of the Russian financial crisis. The crises can be seen as exogenous, but the grave effects on the Kazakh economy unmasked the vulnerability of the economy. Once again, Kazakhstan followed measures taken by Russia, including a major devaluation of the currency to stimulate the economy (interview Z. Baikenova).

As oil prices increased and the economy stabilised, the growth became rather strong in the late nineties, and therefore the negative implications of the Russian financial crisis did not persist as long as in other FSU countries. Major reforms of the mid-nineties, including freely convertible currency and launching of a stock exchange and development of a modern bank sector, started to give positive results. From 2000 onwards the growth was impressively strong with annual growth often reaching two-digit numbers. This made Kazakhstan one of the fastest growing countries in the world.

The rapid economic growth in the 21st century was to a high extent based on the revenues from natural resources. Shortly after independence immense fields of gas and oil were discovered in Kazakhstan. Interest was huge among foreign oil companies and some talked about a new great game where Russia and Western powers tried to take part of the abundance of energy resources.[5] Kazakhstan became an exception to the strong anti-interest from the international community towards Central Asia and billions of dollars were coming in as Foreign Direct Investment (Olcott 2005:22). The sectors of oil and gas attracted FDI inflow of $35 billion during the period 1993-2006 (UNCTAD 2007:102) and 2005 UNCTAD ranked Kazakhstan number 14 in the world in their *Inward FDI Performance Index* (UNCTAD 2007:220). In 2008 the FDI inflow was $14.5 billion. The FDI stock grew from $10 billion in 2000 to $58 billion in 2008 (UNCTAD 2009:250), thereby contributing 44 percent of the GDP. The impressive inflow (among CIS countries only outpaced by Azerbaijan in terms of FDI inflow per capita) can mostly be explained by lucrative energy resources and contributed between 36 and 54 percent of the annual total investments in the country between 1997 and 2004 (UNCTAD 2007:250).

The economy became oriented around export on oil and gas, which had strongly positive effects on the growth (see table 4.1). The huge FDI inflow has certainly played a crucial catalytic role in the economic growth and transition process. However, it should be mentioned that FDI outside the energy sector has been limited. In banking,

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[5] The Great Game was coined by Arthur Conolly – an intelligence officer of the British East India Company – and refers to the struggle for influence in Central Asia between Russia and United Kingdom. During this time vast areas in the region became part of the Tsarist empire.

construction and communication FDI has slowly developed, but still at an unsatisfying level in order to promote a diversified economy. Furthermore, it is likely that these would be much higher were it not for impetuous behaviour when the political leaders hastily negotiated with foreign investors in the wake of independence (interview senior official, World Bank). Nevertheless, this development would not have been possible without the comprehensive reform programme pursued in the early 1990s. The effect of the reforms were initially not the expected ones, but far more negative. However, with time growth was surprisingly fast.

Table 4.1 Oil production and export 1998-2002

	1998	**2000**	**2002**
Oil production (millions of tonnes)	25.6	35.4	47.3
Oil exports (millions of tonnes)	20.4	29.4	39.3
Oil exports (million USD)	1650	4429	5157
World oil price (USD/barrel)	13.1	28.2	24.9

Source: Pomfret 2006:42.

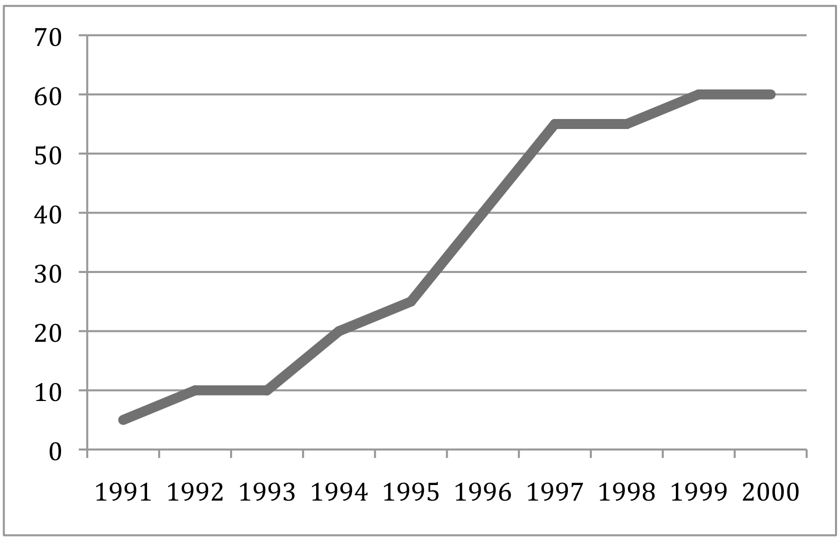
Private sector development

The second part of the privatisation in 1995-1996 included a range of large enterprises. Vouchers were used and the system was chaotic. It is comparable to the privatisation in Russia. The oil and energy sector was to a high extent privatised at an early stage. Several of the largest and most valuable enterprises were sold to foreign investors. Managers and employees of SOEs were given a reduction when the enterprises were sold at voucher auctions. In some cases, this might have led to an inefficient ownership of the company (Jones Luong & Weinthal 1999:3).

As figure 4.2 displays, the private sector accounted for more than half of the economy after the second wave of privatisation in 1995-97. Despite the chaotic circumstances that characterised the privatisation process, this should be considered a success. The non-tradable sector had increased rapidly with small restaurants, tea houses etc. Even though their contribution to the GDP might be modest, it was an important step in the transition process as well as pushing for a consumer surplus (interview civil servant, UNESCO). Especially the privatisation of the financial sector has been very smooth, involving a large number of banks created as a result of the reforms.

The privatisation process slowed down after 1997. This was expected since a majority of the economy already had been privatised. There were also other reasons. As the revenues from oil and gas export grew, the state faced less budgetary pressure to denationalise the SOEs. In addition, the government was reluctant to force insolvent SOEs into bankruptcy (EIU 2001:160). This was especially the case with companies that were a major employer of a town or region in order to avoid mass-unemployment and social unrest. The government identified a number of strategic sectors requiring particular government involvement and support, including transport and exploitation of natural resources. The state even renationalised a number of companies of significant size in 2001 (EIU 2001:110), which probably can be seen as an attempt to diversify the economy and support sectors with difficulties. Furthermore, Kazakhstan has weak bankruptcy laws allowing firms to keep operating despite financial difficulties by delaying payments. Nevertheless, from 1999, the private sector stabilised to account for about 60 percent of the economy, which is a success of the reform programme.

Fig. 4.2 Private sector development (% of GDP) 1991-2000



Source: ADB 2001

The lift of regulations in the banking and financial sector resulted in banks and financial institutions mushrooming in Kazakhstan. At independence there were no independent financial institutions at all, and within a few years hundreds of them emerged (Gleason 2003:50), spurred by the privatisation process, currency operations and development of small enterprises. In 1997 the trend turned, and the number of banks diminished from the highest number of 129 due to bankruptcy, merger and acquisition by larger banks (Gleason 2003:51).

The development of the financial sector won high marks from abroad and from international institutions for the successful adaptation of international standards. Despite this, the financial services offered by these banks did not attract the citizens and many of the small enterprises. Cash continued to be the prominent means of transaction for the ordinary citizen (interview senior official, World Bank).

A continuous increase of the private sector share of GDP from 5 percent in 1991 to 60 percent less than 10 years later is indeed a rapid shift from a state controlled economy to a market economy based on private ownership. The privatisation has gone through different phases where the second wave, between 1995 and 1997, was the most expansive. In the end of the 1990s, private property incentives for management were achieved and the private sector grew larger than the public sector. The remaining SOEs were operating in competition with private firms, domestic as well as international, and were subject to market forces, which has prevented a major misallocation of resources. Hence, the goals of privatisation have been reached.

4.2 Internal and external balance

Inflation and fiscal deficit

Price liberalisation in combination with shortages of many commodities pushed prices up. The inflation skyrocketed in 1992 and not until 1996 did it fall below 30 percent (table 4.2, figure 4.3). The initial extreme values of the inflation have to be seen in the light of liberalising prices that used to be subject to government control. Until 1993

Kazakhstan was still part of the ruble zone and had thereby no possibility of pursuing an independent monetary policy. During this time the Russian central bank and the state banks of the former Soviet republics had confusing agreements and there was a lack of control of the money supply. The period was characterised by chaos and bad organisation.

The independent currency introduced in November 1993 gave Kazakhstan the chance to pursue an independent monetary policy in order to fight hyperinflation. Contrary to what was expected, inflation actually further accelerated after Kazakhstan left the ruble zone. Despite the stabilisation program adopted by the National Bank of Kazakhstan, inflation did not decrease. This can probably be explained by a wide range of causes e.g. lack of stability and credibility.

Table 4.2 Inflation (%), 1991-2006

Year	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Inflation (%)	136.8	2984.5	2169.4	1158.2	60.4	28.6	11.3	1.9
Year	**1999**	**2000**	**2001**	**2002**	**2003**	**3004**	**2005**	**2006**
Inflation (%)	18.1	9.8	8.4	5.9	6.4	6.9	7.6	8.6

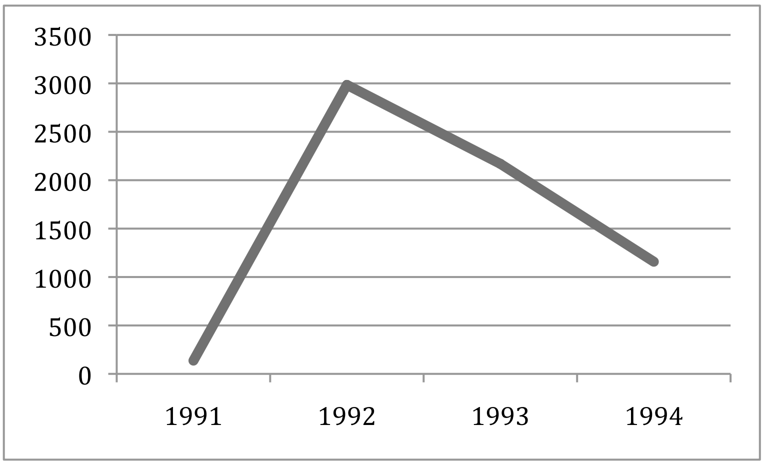
Source: ADB 2001, ERDB 2007

Macroeconomic stabilisation was difficult to reach. It requires strong political will to pursue maybe unpopular reforms in order to avoid or at least reduce the fiscal deficit. In the newly independent Kazakhstan this was not a political priority. The National Bank of Kazakhstan took serious measures to halt inflation and stabilise the exchange rate of the tenge in 1994-1995, including a tight monetary policy. Restrictions on the financing of the state's budget deficit were introduced and gradually had effects. Annual targets of inflation generated confidence in the monetary policy.

The close relation between fiscal deficit and inflation can be seen by comparing figure 4.3 and figure 4.5. As Kazakhstan reduced expenditure and approached fiscal balance, inflation decreased dramatically. Hence, by tightening up the monetary policy (and by pursuing this policy independently) and taking control over expenditure, inflation could be pushed down below 20 percent (figure 4.4). The high interest rate has helped in absorbing excess liquidity and hence not pushed inflation.

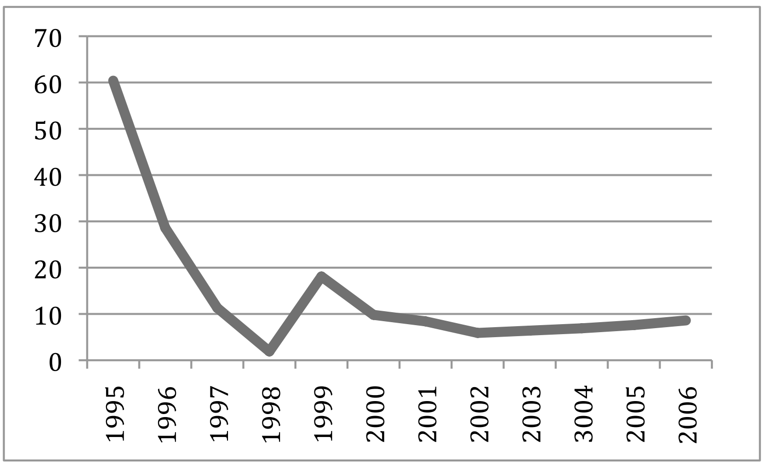
Nevertheless, in 1997 inflation was 11.3 percent, followed by 1.9 percent in 1998 and 9.8 percent in 2000, meaning that inflation was neither stable nor low. This pattern was not atypical among the transition countries of the former Soviet bloc. Since 2001, as illustrated in figure 4.4, inflation has been more stable, ranging between 5.9 percent in 2002 and 8.6 percent in 2006.

Fig. 4.3 Inflation (%), 1991-1995



Source: ADB 2001

Fig. 4.4 Inflation (%), 1995-2006



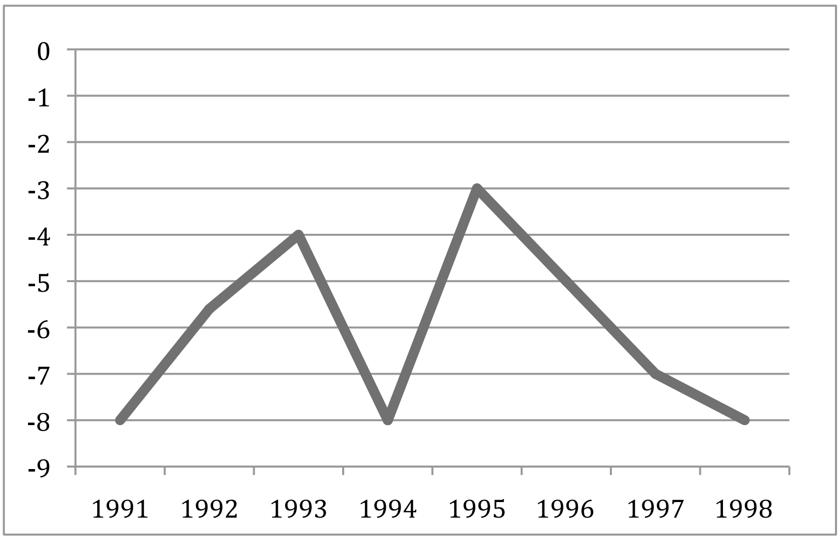
Source: ADB 2001, ERDB 2007

The tax reforms of 1992 and 1995 were smoothly implemented and had positive economic effects. The system became simple and provided for sound development of the private sector. As mentioned above, the reform of the financial sector is a relatively successful one, characterised by pluralism and competition.

The fiscal deficit accelerated inflation. The ruble zone can partly be held responsible for this. There would probably have been some difference if Kazakhstan directly at independence had left the ruble zone and introduced its own currency. At independence the fiscal deficit was 8 percent of GDP, and a fairly tight fiscal policy reduced the deficit to 5.6 percent of GDP in 1992. During the following years the fiscal deficit moved up and down in the range between 3 percent and 5 percent of GDP (figure 4.5).

The J-curve hypothesis can also be applied to the macroeconomic development. In the initial stage of transition fiscal balance is hard to reach since the new tax code does not cover the loss of state income that the SOEs used to generate. Meanwhile, comprehensive and rapid cuts in budget are difficult to reach. However, with time the systemic reforms boost the growth, implying an increase in tax revenues and macroeconomic stabilisation. In Kazakhstan, the record of the fiscal balance does not really confirm the theory. The inflation has been curbed with time, thanks to an improved fiscal situation and a relatively successful monetary control. The inflation curve can thus almost be compared with an inverse J-curve, which can be regarded as an accomplishment taking consideration the sky-rocket inflation following the price liberalisation.

Fig. 4.5 Fiscal balance (% of GDP), 1991-1998



Source: IMF 1999:19, World Bank 2005:60

Trade balance and current account balance

Kazakhstan inherited a state-controlled foreign trade system where price signals were playing a minor role in the allocation of resources. Bureaucrats set complex exchange rates and there were few possibilities and incentives for individual firms to engage in foreign trade. Since independence Kazakhstan has experienced rapid and comprehensive trade liberalisation including tariff reforms and elimination of monopoly on trade. The country has engaged in world trade and foreign trade has grown dramatically (table 4.3).

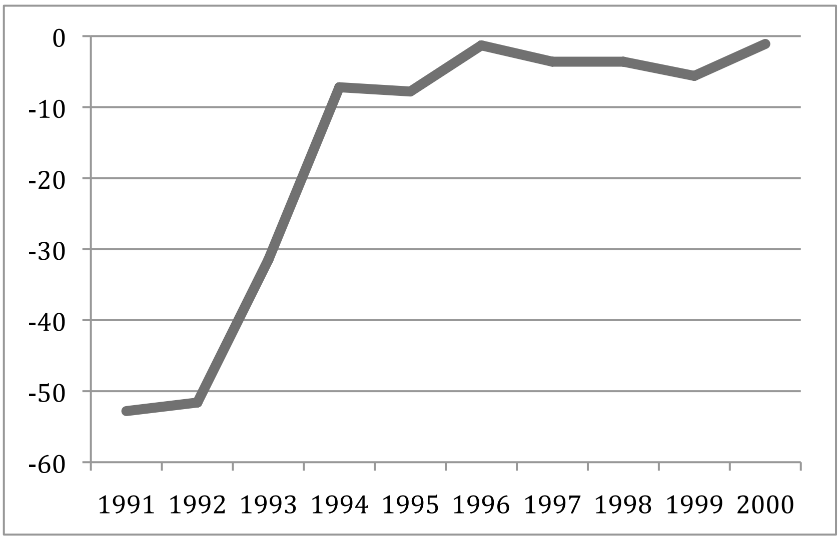
Table 4.3 External trade (million USD), 1991-2000

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Exports	928.0	1451.0	1486.0	3542.5	5912.7	6720.4	6497.0	5435.8	5592.2	9139.5
Imports	584.0	566.0	472.0	5284.7	6891.1	7123.7	4300.8	4349.6	3686.5	5052.1
Trade balance	344.0	885.0	1014.0	-1742.2	-978.4	-403.3	2196.2	1086.2	1905.7	4087.4

Source: ADB 2001

Kazakhstan has succeeded in geographically diversifying its export markets that at independence mostly consisted of FSU states. Russia has remained the most important trade partner (exports as well as imports), followed by China, the EU, Turkey, Ukraine and the US (ADB 2001). Kazakhstan suffered from a sizable current account deficit at independence. This has been controlled to less than 10 percent of GDP since 1994, approaching zero in 2000 (figure 4.6). This is a comparably good record in Central Asia. Export is concentrated to primary products in the oil, gas, minerals and mining sectors accounting for about 80 percent of total exports. This has been the key to export growth and foreign investments.

Fig. 4.6 Current Account Balance (% of GDP) 1991-2000



Source: ADB 2001

Already in 1991 the government started to negotiate on the development of the Tengiz oil fields which resulted in a joint venture between the government and the American energy company Chevron. This was the first of a series of huge investments from western and Russian companies in the field of natural resources. The high reliance on export to Russia resulted in direct impact of the Russian financial crisis in 1998. The terms of trade have however improved and Kazakhstan has developed towards an open export-oriented economy thanks to the exploitation of the vast natural resources.

The trade balance following the liberalisation of foreign trade does not follow a J-curve. Total exports were growing faster than total imports until 1994 when imports sky-rocketed, implying a negative trade balance (table 4.3). From 1997 onwards the balance has been positive while total trade has been constantly growing. This is closely linked to the currency rate and the devaluation of 1999.

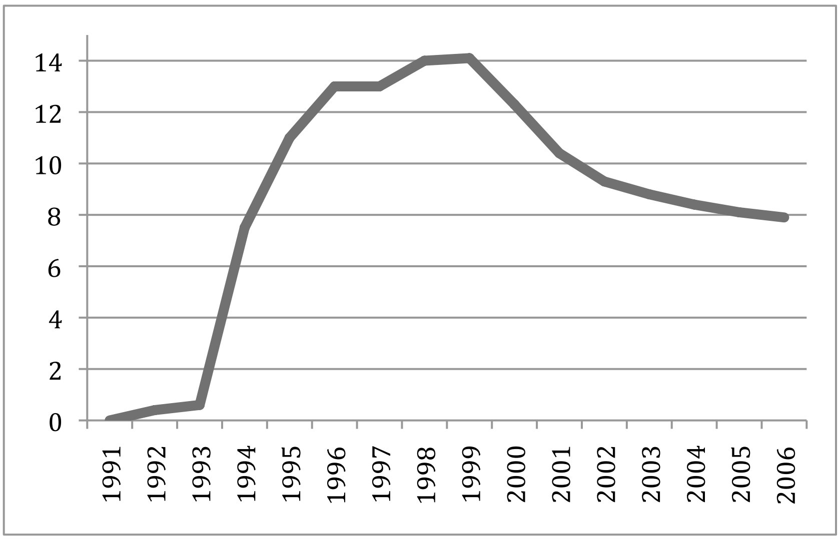
4.3 Social outcome

Unemployment

Despite initial attempts to keep it down, unemployment rose rapidly at the early stage of the transition. From officially being nonexistent during Soviet time, unemployment increased to more than 10 percent in 1995 (see figure 4.7). Meanwhile, just a limited part of those meeting the strict Kazakh criteria of unemployment received some kind of unemployment benefit (Verme 1998:23). The decline of employment was twice as fast in large and medium-sized enterprises compared to the total decline (Verme 1998:19). This can be explained by the rapid growth in self-employment and small-scale entrepreneurship.

Unemployment reached 14 percent in 1999 and then decreased as the economic boom started. An unemployment level of about 8 percent is not strikingly high, especially not since many of the ‘unemployed’ actually are working in the informal sector. However, the economic situation for those who are unemployed is difficult due to lack of a proper security net (interview civil servant, UNESCO).

Fig. 4.7 Unemployment (% of labour) 1991-2006



Source: ADB 2001

Poverty and equity

The economic recession combined with hyperinflation had severe social consequences for the Kazakh population. The birth rate declined from 23/1000 in 1989 to 17/1000 in 1995 while the death rate grew from 7.6/1000 to 10.1/1000, implying a decrease of the natural population growth rate from 15.4/1000 to 6.5/1000 (UNDP, 1996). Meanwhile, Kazakhstan experienced a net out migration of 1.5 million people. Life expectancy at birth decreased from 73.2 years in 1989 to 70.8 years in 1995 for women and from 63.9 to 60.1 for men. Between 1987 and 1994 suicide rates rose by some 40 percent (UNDP 1997).

For 'ordinary people' the first half of the 1990s were characterised by poverty and a scarcity of basic food products. Salaries did not augment with inflation, and hence implied a fall in real income. Furthermore, savings were more or less erased by the inflation. The unemployment rose significantly, but an even more widespread problem was that the salaries were not paid, or delayed for several months (interview Z. Baikenova).

Income inequality increased in the transition phase and was a growing social problem. The Gini-coefficient (the most used measure of inequality) increased from 0.26 in the late 1980s to 0.33 in 1996 and poverty spread significantly (Pomfret

2003:454). There are strong regional equities, low integration between the north and the south, as well as between urban and rural areas. Expenditure on education dropped during the 1990s and accounted for about 3 percent of GDP during the second half of the decade (IMF). Corruption and criminality grew, and so did social problems such as alcoholism and drug addiction. The financial centres of Astana and Almaty have experienced a rapid growth since the late 1990s which is visible through modern buildings and cars while some areas of the vast country still are very poor. Despite this, the strong economic growth since 2000 has somehow improved overall social conditions in Kazakhstan.

4.4 Summary and discussion

The Kazakh reform programme was a relatively radical and rapid one. Starting at independence in 1991, the comprehensive reforms included price liberalisation, privatisation, labour market reforms, financial sector reform, tax system reform etc. The state monopoly on trade was abolished; import tariffs were reduced; and export towards new markets was promoted. The new independent currency, the tenge, was introduced as Kazakhstan left the ruble area and an independent monetary policy was thereby possible.

In the wake of the breakdown of the Soviet Union, Kazakhstan experienced a steep decline in output, GDP, real wages and investments. This unexpected decline in output can be explained by several factors. Political and institutional disruption, deflation of consumer demand, and maybe a too radical price liberalisation and currency convertibility are some important aspects. Probably it would have been better to leave the ruble zone directly at independence. This might have made it possible to decrease inflation at an earlier stage through an independent monetary policy.

1995 was an economic turning point and the economy slowly started to stabilise after a few years characterised by negative turbulence. Kazakhstan experienced another negative economic shock in 1998 as a result of a reduction of world oil prices and the financial crisis in Russia. The economy however recovered and output grew.

The positive results of the comprehensive measures taken in the mid-1990s could finally be seen. Driven by high world prices on oil and gas, growth reached annual two-digit numbers from 2000 onwards and FDI inflow grew significantly. It is difficult to say to what extent a successful reform programme can explain this growth and to what extent the discovery of immense fields of oil and gas is the predominant element.

Kazakhstan started the process of privatising SOEs immediately after independence. Initially it mainly concerned small companies, but further reforms accelerated the privatisation process in 1993, and a second wave occurred after another law extension in 1995. In 2000 the private share of GDP stabilised around 60 percent of GDP, and the privatisation process has been a success.

Price liberalisation resulted in inflation accelerating for several years. Huge fiscal deficits and the lack of control of the monetary policy made it difficult to control inflation. However, after taking serious measures, inflation halted and the exchange rate was stabilised in 1994-1995.

The facts that SOEs dominated the Soviet economy and that the sectoral misallocation was huge worsened the initial output decline. Even though not initially credible, it is now visible that the liberalisation had a J-curve effect on the economic output in Kazakhstan, as well as almost an inverted J-curve effect on inflation. This implies that the transition in Kazakhstan is one of few countries in the region strengthening the thesis that initial recession is a natural result of liberalisation before growth and stabilisation can be expected.

The initial economic recession and hyperinflation had negative consequences on the population, including poverty, high unemployment and health problems. Income inequality grew significantly and differences between the financial centres of Astana and Almaty increased. The strong growth of the 2000s has however improved overall social conditions in Kazakhstan.

5 Summary and policy implications

Kazakhstan pursued a radical economic transition programme in the wake of independence. The macro-economic reforms in Kazakhstan have been relatively successful, helped by vast reserves of natural resources. The price reform initiated in 1992 was radical and comprehensive and liberalised prices by removing price controls and reducing subsidies. Although followed by hyperinflation it at least sent the right signals of prices.

Did the economy react to the reforms as expected? Certainly hyperinflation and steep decline in output were not the intended and desired effects of the reforms. The economic recession in the 1990s can partly be explained by the reforms being rapid and comprehensive. There is consensus on the fact that at least some of this could have been avoided, but the policies suggested differ between those advocating shock-therapy and those suggesting a more gradual approach. The former would say that the inconsistency of the policies followed is to blame, including the failure of governments and central banks to fight inflation during the first important years, i.e. the first half of the 1990s. Gradual transition advocates rather blame the shock therapy packages for being too radical.

Were the reforms too radical and rapid? Many extreme neoconservative scientists and think-tanks wanted this unusual situation of an enormous economic shift to be used for a politic-economical experiment, and advised the countries not to follow the capitalistic path of Europe and the US, but a new one, where the functions and responsibilities of the state are minimised (Nove 1995:229). However, it all boils down to a theoretical idealisation of equilibrium far from reality. The theories were to a high degree based on perfect markets, perfect information, a large number of producers, and strong institutions to emerge immediately. This was certainly not the case in Kazakhstan in the early 1990s, and hence, the laissez-faire spirit did not have the desired effects.

Kazakhstan followed the reforms of Russia in several senses. One major difference between the countries however is the result of the privatisation. Although more or less the same measures were used, the Kazakh privatisation did not result in what in the Russian case popularly has been called *oligarchs*, i.e. a handful of businessmen that took advantage of the privatisation process and became billionaires. The private share of the economy has risen to comprise a major part of the economy and the goal has been achieved.

A private economy has been promoted by legal reforms and a sound monetary and fiscal policy was established relatively early in comparison with other states. The tax system as well as banking and investment laws quickly followed international standards and promoted investment. The privatisation was relatively successful, although to some extent characterised by lack of transparency. Trade and foreign investment have been encouraged through elimination of trade monopoly, simplified regulations etc. and have been successful.

Despite official claims of continuation of the reform programme, several of the commitments in IMF-supported reform packages etc. were in the end never implemented (interview civil servant, UNESCO). The economic situation in the mid-1990s was difficult and the reform programme slowed down. This coincided with president Nazerbayev using more and more authoritarian methods.

Due to the financial crisis in Russia and decreased oil-prices, the economy of Kazakhstan again turned downward in 1998 with a 2 percent decline in GDP. By then, the outcome of the economic reforms could be seen with dissatisfaction. Given the promising point of departure, as well as the new findings of vast oil resources, the economic situation in Kazakhstan was not successful. However, the increases of world oil prices in 1999 combined with devaluation of the tenge pulled the economy out of recession, and since 2000 Kazakhstan has experienced an impressive growth.

Thanks to high prices of oil and gas on the oil market the growth has been impressive during the 21st century. To some extent other sectors have been neglected, which can be dangerous and potentially lead to a form of Dutch disease. The agriculture that used to be important has not been the subject of major investments which has resulted in inadequate infrastructure such as roads, processing equipment and farm inputs. The banks have not provided much-needed credits for farm expansion (Gleason 2003:64).

The oil boom of the 2000s gave Kazakhstan the possibility of continuing with reforms and finance programmes to ameliorate the social sector. Although the oil boom to some extent can be explained by radical reforms in the 1990s, a sound long-term economic development will not be reached if the economy relies too heavily on the natural resources and if FDI is limited to this sector.

The distribution of the huge incomes from the natural resources has been uneven. The wealth accumulation was mostly concentrated to a small number of individuals while a significant part of the population has not benefited from transition but rather become worse off. The economic dependence on natural resources is structured in a way that distribution of income and wealth is not likely to change in the future unless more radical reforms are pursued. The financial centres of Astana and Almaty will continue to benefit from the growth whereas the rural areas will continue to be left behind. Furthermore, the deep recession in Kazakhstan was accompanied by a sharp increase in mortality, migration and population crisis, and a steep rise in unemployment. This can possibly to some extent be explained by data “manipulation” during the Soviet regime (which would mean the social decline actually is exaggerated), but probably mainly by the socioeconomic change.

The economic transition is also a political one. Like in many other former Soviet republics, the independence in Kazakhstan did not mean that democracy was established. Nursultan Nazarbayev has led the country through independence and economic transition. Initially the regime was considered as rather liberal and pluralism began to rise. Nazarbayev tolerated press freedom and independent political organisations. After a few years, as the first chaotic period had passed and the newly discovered oil and gas fields started to generate money, the briefly flourishing pluralism died in the mid-nineties. Ever since, Nazarbayev, together with his family and couple of friends, has kept the political power, and to a lesser degree also the economical control, in Kazakhstan and he seems unwilling to give it up (McFaul 2004:79-80). Nowadays, the press and political climate, just like the elections, are far from free. In the general elections of 1995 the opposition was almost non-existing, and it was followed by changes in the constitution in 1998, which implied an extension of the presidential term to seven years. Nazarbayev was re-elected as president in 1999 after his main rival and former Prime Minister, Akezhan Kazhegeldin, was barred from running due to a criminal record for holding an unsanctioned meeting in order to launch a political party. Kazhegeldin had to flee to Europe.

An investigation of Swiss accounts showed huge amounts of money in the name of Nazarbayev and his companions, which became a huge scandal in the US as oil companies and consultants hired by the Kazakh government were involved. The corruption is solid, and many foreign businessmen complain about the problems of doing business in Kazakhstan (Olcott 2005:34-35). Corruption is a challenge that unfortunately does not seem to be developing in the right direction. It requires structural, institutional and legal reforms, something which is not in the interest of the leader of Kazakhstan.

Nonetheless, the economic reforms in Kazakhstan indicate considerable progress towards establishing a well working market economy. The country has achieved a sound macroeconomic environment. The rapid and comprehensive reform programme was followed by a steep decline in output, but the implementation of structural measures had positive economic effects after a few years. Some reforms call for more reforms, they are interdependent, and hence self-reinforcing and Kazakhstan's economic transition has been the smoothest among the Central Asian states. This can be explained by relatively good initial conditions, an ambitious transition programme with rapid and comprehensive reforms, and vast natural resources. It is however hazardous to point out which of these elements have been predominant. Although corruption and lack of democracy are unlikely to change in the immediate future, a strong economic growth may be maintained, with export of energy resources as the engine.

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