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Abstract

A voluminous theoretical and empirical literature exists on the relationship between financial sector development and economic growth. However, this literature has largely ignored progress in former Soviet Central Asian republics engaged in transition from socialist command economies to market economies. Accordingly, this paper fills the gap in the literature by discussing Kazakhstan's experience with financial sector liberalisation and the resultant socio-economic impact of these reforms. We summarize the pre-reform economic circumstances prevailing in Kazakhstan, outline the major characteristics of its post-communist financial system, and provide a detailed chronicle of financial sector reform measures over the period 1993 to 2002. The paper focuses on the evolution of the Kazakhstan's banking sector structure, policies adopted by the National Bank of Kazakhstan and the approach taken to the privatization of state banks, as well as the steps taken to improve bank accounting standards and banking supervision. Moreover, the development path of non-bank financial institutions and capital market is also examined. We consider the outcomes of financial sector reform and their impact on the economy as a whole.

Key Words: Economic growth; financial development; Kazakhstan; transition economies.

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INTRODUCTION

A substantial theoretical and empirical literature exists on the putative links between the degree of financial development and the rate of economic growth in national economies (see, for instance, Bagehot (1991 (1873)), Schumpeter (1936 (1911)), Bhatt, (1989), Merton and Bodie (1995), Levine (1997), Goldsmith (1969), McKinnon (1973), Jung (1986), King and Levine (1993a; 1993b), Neusser and Kugler (1998), Odedokun (1996), Ram (1999), Levine et al. (2000), Benhabib and Spiegel (2000), Lensink (2001) Calderon and Liu (2003), Dawson (2003), Gillman and Harris (2004) and Akimov, Wijeweera and Dollery (2006)). Most economists seem to support the argument that the development of the financial sector is an important prerequisite for economic growth.

Kazakhstan has recently emerged as a front-runner in terms of economic growth in the post-Soviet region. Many observers tend to attribute its impressive growth performance to the favourable prices of Kazakhstan's abundant mineral resources. While this proposition has obvious merit, it would be wrong to believe that it constitutes whole story. In contrast to some other resource-rich economies, like Russia, Kazakhstan undertook aggressive and carefully designed reforms in the financial sector as well as a general liberalisation of its economy. This has ensured more efficient use of mineral resources and better economic performance in recent years. Indeed, Kazakhstan is now the most prosperous country in post-Soviet Central Asia and an attractive destination for migrants from neighbouring countries.

The paper itself divided into five main parts. Section 2 discusses the pre-reform economic environment and outlines main characteristics of Kazakhstan's pre-reform financial sector. Section 3 considers financial reform policy measures taken over the period 1993-2002. The outcomes of the financial sector reforms are presented in section 4. Section 5 examines the socio-economic impact of these financial sector reforms. The paper ends with some brief concluding remarks in section 6.

PRE-REFORM ECONOMIC ENVIRONMENT AND FINANCIAL SECTOR

Kazakhstan generally shared in the stagnation of the Soviet economy since the late 1970s. In common with all Soviet republics at the end of the 1980s, Kazakhstan experienced a slowdown in growth, which turned negative in the early 1990s. Agriculture, industry (mining and energy), construction, transport and communication dominated the structure of the output in pre-reform Kazakhstan, accounting for 42 per cent, 21 per cent, 16 per cent and 10 per cent respectively in 1990 (Pomfret 1995).

Kazakhstan began its own reform program towards a market-oriented economy since Independence in 1991. In January 1992, most prices were liberalised. The newly founded Kazakh State Property Committee started work on a programme of privatisation (Pomfret 1995). However, reform measures remained largely unrelated until 1993, which a Kazakh government official termed a 'preparatory phase' (Jandosov 1998).

At Independence in 1991, the Kazakh financial system consisted of the National Bank of Kazakhstan (NBK) (formerly a branch of the Soviet Gosbank), five state-owned banks, and 72 commercial banks that had been licensed in 1988-1991. After Independence, the number of banks rapidly increased and by 1993 it was three times greater than in 1991. However, most of these banks were poorly capitalised and managed, and were created to serve the financial needs of their parent state-owned enterprises or joint ventures. This created the thorny problem of non-performing loans that became very marked by 1994 (International Monetary Fund 2000b).

One of the major problems facing the Kazakh banking sector since early independence lay in the large stock of non-performing loans. This affected both state-owned banks that inherited poor performing assets from Soviet era, and newly created private banks that had practiced imprudent loan policies. This has been the result of lax or absent regulations as well as the lack of appropriate risk assessment and management skills. Moreover, the accounting and financial disclosure standards inherited from the Soviet Union were of poor quality.

FINANCIAL SECTOR REFORMS IN 1993-2002

More intensive reforms across economy began in 1993 with the introduction of a national currency - the 'tenge'. The National Privatisation Programme for 1993-1995 launched the mass privatisation of medium-sized enterprises. That same year, the first large enterprise was privatised by means of successful tender and this process continued on a 'case-by-case' basis. At the end of 1994, new legislation on foreign direct investments was introduced permitting the repatriation of profits. Substantial trade liberalisation was achieved by the first half of 1995, following the abolition of all export quotas and the elimination of most export and import licences (European Bank for Reconstruction and Development 1995).

In 1993, the Kazakh authorities also initiated a comprehensive financial reform programme that included the adoption of an appropriate legal framework, actions to deal with non-performing loans and addressing the problems of inadequate prudential regulation and supervision.

Legislative reforms in the financial sector began with the introduction of the Banking Act in 1993. That same year, the Act on Securities Trading was passed by the Kazakh parliament. Furthermore, the President signed a Decree ‘On Insurance’. In 1994, the National Bank of Kazakhstan introduced the first prudential regulations. Moreover, in February 1995, the Kazakh President approved the NBK’s Programme for the Reform of the Banking Sector. The programme included: (i) adoption of regulations establishing independence of the NBK; (ii) adoption of BIS guidelines for prudential supervision; (iii) the introduction of on-site examinations; (iv) compulsory risk classification of assets and provisioning requirements; and (v) closure of non-viable banks.

To address the problem of non-performing loans, the government had limited options, since neither the NBK nor the government itself was able to recapitalise the entire banking sector. Accordingly, the NBK first began withdrawing licences from smaller non-viable banks. With respect to the larger state banks, the authorities shifted part of their non-performing loans to newly created asset-management companies and left the banks to resolve remaining problems themselves. In total, loans equalling 11 per cent of GDP were transferred from original banks to specialised institutions (Hoelscher 1998).

At the same time, the NBK was steadily improving the scope and quality of prudential regulations and supervision. During the period 1995-1996, substantial changes were introduced in regard to regulatory and accounting policies. Regulations were established on liquidity, lending limits, insider transactions, and reserve requirements. Moreover, requirements for loan classification and loan loss provisions were introduced.

However, the banks were unfortunately unable to keep pace with the rapidly tightened requirements and many of them would have to close if requested to comply with the regulations immediately. The NBK recognised that a prolonged period for the full implementation of the prudential standards was necessary and therefore allowed a five-year grace period to the non-compliant banks. However, banks had to prove that they had developed thorough plans in order to achieve the targets. Furthermore, the NBK offered incentives if the transition period to meet regulatory requirements was to be shortened from five to three years. Potential benefits included permission: (i) to own shares in investment companies; (ii) to participate in credit auctions; (iii) to issue debt instruments; (iv) to act as a custodian of corporate securities; and (v) to make international transactions (Hoelscher 1998).

The capability of the NBK to implement supervisory functions was strengthened. The number of staff members in the supervisory department of the NBK was increased and intensive training was offered. On-site inspection procedures were improved and off-site supervision was enhanced by an introduction of a standardised reporting form, which made financial statements more informative and easier to analyse.

In order to address the problem of poor accounting and financial disclosure standards, a new charter of accounts for commercial banks was drafted in 1995. An intensive programme of training and various manuals and guidelines were designed to assist accountants to adopt the new standards. Whereas the new charter of accounts was not completely compatible with the existing accounting practices, the Accounting Commission was established to develop and implement the new accounting standards in line with International Accounting Standards (IAS). In late 1997, all banks switched to the new chart of accounts.

In 1999, the NBK introduced a deposit insurance scheme, but it became compulsory only on January 1, 2004 for banks accepting household deposits (International Monetary Fund 2004c). Prior to this date, it was used as an incentive for banks to rapidly adopt new IAS-based policies. Only those banks that adopted the new standards could participate in the scheme.

Since Independence, the Kazakh banking system was and remained highly concentrated. In 1992, over 80 per cent of total assets of the system were initially held by the five largest state-owned banks. The entry of new banks somewhat reduced concentration but, in 1996 and 1997, five of the largest banks still controlled about 60 per cent of the banking sector assets. The NBK believed that the failure of any of these largest banks might shake confidence in the banking sector and therefore assisted in their restructuring and recapitalising. Four of the five major banks faced financial difficulties during 1993-1997, including three state-owned banks (Agroprombank, Alembank and Turanbank) and one private bank (Kramds bank). The NBK provided financial support, but required adoption of a comprehensive restructuring programme. Agroprombank (responsible for rural finance) transferred its non-performing assets to one of the debt recovery institutions, closed non-viable branches and reduced operational expenses. These measures facilitated privatisation of the bank in late 1996. Turanbank (responsible for heavy industries and construction) and Alembank (responsible for commercial foreign operations) merged in 1997 and underwent extensive restructuring in order to be sold to private ownership by the end of 1998. Kramds bank was the only private bank among the large banks facing financial difficulties. Nevertheless, the NBK supported the bank to overcome liquidity problems twice in early 1996 by extending emergency loans. When Kramds bank faced a liquidity problem for the third time in 1996, the NBK decided to revoke its licence. Household depositors were all compensated from the funds derived from the bank's asset sales, but larger creditors incurred some losses.

The privatisation of an additional state-owned bank was also on the agenda of the government. Halyk bank (savings bank), the largest of the remaining state-owned banks, underwent privatisation in 2001. By that time, the other smaller commercial banks had already been sold off. With the state banks, the NBK had followed the strategy of ‘case-by-case’ privatisations and undertook the necessary preparatory measures depending on individual circumstances.

In 2003, the government established a new commercial bank to support residential housing construction. It seems clear that the authorities did not consider the long-term ownership of the bank, and the timing of possible privatisation was not known.

A number of legislative documents were adopted since 1993 to regulate the insurance sector. In 1998, the supervisory function over the insurance market was transferred from the Ministry of Finance to the NBK. Moreover, the NBK acquired supervisory and licensing functions in regard of credit partnerships and pawnshops. These sub-sectors still lacked a regulatory framework but nevertheless steadily grew in recent years (International Monetary Fund 2000b).

In 1997, the government of Kazakhstan introduced an ambitious reform of the pension system by moving from a ‘pay-as-you-go’ system to a system of mandatory savings managed by pension funds. A number of private pension funds entered the market, aside from the remaining State Pension Fund. This has already provided substantial capital to the financial markets offering an impetus to its dynamic development.

Since the introduction of a national currency, the National Bank of Kazakhstan began moving to indirect instruments for the conduct of monetary policy. In 1994, for the first time the government issued its own Treasury bills, which enabled the NBK to conduct the open-market operations. That same year, reserve requirements for commercial banks were introduced. In 1995, the NBK abolished the use of directed credits as an instrument of monetary policy, relaxed controls over interest rates, but continued announcing a rate for the refinancing of credits.

OUTCOMES OF THE FINANCIAL SECTOR REFORMS

Solid progress was made by the authorities of Kazakhstan in laying the foundations for a strong and efficient financial sector. This has largely been due to the early introduction of structural reforms and consistency in the implementation of these reforms. The banking sector of Kazakhstan is considered to be the most efficient in the CIS, as confirmed by the ratings assigned to leading Kazakh commercial banks by international ratings agencies (BankTuranAlem 2006; Kazkommertsbank 2006). Capital markets were not as liquid as those in Russia, but nonetheless recently showed very impressive growth. In terms of pension reforms, Kazakhstan was far ahead of its CIS counterparts.

As mentioned earlier, the introduction of tight prudential regulation measures reduced the number of banks from 1994 onwards. This has been primarily due to the liquidation of smaller banks, but also to the processes of mergers and acquisitions in the banking sector. The number of new local banks established later was negligible due to stricter licensing requirements. However, in later years, foreign banks started to enter the banking sector as a consequence of the relaxation of entry requirements for foreign banks by the NBK. Table 1 presents the structure of the Kazakhstan's financial sector in the period 1991 to 2002.

Table 1: Structure of the financial sector of Kazakhstan

Financial institutions	1991	1995	1998	2000	2002
Banking institutions					
Commercial banks, total	76	130	71	48	38
State-owned	5	4	1	1	0
With foreign participation	0	0	23	16	17
Other banks	71	126	47	31	21
Non-bank financial institutions					
Insurance companies	na	na	72	42	34
Private pension funds	na	na	13	15	16
Non-bank financial institutions licensed to carry out certain banking operations	na	na	29	53	44
Credit associations	na	na	2	8	29
Licensed pawn shops	na	na	36	42	52

Source: IMF (2000b; 2004c).

The non-bank financial sector also underwent substantial changes since Independence. However, the pace of development has been not as rapid and comprehensive as in the banking sector. The insurance market is the largest financial services market apart from banks. However, as shown in the Table 1 above, the number of insurance companies decreased in common with the consolidation in the banking sector.

In league with most transition economies, the banks in Kazakhstan played a more important role than stock markets in attracting savings and allocating financial resources to the private sector, particularly in the early years of reform (International Monetary Fund 2001b). The first legislation on securities was adopted in 1993 and in the same year the Central Asian Stock Exchange opened in Kazakhstan. However, trading did not really begin in earnest until 1997, when the Kazakhstan Stock Exchange (KASE) was opened. That same year, a new package of legislation on securities and trading of securities was passed. Since then, the capital market has developed rapidly. Initially, KASE served mainly the foreign exchange and treasury instruments market. However, in recent years, equities and corporate debt instruments have been gaining in importance. Market capitalisation has remained high since 1997 mainly due to the so-called 'Blue Chip' Programme that envisaged listing the largest Kazakh companies in which the government retained an interest. However, it did not record much growth because the exit of several large companies in 2000-2001 induced a drop in the official market indicator. The other main market indicators of KASE are presented in Table 2.

Table 2: Capital market development in Kazakhstan

	1997	1998	1999	2000	2001	2002	2003
Corporate securities (CS)							
Number of issues	24	59	88	81	96	124	180
incl. listed	5	31	29	39	57	88	129
Number of companies	13	36	66	54	62	78	106
incl. listed	3	18	17	23	29	50	69
Turnover, mln. USD	2.3	26.2	31.2	119.7	315.7	603.6	1025.2
Equity instruments							
Number of issues	24	59	84	68	72	68	112
Market capitalisation, bln. USD	1340.9	1834.9	2263.2	1342	1207	1341	2425
Share in CS turnover, %	100	100	73.2	58.1	32.6	35.1	31
Debt instruments							
Number of issues	0	0	4	13	24	42	68
Share in CS turnover, %	0	0	26.8	41.9	67.4	64.9	69
Government securities							
Par value, bln. USD	0.974	1.571	1.459	1.848	1.628	1.898	3.327
Number of issues (excl. municipal)	na	na	na	na	225	187	160
Number of municipal bond issues	0	0	3	1	5	4	2

Source: KASE (1998; 1999; 2000; 2001; 2002; 2003).

A significant impetus to the growth of capital markets was provided by pension reform. By the beginning of 2004, pension funds generated US$ 2.5 billion and already faced the challenge to invest those funds (International Monetary Fund 2004b). Privatisation of large 'blue chip' companies should add to the liquidity in the market.

Financial intermediation decreased sharply during the period and has yet to recover. Both total and private financial intermediation to GDP ratios slumped from over 50 per cent in 1993 to under 16 per cent in 1996. Since then, both ratios have grown slowly and have recorded 35 per cent and 23 per cent growth accordingly. The money supply (M3/GDP) fell from 27.9 per cent in 1993 to 9.5 per cent in 1996. Thereafter the ratio has steadily improved to reach 21 per cent in 2003. Table 3 provides the dynamics of financial liberalisation indicators.

Table 3: Indicators of the financial liberalisation in Kazakhstan

Indicator	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
M3/GDP (%)	27.90	13.10	11.40	9.50	10.30	8.60	13.60	15.30	17.70	19.20	21.00
FIR (total)/GDP	56.26	27.11	16.53	15.50	15.22	15.58	22.17	23.93	27.75	32.51	35.02
FIR (private)/GDP	51.38	24.83	6.89	6.60	5.39	6.93	8.36	11.16	16.42	18.98	22.66

Source: IMF (2000a; 2001a; 2004a).

Interest rates turned positive in real terms shortly after hyperinflation had been curtailed in 1996. The lending rate has been above both the producer and consumer inflation rates since 1996 and the deposit rate since 1997. The only exemption was 1998 – the year of the Russian financial crisis - which had a negative impact on the Kazakh economy and financial system.

After a large depreciation in early 1990s, the exchange rate stabilised in 1996. That same year, the government introduced current account convertibility, which made monetary management more complicated. The NBK adopted a managed floating exchange rate arrangement, allowing the tenge to slowly depreciate. In 1998, the Russian crisis adversely affected the exchange rate of the tenge and pushed the government to introduce temporary restrictions. By 2000, the crisis was largely over and the exchange rate has deviated only very marginally since. The statistics on inflation, exchange and interest rates are presented in Table 4.

Table 4: Exchange rates and interest rates

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Exchange rate*	1.9	36.0	61.0	68.2	75.4	78.3	119.5	142.1	146.7	153.3	149.6
Inflation rate (CPI %)	1662.3	1892.0	176.3	39.1	17.4	7.1	8.3	13.2	8.4	5.8	6.4
Inflation rate (PPI %)	n/a	2920.4	231.2	24.3	15.6	0.8	18.8	38.0	0.3	0.4	9.3
Interest rates (%)											
Treasury bill rate**	n/a	456.4	49.0	28.9	15.2	23.6	15.6	6.6	5.3	5.2	5.9
Deposit rate	n/a	n/a	44.4	29.3	12.0	14.5	13.5	15.6	12.8	11.0	10.9
Lending rate	n/a	n/a	58.3	53.6	22.8	17.0	20.8	18.8	15.3	14.1	14.9

* Kazakh tenges per US dollar
** Three-month T-bill rate till 1998; average effective yield of short-term NBK notes thereafter.
Source: EBRD (2001; 2003; 2004).

SOCIO-ECONOMIC IMPACT OF THE REFORMS

The financial sector became an effective channel for the allocation of financial resources to the private sector in recent years. This contributed to the high level of economic growth consistently recorded by Kazakhstan from 2000. The pre-reform level of 1991 has not yet been reached. However, Kazakhstan has recorded the best recovery among all other CIS countries that initiated comprehensive reforms and only marginally behind ‘reluctant’ reformers like Uzbekistan, Belarus and Turkmenistan[1]. This situation is likely to change in the near future as Kazakhstan consistently records growth level at least double of those countries.

After Independence, Kazakhstan underwent a period of severe economic instability. The collapse of inter-state trading and expansionary demand management policies resulted in high inflation and reduced economic activity. Inflation peaked in 1993-1994 and cumulative GDP fell in 1992-1994 by 25 per cent. However, since 1996, as a result of reforms, it has moved into positive territory and remained there, except for 1998 - the year of Russian crisis. In contrast, GDP per capita recorded growth over the period of 1991-2003 of 18 per cent when calculated using the direct method and 25 per cent using the PPP method.

The major driving force for the impressive GDP growth in recent years was recovered domestic investments as well as strong foreign direct investments. Domestic investments initially fell from 30.4 per cent in 1991 to a low 15.7 per cent level in 1998, but increased to 23-24 per cent in 2001-2003. Domestic savings have shown a similar pattern with an initial reduction from 30.2 per cent in 1991 to a very low 11.3 per cent in 1998, followed by a stronger recovery to 32.8 per cent in 2003. Foreign direct investments began their substantial inflow since 1994 with a peak year in 2001 when an impressive 13.28 per cent of GDP was recorded. However, it should be recognised that the primary cause of FDI inflow was the petroleum sector (European Bank for Reconstruction and Development 2005). The official

[1] For detailed discussion of financial sector reforms in Uzbekistan, see Akimov and Dollery (2006).

unemployment level remained reasonably low over the whole period of reform with a peak in 1996, when 4.2 per cent unemployment was recorded. However, this figure might be an underestimation of the true level due to sizable hidden unemployment.

Key statistical measures of economic development in Kazakhstan are presented in Table 5.

Table 5: Main economic indicators of development in Kazakhstan

Indicator	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Change for the period[3]
GDP growth, %	-11.0	-5.3	-9.3	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.8	13.5	9.5	9.0	-14%
GDP per capita[1]	1425	1344	1224	1081	1007	1021	1050	1045	1090	1215	1393	1533	1675	18%
GDP per capita[2]	5055	4877	4350	3855	3603	3653	3776	3756	3988	4594	5206	5672	6294	25%
Domestic savings/GDP	na	30.2	11.2	18.7	18.7	15.4	13.1	11.3	20.1	26.7	26.0	28.2	32.8	
Investments/GDP	na	30.4	27.9	26.1	23.1	17.2	16.3	15.7	16.2	17.3	23.7	24.0	23.0	
FDI/GDP (%)	na		3.18	5.05	5.61	5.73	6.21	5.42	9.02	6.96	13.28	8.95	7.29	
Unemployment rate	0.05	0.4	0.6	1.1	2.1	4.2	3.8	3.7	3.9	3.7	2.9	2.6	na	

[1] Constant, year 2000 USD
[2] PPP method; constant 2000 international USD
[3] 1989-2000 for GDP growth
Source: EBRD (1995; 2003); World Bank (2006); IMF (2000a; 2001a; 2004a)

CONCLUSION

Kazakhstan has successfully implemented comprehensive reform package across economy over 1993-2002. Financial sector reforms were especially comprehensive, which made the Kazakhstan financial system the most efficient in the Commonwealth of Independent States. The outcomes of financial sector reforms, together with general economic liberalisation and favourable prices for major exports, ensured economic outstanding growth rate since 2000. Moreover, welfare has also improved due to increased real wages and better social conditions.

In spite of all these achievements, much remains to be done before Kazakhstan’s financial system can achieve the level of Western countries. Further steps are required in enhancing supervision practices, addressing the problems of non-performing loans by banks, developing a wide range of non-bank financial institutions, among other policy actions. A serious challenge to further development of financial system is posed by relatively sluggish enterprise restructuring and privatisation and inadequate credit rights (Barisitz 2000).

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