DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR KAZAKHSTAN

As approved by the Board of Directors at their meeting on 26 January 2010

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ABBREVIATIONS / CURRENCY CONVERSIONS

ABV	Annual Business Volume
ADB	Asian Development Bank
AIC	Agency of the Republic of Kazakhstan for Information and Communication
AML	Anti-money laundering
APC	Agency for Protection of Competition of the Republic of Kazakhstan
BAT	Best Available Technology
BAS	(the EBRD) Business Advisory Services
AREM	Agency of the Republic of Kazakhstan for Regulation of Natural Monopoly
BCC	Bank CenterCredit
BEEPS	Business Environment and Enterprise Performance Survey
BTA	Bank TuranAlem
CAPECO	Central Asian Power and Energy Company
CAEPCO	Central Asian Electric Power Corporation
CCGT	Combined Cycle Gas Turbine
CAREC	Central Asia Regional Economic Cooperation Program
CIS	Commonwealth of Independent States
CTF	Clean Technology Fund
CPC	Competition Protection Committee of the Ministry for Industry and Trade of the Republic of Kazakhstan
CSU	(the EBRD) Consultancy and Service Unit
CSP	ADB's Country Strategy and Programme Update for Kazakhstan
DBK	Development Bank of Kazakhstan
EBRD or the Bank	European Bank for Reconstruction and Development
EIB	European Investment Bank
ECO	Economic Cooperation Organisation
ESCO	Energy Service Company
EVD	Dutch Agency for the International Business and Co-operation
EITI	Extractive Industries Transparency Initiative
EU	European Union
€	Euro
FIC	Foreign Investors Council
FDI	Foreign direct investment
FI	Financial Institutions
FX	Foreign Exchange
GDP	Gross domestic product
GEF	Global Environmental Facility
GI	General Industry
GoK	Government of the Republic of Kazakhstan
GNPF	Accumulation Pension Fund GNPF, the state-owned pension fund management company
IAIS	International Association of Insurance Supervisors
IBRD	International Bank for Reconstruction and Development
IDB	Islamic Development Bank
IFC	International Finance Corporation

IFRS	International Financial Reporting Standards
IFI	International Financial Institution
IFK	Investment Fund of Kazakhstan
IMF	International Monetary Fund
ILO	International Labour Organisation
IOSCO	International Organisation of Securities Commissions
IPO	Initial public offering
JERP	Joint Economic Research programme
JSC	Joint stock company
KASE	Kazakhstan Stock Exchange
KazSEFF	Kazakhstan Sustainable Energy Financing Facility
KEGOC	Kazakhstan Electricity Grid Operating Company
KMG	KazMunaiGas
KKB	Kazkommertsbank
KPIC	Kazkommerts Policy
KTC	Kazakhtelecom
KTZ	Kazakhstan Temit Zholy [railways]
KZT	Kazakhstan Tenge, the national currency of Kazakhstan
MEI	Municipal and Environmental Infrastructure
MEBP	Ministry of Economy and Budget Planning of the Republic of Kazakhstan
MoE	Ministry of Economy of the Republic of Kazakhstan
MoU	Memorandum of Understanding
MMG	MangistauMunaiGas
MSME	Micro, small and medium-sized enterprise
NBFI	Non-bank financial institution
NBK	National Bank of Kazakhstan
NGO	Non-governmental organisation
NIF	National Innovation Fund
ODIHR	Office for Democratic Institutions and Human Rights
OCE	(the EBRD) Office of Chief Economist
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Cooperation in Europe
PPF	Post Privatisation Fund
PPP	Public-private partnership
PSA	Production Sharing Agreement
PR	Performance Requirements
PSTN	Public Switched Telephone Network
SEAP	Sustainable Energy Action Plan
SK	National welfare Fund Samruk Kazyna
SME	Small and medium-sized enterprise
SPECA	(The UN's) Special Program for Economies of Central Asia
S&P	Standard and Poor’s
TACIS	(The EU's) Technical Assistance for the Commonwealth of Independent States
TAM	(the EBRD) Turn-Around Management programme
TIM	(the EBRD) Telecom, Informatics and Media
TC	Technical Cooperation
TSATEK	Central Asia Power and Energy Company
TRACECA	(The EU's programme on) Transport Corridor Europe-

	Caucasus-Asia
TFP	Trade Facilitation Programme
UAE	United Arab Emirates
UK	United Kingdom of Great Britain and Northern Ireland
UKSPF	UK Strategic Programme Fund
UN	United Nations
UNDP	United Nations Development Programme
UNCITRAL	United Nations Commission on International Trade Law
UNESCO	United Nations Educational, Scientific, & Cultural Organization
UNFCCC	UN Framework Convention on Climate Change
UNEP	UN Environment Programme
US	United States of America
USAID	US Agency for International Development
US$	United States dollar
WB	The World Bank
WTO	World Trade Organisation

EXECUTIVE SUMMARY

Kazakhstan is committed to the principles of multi-party democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank. The authorities have confirmed the importance they attach to these principles, and Kazakhstan has made some progress towards their implementation in the last three years, although challenges remain in both the political and economic fields: the strong presidency is not yet adequately balanced by the legislature or judiciary, corruption remains a significant problem, as recognised by the authorities, and the most recent parliamentary elections fell short of a number of international standards for free and fair democratic elections.

For most of the past decade, Kazakhstan's macroeconomic performance was strong, as a combination of improving macroeconomic policies and structural reforms with high prices for its main exports – in particular oil and other commodities – contributed to rapidly rising incomes, robust consumption, increasing FDI inflows, and the emergence of an urban middle class. However, by the same time, certain vulnerabilities had built up, which became magnified by the global financial crisis starting in mid-2007. Kazakhstan suffered a twin external shock: it was one of the first countries of operation where banks were cut off from external wholesale funding, and a year later, in mid-2008, the country was hit by a second shock in the form of a very steep decline in oil prices. Economic growth, which had been fuelled in part by a credit boom and increasing commodity exports, consequently slowed down sharply, and is forecast to turn negative in 2009. This led to a severe banking sector crisis, prompting the state to intervene and nationalise or provide significant equity support for most systemic banks. The banking crisis has exacerbated problems in the real economy**.**

Yet the medium-term growth prospects for Kazakhstan remain good. The large Kashagan oilfield expected to start production in 2013. There is also potential for expanding uranium, copper and grain production. Yet, the crisis has laid bare the imbalances of Kazakhstan's longer-term economic development, in particular the country's reliance on commodity exports and the excessive reliance of the banking system on foreign wholesale funding, and significant risks related to the banking sector's foreign exchange denominated exposures to unhedged borrowers. This has prompted the country's leadership to declare economic diversification and the development of a new 'financial model' as its main priorities. In pursuing diversification, it will be essential to safeguard the fundamentals of the market economy against the growing tendencies towards an increased role of the state in the economy, reduced competition, and autarchy.

Thus, the key elements of the EBRD's strategy in the coming post-crisis period will be to foster transition by assisting Kazakhstan in its efforts to promote economic diversification and moving towards a more sustainable model of financial development.

Strategic Challenges

In its transition path Kazakhstan faces a number of strategic challenges, many of which have been emphasised by the economic and financial crisis:

- **The crisis has highlighted Kazakhstan's excessive dependence on primary industries and commodity exports**. It is necessary to **diversify the economy** towards value-added industries, provided this diversification is based on economic rationale. With oil production expected to increase significantly in the coming years and with oil prices rising due to a gradual global economic recovery, the underlying economic tendencies – real exchange rate appreciation and human and financial resources flowing to the hydrocarbon sector – will make economic diversification even more challenging.

- **The domestic financial sector has proved less developed and on a weaker foundation than previously thought**. It is therefore of vital importance to reform the financial sector and to ensure that it emerges from the crisis with a sustainable business and funding model, which can provide sustainable and reliable financial intermediation and lending a lasting source of strength for the real economy. To this end, the banks will need to further develop their local currency funding base and lending products, and strengthen their balance sheets, transparency, and core competencies such as risk management. It is likewise important to further develop local currency and capital markets.

- To put sustainable development on a firm footing, the remaining transition gaps in the country's **infrastructure**, including shortages and imbalances in power and energy, and transport bottlenecks, need to be filled.

An overarching policy challenge for the Government is to ensure that its efforts to address the impact of the crisis and the country's medium term transition challenges do not result in undue and lasting interference in the economy and erosion of market principles. In the private sector, fair competition on a level playing field needs to be preserved and in some cases improved as economic incentives are re-designed.

Strategic Directions

The Bank's strategic directions reflect the immediate need to help Kazakhstan weather the crisis and get on the path of economic recovery, as well as to assist the country in confronting its fundamental transition challenges, as follows:

- Support for the **corporate sector**, including through addressing the immediate financing needs as part of our crisis response, while promoting economic diversification and innovation, including utilisation of best available technology, integration into the global economy (including through supporting inbound and outbound direct investment), best business and environmental practices, and energy efficiency. The Bank's engagement with Kazakh corporate clients will be underpinned by the principles of integrity, transparency and good corporate governance. The EBRD will seek to engender these principles further through greater use of equity instruments.

- Co-operation with the authorities and other IFIs to help formulate a vision for the **financial sector** with the aim of achieving a sustainable financial model, including through the scaling back over time of the government's involvement in the banking system. Through targeted investment, policy dialogue and technical assistance, the Bank will structure its work around that vision to help redress over-reliance on foreign wholesale funding and a still limited deposit base, FX lending to unhedged borrowers, excessive sectoral concentration of loan portfolios – in particular in real estate – and shortcomings in risk management, corporate governance and transparency. The banking sector will remain the primary conduit for channelling the Bank's funds to SME's and into energy efficiency and climate change projects. To allow the Kazakh banking system to fulfil this role in a sustainable way, the Bank will also seek to promote and support the development of local currency and capital markets in Kazakhstan through engagement with pension funds, increased involvement with non-bank financial intermediaries, and development of institutional capacity through both macro and micro (project-related) technical assistance. In particular, the Bank will continue to support the emerging private equity sector in Kazakhstan in order to ensure a sufficient supply of risk capital in addition to debt funding.

- Advance the transformation of the **energy sector** through implementation of the milestone principles of the Sustainable Energy Plan (SEAP). The EBRD will work to help redress energy imbalances and shortages through investment, conditional on clean technology, and emphasising sustainable energy, as envisioned by the SEAP.

- Support the development and transformation of **infrastructure sectors**, which is pivotal to further economic diversification and longer-term sustainable growth, while fostering commercial viability, competition, and private sector participation.

- Intensify policy dialogue, with the focus on three pivotal elements, as follows:

  - Stabilisation of the banking sector and development of local currency money and capital markets;
  - Implementation of Sustainable Energy Action Plan;
  - Improvement of the business climate through Foreign Investment Council.

In keeping with its transition mandate, the Bank will concentrate its operations and policy dialogue on promotion of the private sector and seek to further the diversification of ownership in the economy. To that end, the Bank will selectively work with creditworthy state-owned companies if deemed consistent with the Bank's transition objectives, i.e., by requiring commercial viability, good corporate governance, and best business practices, in particular when privatisation prospects are realistic, but also when, in the absence of an imminent privatisation plan, there are opportunities to promote reform . In doing so, the Bank will carefully balance its work with national companies to contribute to separation between ownership and regulation.

The Bank will continue to ensure that all of its operations in Kazakhstan are subject to the Bank's 2008 Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans.

COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1 Overview of the Bank's activities to-date

Since 1991, the EBRD has signed 100 projects in Kazakhstan with the cumulative total business volume of EUR 2.4 billion. In 2008, the Bank signed 17 projects worth EUR 434 million. In 2009, 12 projects with a total ABV of EUR 336 million have been signed. As of 30 June 2009, the Bank's portfolio in Kazakhstan stood at EUR 1.6 billion, spread among 57 projects, with 71% of the portfolio in the private sector, reflecting the Bank's historical focus on supporting the private sector, even as the state's role in the economy has increased. Transition impact gets high ratings, with more than 50% of projects rated "good" or "excellent".

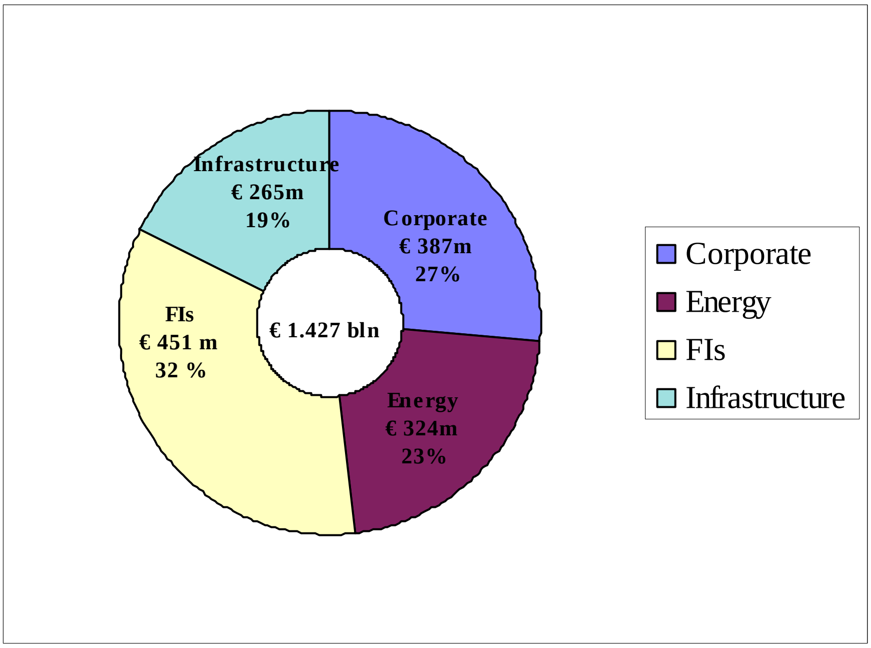
Table 1: Kazakhstan Portfolio Development 2006-Sep 2009

				mln €
	2006	**2007**	**2008**	**III Q 09**
Net Cumulative Business Volume	1,380	1,734	2,090	2,310.60
Current Portfolio Stock	777	1,070	1,330	1,427
# Projects (excl. regionals & TFPs)	43	47	51	53
Operating Assets	563	749	895	910
Annual New Business	242	532	434	383.6
Annual Gross Disbursements	260	317	284	183.3
Annual # Projects (excl. reg & TFPs)	10	18	17	12
Active Pipeline Stock	638	701	1003	546.2
Private Sector Share (% Portfolio)	66%	82%	72%	69%
Non-Sovereign (% Portfolio)	79%	88%	91%	84,5%
EUR/USD rate at end of period	1.31	1.47	1.41	1.48

The EBRD is the largest investor outside the oil and gas sector in Kazakhstan. Broadly defined, operational priorities include supporting domestic and foreign investment; supporting the financial sector, corporate sector and infrastructure.

Despite the crisis, the underlining quality of the portfolio remains good, although impaired assets have increased to 10% of the portfolio, or EUR 155.3 million, largely reflecting a spike in risk ratings for the equity portion.

Chart 1: Sector composition of the portfolio as of Sep 2009



As seen from the above chart, the portfolio, which used to be dominated by Financial Institutions, is now reasonably well-diversified among sectors. Although the financial sector remains the single largest in the portfolio, partially reflecting the role of the banking sector as a primary conduit for channelling the Bank's funds to SME's, as well as supporting industrial energy efficiency, its share has declined to 32% of the portfolio from 48% at the beginning of the strategy period. The corporate sector has increased in its relative significance from 20% at the beginning of the strategy period to 27%, with a portfolio that is well-diversified among the telecom, agribusiness, property and tourism, natural resources, and general industries sectors.

The portfolio reflects the progress the EBRD has made in the power and energy sector, whose share of the portfolio increased to 23% from 14% at the start of the strategy period, including loans to KEGOC and to a private generating company, TSATEK. The contribution of the infrastructure sector has remained stable at 19%, as the Bank reasserted itself in the infrastructure sector through the loan to the national railway company and the by financing a portion of a major transport corridor, as well through its new beachhead in MEI.

One of the Bank's strategic objectives in the new strategy period is to further increase the equity component of the portfolio from an already significant 25%, with the aim to promote wider use of non-debt instruments in the presently over-leveraged and under-capitalised Kazakh economy, as well as to foster transparency and corporate governance, thus also contributing to the development of local capital markets.

The weighted risk ratio of the Bank's portfolio in Kazakhstan is 6.23, compared to 6.04 for the Bank in general, which is up from 5.7 as of a year ago, reflecting the crisis-related increase in the country's risk assessment and the higher proportion of the riskier equity portion in the portfolio.

1.2 Implementation of the previous country strategy

The 21 November, 2006 Country Strategy for Kazakhstan set forth the following strategic priorities for the EBRD:

- Engage actively in further reform process by working with both the private and public sector
- Broaden the Bank's operations and increase its impact with a special focus on the corporate sector, including the SME's, to support the diversification of the economy of Kazakhstan, and to promote competition
- Continue to finance infrastructure with strong emphasis on transport and power sectors
- Stay engaged in the financial sector, with a clear focus on increasing competition and supporting non-bank financial services as well as capital markets
- Promote higher transparency and governance standards, and FDI

1.2.1 Corporate Sector

During the previous strategy period the EBRD directly provided a total of EUR 290 million to the private corporate sector, spread among 18 projects in agribusiness, general industries, telecom, property and tourism, and natural resources. The agribusiness sector has dominated the growth in the corporate portfolio, having benefited primarily from the robust inflow of FDI into such value-added segments as soft-drinks, breweries, agrochemicals and edible oils. Only one domestic producer (RG Brands) received Bank financing, partially reflecting the prevailing lack of financial transparency and overall "bankability" among the domestic companies in the sector.

The previous strategy period has also seen significant growth of the general industries portfolio, with both equity and debt financing directed into supporting FDI and local manufacturers, in such segments as construction materials (Stepcement/Karcement), paper (Kagazy), and steel production (Mittal Temertau). The Bank has also increased its participation in the telecom and media sector through its loans to K-Mobile and RTS Decaux (advertising). In 2009, some of the growth in the corporate portfolio, including in agribusiness, came from anti-crisis activities. Overall, however, contrary to the initial expectations, the crisis has not manifested itself in a material increase in demand for financing from Kazakh corporates, partially reflecting the contraction of the economy and the resulting timidity among foreign investors.

1.2.2 Financial Sector

The Bank provided close to EUR 530 million to the sector through loans, equity, and trade facilitation facilities to banks, pension funds and through participation in regional and country-specific investment funds. The scope of the Bank's participation partially reflects the perhaps excessive appetite for syndicated loans that existed in the industry prior to the crisis. The banking sector was the primary beneficiary of the Bank's funding, while opportunities in the non-banking segment of the sector proved relatively limited, owing primarily to the small size of Kazakh insurance and leasing companies, and most of the pension funds. The banking sector was also the primary conduit of the EBRD financing to the SME sector, and, in the second half of the strategy period, became an important instrument for financing energy-efficiency projects through Kazakhstan Sustainable Energy Financing Facility (KazSEFF). The EBRD continued to work with a relatively small universe of partner banks (7 out of the total number of over 30), reflecting the high level of concentration in the industry. The influx of foreign investment into the sector enabled the EBRD to engage with such banks as BCC and ATF, with the acquisition of the latter by UniCredit removing integrity issues associated with the previous owners.

The Bank maintained its stake in the Government Accumulation Pension Fund (GNPF), although the objective of privatising the fund was not achieved, partly owing to the internal bureaucratic process, but also to the lack of interest from potential strategic investors due to the crisis. The Bank further sought to contribute to the development of Kazakhstan's capital markets through investment in two local private equity funds, Centras and Aureos (2007 and 2008, respectively), and launched an investment fund jointly with Kazyna Capital Management (part of Samruk-Kazyna) in 2009.

As part of the crisis response, the Bank increased provision of Tier I and II capital, as well as of debt funding (much of the latter through anti-crisis support of SME's) to its partner banks. The two most notable transactions were the increased equity stake in KKB (USD 40 million) and a loan to ATF bank, as part of the regional UniCredit initiative (EUR 70 million). At the same time, two of the Bank's partner banks, BTA and Alliance, fell victim to the crisis, with BTA effectively nationalised.

1.2.3 Power and Energy

The Bank provided three financing facilities in the total amount of EUR 194 million, including, debt and equity, to the sector. These included a EUR 127.5 million loan to the national transmission company, KEGOC, and an equity stake in Pavlodarenergo, a subsidiary of TSATEK, a private company. The Bank subsequently acquired an equity stake in CAEPCO, another subsidiary of TSATEK for EUR 46 million. In accordance with the strategy, the Bank's funding was used to promote efficiency, clean energy and the use of best available technologies (BAT). These priorities were further highlighted in the Sustainable Energy Action Plan (SEAP), signed with the Government in 2008. The Bank's commitment to the principles of SEAP was reflected in its standing decision to decline to participate in the financing of Ekibastus-2 (Unit 3) power station rehabilitation project, which was based on using technology, which was sub-optimal from the perspective of energy efficiency and environmental performance.

The Bank provided a significant amount of technical assistance to the sector, including for supporting Renewable Energy and Energy Efficiency legislation, and towards development of a competitive generation market.

1.2.4 Infrastructure

After a period of active engagement in the sector in 2004-2006, the previous strategy period did not see the Bank re-establishing itself in the sector until 2008, when the

EBRD provided a EUR 39.1 million loan to Transtelecom, a subsidiary of the national railway company, KTZ. In 2009 the Bank provided a sovereign loan of EUR 128 million to finance a stretch of the Western China-Western Europe road. The Bank has been actively involved in the policy dialogue on road PPPs and is providing a technical assistance package of USD1.5 million to develop a pilot PPP project in the sector. Also in 2009, for the first time in Kazakhstan, the EBRD engaged with the municipal sector through the loans to a private water utility in Shymkent and Almaty Electrotrans, an urban transport company in the nation's largest city. Due to the limitations on the municipalities' ability to borrow and guarantee third-party debt, the Bank employed creative mechanisms, including greater use of transaction support agreements.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

1.3.1 The Financial Sector

Banking – In its operations with Kazkommertsbank (KKB) and Bank Turan Alem (BTA), EBRD sought to strengthen the banks' capital base and liquidity, as well as their competitiveness and corporate governance. Project implementation showed that although the operations succeeded in developing the banks as financially sound institutions, the lack of transparency regarding the beneficial ownership and ultimate control prevented substantial improvements in corporate governance. Recently, EBRD focuses in its financial sector projects on financing energy efficiency and sustainable energy measures. The KAZSEFF - Kazakhstan Sustainable Energy Finance Facility and the ATF Bank Energy Financing (Unicredit Group) are examples from 2008 and 2009. ***A lesson learned*** from the operation with BTA is that the Bank must set specific milestones for expected improvements in corporate governance. It is also important for EBRD to be transparent both internally and externally with the steps the Bank intends to take should such objectives not be met in due time (PE06-358).

NBFI - Two credit lines extended to a specialised mortgage financing subsidiary of Bank Turan Alem, BTA Ipoteka, facilitated the introduction of good industry practices. In the leasing sector, the asset growth of the leasing company supported by the Bank (BTA leasing) was sluggish until legislative changes were adopted in 2004. The Bank has been active in the privatisation process of the state owned accumulation pension fund management company GNPF and in highlighting weaknesses at the company and in the pensions legislation. Finally, EBRD made an equity investment in a subsidiary of Kazkommertsbank, Kazkommerts Policy (KPIC) with mixed results. ***A lesson learned*** from the KPIC project is the necessity of EBRD involvement at early stages of sector reform, even though the level of support required is high. Indeed the Bank will need to be committed to a long-term involvement (as much as 5 years or more) to ensure that transition is fully accomplished (PEX06-297).

Private Equity Funds - The Bank has been present through the commercial AIG Silk Road Fund and the donor-supported Kazakhstan post-privatisation fund (PPF). In line with other such funds, the Kazakh PPF also had a slow portfolio building pace, high relative handling costs and unrealistic exit forecasts. While some of the portfolio companies are sold to reputable western strategic investors, overall transition impact beyond this is still questionable. The country has not yet developed a critical mass of local fund managers or investors willing to commit to the local market.

***SMEs* –** Over the years the Bank has extended credit lines and TCs support to a number of banks, including HSBC, Bank Center Credit, Alliance Bank and ATF Bank. A specific SME Facility to cover rural areas was in preparation in 2005 but could not be implemented. The international liquidity crunch has affected the SME sector in particular resulting an increased aversion to lending to the MSMEs in the country and reduced access to finance. The sector saw a downgrading in OCE's 2009 'Remaining Transition Challenges' from *Medium* to *Large*.

A broader lesson learned is the necessity to focus more on institution building and business environment-enabling policy dialogue. Lack of focus on local currency money markets and local currency funding and lending proved to be a source of vulnerability in the economy.

Overall, a *Minimal* to *Moderate* transition impact has been achieved in the Financial Sector.

1.3.2 The Enterprise Sector

Agribusiness - Following the adoption of the warehouse receipts law in early 2001 EBRD has been actively supporting the use of this tool through its operations. The Bank has supported several projects with Efes breweries under a regional framework resulting in a successful IPO of the company. In 2007 an additional project was signed to allow Efes Karaganda Brewery JSC to increase brewing capacity, infrastructure facilities and marketing assets of the existing plants in Almaty and Karaganda. EBRD also engaged with agricultural equipment financing, by cooperating with ATF Bank and Bank CenterCredit. The concept of having local risk sharing partners that would on-lend to beneficiaries, either directly in case of sub-loans or through their fully owned leasing companies proved successful. A ***lesson learned*** from the Agricultural Equipment Finance project is that risk sharing operations require reputable specialised partners in lending or leasing, with strong internal credit systems and large branch network (PEX06-288).

Industry **-** During the 1990s the Bank had a very significant impact on the whole sector with its Ispat-Karmet Steel Works project. EBRD together with the IFC financed post privatisation restructuring which was both radical and effective to bring modern business practices in the company. The Bank's 2005 investment in Karcement was done with a view to expand and modernise the Karaganda cement plant at a time when demand for cement was significantly outpacing supply in Kazakhstan. Despite some difficulties with liquidity which led to a delay of the foreseen capex programme, the project was able to meet its main benchmarks and overall sees a *Good* rating of its transition impact so far. Nevertheless, the Bank's involvement in the industrial sector is generally undermined by the reluctance of the companies to enhance transparency and corporate governance with state interference and corruption remaining serious issues.

Natural Resources Sector **-** In 2004 the Bank signed a transaction to help finance the construction of the Kenkiyak-Atyrau private oil pipeline. Good progress has been made by the project partners - KazTransOil and MunaiTas - to date in the areas of accounting, environmental and health & safety standards while important regulatory issues, such as equal third party access are yet to be solved. The Bautino Atash Marine and Supply Base Project aims to foster the involvement of private infrastructure operators at the Caspian Shore. The construction of the base however, is nine months late with respect to the original schedule and thus, too early for an assessment.

Property and Tourism – The only recent activity in this sector is the 2005 Tulpar operation. EBRD provided a parallel senior loan to a limited liability company for the construction of a compound of 134 high-quality houses, including sport facilities and other social services, in Shymkent, southern Kazakhstan. Construction activities went well but the foreseen sale of premises developed worse than expected and suffers substantially from the financial crisis. In respect of transition, the Project saw some positive effects mainly associated with the construction side: e.g. transfer of skills, demonstration effect of increased quality in construction, and market expansion in the sector. A ***lesson learned*** from the Tulpar project is the need for promoting the development of the mortgage market in parallel with the residential real estate market, which might in this case helped to secure commercial success. (PE08-421).

Telecommunications - In 2003, the Bank provided a loan to Kazakhtelecom to refinance its obligations and support network expansion leading to improvements in digitalisation and network coverage. Still the government holds a 51 percent stake in the company which dominates 90 per cent of the fixed-line market. The Bank's loan operation with K-mobile has successfully supported the formerly second GSM operator to become the market leader and contributed to an expansion of the sector network and coverage. EBRD has also been engaged in policy dialogue aimed at supporting the Telecoms Law and the regulatory regime, promoting tariff rebalancing and removal of exclusivity. ***A lesson learned*** from the Bank's project with K-Mobile is that rural access needs to be addressed by the Government desirably in tandem with a properly funded mechanism. This proves especially important in large countries with a low density of population (PE07-366).

Overall, a *Moderate* transition impact has been achieved in the *Enterprise* Sector.

1.3.3 Infrastructure

Power - The KEGOC Power Transmission and Rehabilitation project has met its institutional targets, i.e. the privatisation of distribution companies and the adoption of a Grid Code. The company also achieved all financial targets covenanted under the Bank loan. In addition, EBRD entered into a policy dialogue for sector reform and implemented a number of TC projects with a view to recommend further improvements to regulated tariff methodologies and to strengthen the regulatory body. A ***lesson learned*** from the Bank project with KEGOC is that careful benefit estimates are imperative when the economic and financial viability of large-scale investment operations rests on critical impacts that are difficult to predict and verify. The Bank should ensure due diligence in the assessment of expected impacts, notably in the case when vast sums are spent on elaborate equipment (PE06-350).

Transport* -** The Bank’s projects with the National Railways Company - Kazakhstan Temir Zholy (KTZ) had early on promoted legislative and commercial improvements. The 2008 approved A/B loan was to extend the construction of a fibre optic communications network along the railway tracks. Parallel to the ADB, EBRD provided a senior loan for the rehabilitation of the Almaty–Bishkek road. The physical road rehabilitation was delayed but showed satisfactory results, while its sustainability is a cause of concern due to inappropriate resource allocations for its maintenance. The Atyrau Airport project aimed to finance the construction of a new runway and to enable legislation reform, changes in tariff methodology and corporate development of the airport operator but saw poor results eventually. ***A lesson learned from the Atyrau Airport project is to manage TC funds in the same ‘efficient’ way as other scarce Bank resources. In this case, the TC projects were prevented from implementation over a significant period (see also section 1.3.4) and should have been re-committed to other purposes (PE08-408T).

Overall, and mainly due to a previous lack of presence in the sub-sectors of MEI and Energy Efficiency, a *Minimal* transition impact has been achieved in the *Infrastructure* Sector.

1.3.4. Technical Co-operation (TC)

Since 2002 TC activities are constrained by the Government handling of grant-funded consultants in the public sector. A donor coordination role was assigned in 2001 to the Ministry of Economy and Budget Planning (MEBP) which approves all grants to "state entities". Whilst the intention to strengthen the oversight of grant-funded activities was good, the way it was handled led to severe difficulties for Donors. In the case of EBRD the Kazakh Counterparts found that some provisions of the Bank’s standard documents used for TC purposes would contradict the local legislation.

In practice TC projects could not clearly be exempted from local taxation, putting a threat on both, the local TC beneficiary and the Consulting firm. As a result, TC implementation faltered in the following years and much needed policy advice could not be delivered as planned. In December 2004, the Bank and the GoK entered into a Framework Agreement that formally exempts TC work from taxes levied by the GoK. Nonetheless, CSU reports that this agreement is not yet fully implemented.

1.4 Co-operation with other IFIs and donors

One of the key areas of IFI coordination in Kazakhstan (mainly with ADB) was the improvement of legal framework for PPP projects, as well as the Energy Efficiency and Climate Change topics, including co-operation with the World Bank’s Clean Technology Fund. Another area of co-operation with ADB has been through participation in the Foreign Investors Council, whereby the two institutions have coordinated their approach to selected topics. The EBRD has likewise cooperated with the World Bank and IMF on macroeconomic issues, such as the development of financial sector in Kazakhstan.

The EBRD, the World Bank, IDB and ADB have co-operated on co-financing the Western China–Western Europe Road Project. Rehabilitation of this major international corridor will facilitate the transit of goods and passengers between

Kazakhstan, China, Russia and Europe and advance regional integration. The IFIs have cooperated in joint preparatory work, coordination of the policy advice to the Kazakh Government. Since 2004 the Bank has been also instrumental in financing alongside the Development Bank of Kazakhstan and the World Bank the construction of a new North-South 500kV transmission line through loans to KEGOC. The works on this line are expected to be completed in 2009. An example of successful coordination with IFC is EBRD's equity investment in the leading private power generation and distribution group CAPECO, where IFC intends to follow EBRD's example and co-invest into this company.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political environment

Kazakhstan is a presidential republic where the strong presidency is not adequately balanced by the legislature or the judiciary. The last presidential election took place in 2005 with the incumbent Nursultan Nazarbayev winning an overwhelming majority of the votes and securing another seven-year term in office. Subsequently the Constitution was amended to remove the two-term limit for the First President, thus allowing Nazarbayev to run again and stay in office after the end of his current term in 2012. Although President Nazarbayev is widely expected to stay in power during the strategy period, the issue of succession will be increasingly affecting political developments in the country.

An active borrower on world capital markets, Kazakhstan has been directly affected by the current economic and financial crisis. One of the political consequences of this is an increased role of the state in running the economy, especially through the merger of two state holdings Samruk and Kazyna into one large state mega-holding, which currently controls about 40 per cent of the national economy. A high degree of centralisation of political power in Kazakhstan is reflected in the fact that only the governing presidential Nur Otan party is represented in the lower chamber of parliament, also resulting from the high legal threshold for representation in the legislature.

The upcoming OSCE chairmanship is of particular importance as Kazakhstan is the first Central Asian country and the first former Soviet republic to hold this prestigious position. The chairmanship is associated with increased responsibilities and heightened commitments to democracy, rule of law and respect for human rights. The recent Internet-related legislation, signed by the President into law in July 2009, contravenes, according to experts, OSCE commitments and international standards by introducing limitations on freedom of expression via the Internet.

2.1.2 Business environment

Kazakhstan's governance and regulatory institutions remain weak by the standards of OECD countries and fall below the average for the transition region, with firms citing business licensing and permits, inspections and customs, and trade regulations as important obstacles in the 2008 EBRD/World Business Environment and Enterprise

Performance Survey (BEEPS). This highlights the low enforcement and implementation capacity of Kazakh authorities, which results in part from the fact that political power is highly concentrated in the presidency, making local officials less accountable to their constituencies. There is heavy intervention in the economy by the state and a close connection between political leaders and business. The lack of a Constitutional Court (there is a weaker Constitutional Council) makes for less effective Constitutional control in the country. Other problems include the independence of the judiciary and, as recognised by the authorities, corruption and lack of transparency: more than three-quarters of Kazakh firms report corruption as an obstacle in the latest BEEPS. In Transparency International's Corruption Perception Index, Kazakhstan scores significantly below the transition country average and ranks 145th out of 181 countries. Kazakhstan has endorsed EITI but still has to prove compliance with all EITI criteria and requirements.

2.1.3 Social, labour and gender issues

According to the World Bank, the 2008 overall poverty headcount ratio (at the national poverty line) was estimated at 12 percent of the population. However, regional variation in income and poverty levels is high, with poverty rates above 24 percent in the Mangystauskaya and Kyzylordinskaya oblasts. In the Mangystauskaya oblast rural poverty is exceptionally high at over 56 percent. The prevalence of under nourishment has not come down since 1990 and remained at 5 per cent in 2007. Since 1990 life expectancy at birth has been reduced from 68 to 66 years. Access to safe drinking water remains an important issue across the country and the incidence of tuberculosis is relatively high. HIV/AIDS infection rates are increasing fast, although from a small base, with the number of registered cases doubled since 2000. The worst affected regions are Karaganda, Pavlodar, Kostanay, and Almaty city and transmission is highest among young men, in particular the unemployed and prisoners. On the positive side, the mortality rate of infants has almost halved over the 1990-2007 period from 51 per 1,000 live births to 28. Kazakhstan's Human Development Index ranks it 71st out of 179 countries.

The unemployment rate has gradually come down from 8.4 per cent in 2004 to 6.6 per cent in 2008, but is expected to slightly increase again to around 8 per cent in 2009 and 2010 due to the economic downturn. The increase in the unemployment rate has been limited by government pressure on *akimats* and large regional employers to sign bilateral MoUs that stipulate that employers limit redundancies in return for tax benefits. According to the International Labour Organisation (ILO), trade unions have legal protection under Kazakh law, and their right to exist and act is also protected by the Constitution (Article 23). The management of an enterprise may not discriminate against employees because they belong to a union, although violations of this law have taken place in the form of dismissal of union members. Some of the larger enterprises have also created conditions that do not allow for the creation of a union or collective negotiations. The right to strike is recognized by the Kazakh Constitution (Article 24) but its application is legally highly controlled and strikes are a rarity.

The present Kazakh Constitution and recent legal reforms state the principle of equal access to the benefits of economic growth for women and men. Women are relatively well-represented in the work force, have high literacy rates and the figures for maternal health care are good. Women hold 16 per cent of the seats in Parliament and about 34 per cent of all in management positions. This gives Kazakhstan a high Gender Development Index, ranking it 17 out of 157 countries. At the same time, however, Kazakhstan is a country where over 50 per cent of the population live in rural areas and small towns. These were once supported by single industries which have deteriorated or disappeared altogether, forcing a high proportion of women into informal low-paying work while men migrated to urban areas to seek employment, leaving women alone with the responsibility of family subsistence. Kazakhstan's Constitution (Article 14) does not explicitly rule out discrimination on the basis of sexual orientation, but its non-discrimination principle is formulated in an open-ended way: "Everyone shall be equal before the law and court. No one shall be subject to any discrimination for reasons of origin, social, property status, occupation, sex, race, nationality, language, attitude towards religion, convictions, place of residence or any other circumstances".

2.1.4 Regional cooperation

Regional and interregional trade could be facilitated by reducing tariff and non-tariff barriers. This would make local investment substantially more attractive as larger markets could be served at lower costs. In addition, the investment climate in the region would benefit substantially from further investments in transport infrastructure. This would better integrate Kazakhstan with the world economy, in particular Russia, China and Caucasus/Europe. According to World Bank estimates, transport can add around 15 per cent to the costs of goods supplied to and from Central Asia. These costs affect trade within the Central Asian region as well as transit trade from Asia to Europe and vice versa. Transit costs are increased by the lack of mutual recognition of customs clearance forms, leading to delays. However, also within national borders transport costs are still substantial. Kazakhstan applied for WTO entry in 1996 and has since been negotiating its accession. In June 2009, the country suspended talks on WTO membership and announced that it would instead seek membership together with Russia and Belarus as a single, trilateral Customs Union which is planned to start on January 1, 2010.

Further regional cooperation is also crucial for unlocking the current unresolved issue concerning the fair sharing of the water flows of Central Asia’s two most important rivers. The absence of coordination means that conflicts arise between poor upstream countries (Kyrgyzstan and Tajikistan) that prefer to operate their reservoirs in ‘power mode’ to maximize winter electricity generation and richer downstream countries (Kazakhstan, Uzbekistan, Turkmenistan), which would like to see water kept in dams over winter and discharged in the summer to meet massive demand for agricultural irrigation. Recent harsh winters and looming water stress due to climate change have aggravated tensions over scarce and inefficiently used water and energy resources. More generally, it should be stressed that across Central Asia the energy sector continues to suffer from significant efficiency and capacity underinvestment. This leads to power deficits such as those in South Kazakhstan during the winter. Further regional cooperation is also needed in the creation of additional capacity generation in the power and energy sectors, as regional electricity shortages becoming increasingly disruptive in South-Kazakhstan, the Kyrgyz Republic and Tajikistan. Better regional cooperation among these countries will be crucial to secure sufficient energy supplies.

2.1.5 Legal reform

Kazakhstan's legal environment continues to remain complex and challenging despite notable reforms to its legal system. Over the last few years there have been significant improvements in crucial areas such as securities legislation, concessions, derivative transactions, competition, insolvency and anti-money laundering legislation.. Notwithstanding such improvements, Kazakh commercial laws still fall short in certain respects of standards that are generally acceptable internationally. In company law, the major shortcomings are found in the legislation on "disclosure and transparency" and on "ensuring the basis for an effective corporate governance framework". The Insolvency Law appears to be relatively weak in addressing reorganisation processes, liquidation processes and the treatment of estate assets. The means of enforcement of security rights provided by the law seem adequate on the books, yet in practice, enforcement is reported to be problematic due to deficiencies of the court system, uncertainty regarding the enforcement mechanisms, incidents of non-compliance of the government with enforcement rules and decisions, difficulties in locating and ensuring control of the pledged assets and possible application of exchange control rules to repatriation of enforcement proceeds.

Despite progress towards the establishment of a free market-oriented economy, the challenge facing Kazakhstan in 2009 and beyond is still to further enhance the experience, competence and independence of courts, prosecutors and market regulators, tackle corruption, upgrade its commercial laws and make those laws fully effective through a strengthening of the court system and the rule of law.

2.1.6. Environmental conditions

Although the state of environmental affairs in Kazakhstan is largely affected by its ecological legacy of the Soviet Union, the state of environment has deteriorated even more since country's independence. The most serious aspects are the consequences of nuclear and biological testing in Kazakhstan, the drying out of the Aral Sea and land degradation due to the extensive agriculture, mining, and oil and gas exploration. In addition, present environmental challenges associated with current business practices and the country's economic priorities remain critical and constitute a barrier to the country's development.

The country possesses rich mineral resources and is experiencing industrial and economic potential. Kazakhstan is severely affected by water deficit and decreasing surface water supplies from transboundary rivers. Poor agricultural and irrigation practices resulted in serious soil desertification and land degradation causing not only biodiversity loss but hindering development of many areas in the country. The level of the radiation contamination due to the past nuclear weapons tests in Semipalatinsk (Semey) area and radioactive waste disposal represent a threat to public health and the environment. The Aral Sea's shrinking and salinity increase is one of the world's environmental 'hot spots'. Significant soil, water and air pollution remains a problem for the industrial cities like Balkhash, Ekibastuz, Almaty, Temirtau, Pavlodar, Ust-Kamenogorsk, Aktobe. The Caspian Sea shelf, where a number of oil and gas developments are taking place, is a sensitive ecosystem and needs to be protected.

The government of Kazakhstan recognises the urgency of solving environmental problems and has developed a number of environmental protection programs and action plans. The priorities and commitments are stated in its National Environmental Action Plan, National Biodiversity Strategy and Action Plan, Conception of Sustainable Development for 2007-2024, and Conception of Environmental Safety for 2004-2015. . The Government of Kazakhstan and the EBRD launched a Sustainable Energy Action Plan (SEAP) in June 2008 to promote the conservation and rational use of energy resources as well as the efficient and sustainable supply of power and energy. However, national civil society organisations express concerns over the implementation progress of above plans and conceptions. The overarching regulatory framework for the environmental issues is represented by Ecology Code of Kazakhstan adopted in 2007.

The challenges and opportunities in the environmental domain of Kazakhstan will continue to be appraised and addressed by the Bank through its due diligence, monitoring and sustainability initiatives. Further information on EBRD's approach and priorities, Kazakhstan's legislative framework and international cooperation in the environmental area are provided in the Annex II.

2.2 Progress in transition and the economy's response

2.2.1 Macroeconomic conditions for Bank operations

Kazakhstan has been hit particularly hard by the global financial crisis, a direct result of its 'double dependency' on foreign borrowing and commodity exports. As of September 2007 Kazakh banks have been cut off from most Eurobond and syndicated borrowing. Combined with a sharp decline in commodity prices in 2008 this led to a quick slowdown in bank lending, a deflating real estate bubble, and a paralysed construction sector. In the main cities of Astana and Almaty real estate prices have declined by on average more than 30 and 50 per cent, respectively, from their peak levels in 2007. In the wake of the boom period, Kazakhstan has been confronted with a very substantial adjustment of economic growth. While real GDP growth averaged almost 10 per cent per year during 2004-2007, growth decelerated to 3.2 per cent in 2008. For 2009, OCE expects an economic contraction of about 1.3 per cent and for 2010 limited positive growth of about 1.5 per cent. During the last years, economic growth was mainly driven by construction, real estate and banking and all of these sectors have been hit directly by the sudden stop in foreign funding. On top of that, the country has witnessed a particularly sharp contraction in manufacturing, iron ore production, and coal production at the beginning of 2009. This reflects both a slow down in domestic demand and a reduced demand for commodities from other emerging markets, in particular China.

The combination of the rapidly deteriorating macroeconomic situation, the prospect of large upcoming bank debt repayments, and a reduced inflow of foreign exchange due to the lower oil prices, forced the government to develop a vigorous stabilisation plan (launched in the 4th quarter of 2008) and the National Bank to devalue the Tenge from KZT 120 to 150 per US dollar at the beginning of February 2009. The IMF has advised the government and central bank to keep the exchange rate stable in the short term, while simultaneously reducing the proportion of FX lending in the country. During the next couple of years, the exchange rate will then need to become more flexible, in particular to limit inflationary pressures when the country will be confronted with increasing FX inflows from expanding oil production at the large Kashagan oil field.

On the fiscal side, the Kazakh government responded through large-scale support packages to take equity stakes in banks, provide these banks with funding for SMEs and mortgages, and to finance infrastructure, agricultural, construction, and selected industrial projects. The total stabilisation program was increased several times and now amounts to about 14% of GDP, of which at least US$ 10 billion is funded from the off-shore National Oil Fund.

Although the World Bank and some investment banks have suggested that Kazakhstan should apply for a precautionary stand-by agreement with the IMF, Kazakh officials have so far rejected this, instead turning to regional partners such China, Russia, and the UAE for large bilateral loans. Balance of payments support has recently also become less urgent, with oil prices slowly recovering, the availability of still substantial reserves in the Oil Fund and a stable and substantial inflow of new FDI. While the current account is expected to show a deficit of around 4 per cent of GDP in 2009, OCE expects the deficit to shrink to about 3 per cent of GDP in 2010 on the back of positive oil price developments. OCE expects an average oil price of USD 61/barrel and USD 75/barrel in 2009 and 2010, respectively, reflecting both a recovery in demand and shrinking supplies. Overall, total FX reserves in the central bank and the Oil Fund (jointly USD 42 billion) are expected to gradually increase again during the next couple of years on the back of higher oil prices, substantial FDI inflows, and delayed repayments by the main banks.

In the short-term, the main macroeconomic risks in Kazakhstan continue to hinge on the oil price development and the ability of the authorities to both solve the crisis in the banking system and to keep the exchange rate stable. Besides the oil price, the other main economic unknown relates to the question whether the government's huge fiscal stimulus package can stabilise the economy and kick-start bank lending again. In the medium to long term, the main economic risks relate to Kazakhstan's continuing dependency on commodity exports, particularly of oil. This is unlikely to change anytime soon, as the large off-shore Kashagan oil field is expected to become on stream around 2013. Provided that Kazakhstan will have increased its oil export capacity by that time (in the form of new or expanded oil pipelines and/or a trans-Caspian tanker transportation system) oil exports will increase significantly. This will draw more human and financial resources into the hydrocarbon sector, further adding to the difficulties of other emerging sectors in the country. The increase in oil export related FX inflows will also put upward pressure on the real exchange rate, further adding to the difficulties of other export sectors.

2.2.2 Transition achievements and challenges

Substantial transition challenges remain in Kazakhstan as both market structure and market-supporting institutions need substantial further improvement. State interference in the industrial sector continues to be high and has increased recently. Further efforts are needed to enable successful restructuring and allow for effective competition. Corporate governance standards and business conduct remain much lower than elsewhere in EBRD's countries of operations. The reduction of barriers for the entry of new enterprises remains a significant challenge. Table 2 summarises the sectoral transition gaps:

Table 2: Summary of sector gaps

	Structure and extent of markets	Market-supporting institutions and policies
FINANCIAL INSTITUTIONS		
Banking	Medium	Large
NBFI	Medium	Medium
MSMEs	Large	Medium
Private equity	Medium	Medium
ENTERPRISE SECTOR		
Agribusiness	Medium	Medium
General industry	Large	Large
Natural resources	Medium	Large
Property/Tourism	Medium	Small
Telecoms	Medium	Medium
ENERGY & INFRASTRUCTURE		
Sustainable energy	Large	Large
MEI	Large	Large
Power	Medium	Medium
Transport	Medium	Medium

Note: The two categories – structure and extent of markets and market-supporting institutions and policies – are those used by the EBRD to assess the transition impact potential of its projects. Kazakhstan is mapped against these two broad dimensions to determine how large the remaining challenges are in each of the 12 sectors in which the Bank operates. The scale goes from negligible, to small, medium and large. 'Negligible' means that the remaining challenges are minor and that the sector is well advanced in moving towards a well-functioning market economy. 'Large' means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

Financial institutions

Banking

Kazakhstan was the first transition country to be directly impacted by the crisis in the international financial markets in 2007. After years of rapid growth in bank lending, fuelled by foreign borrowing, credit growth came to an abrupt halt. The state has significantly increased its involvement in the banking system, not least through taking minority and majority stakes in several systemic banks. The global financial crisis has not merely led to a (temporary) reduction in the external funding available to Kazakh banks. The crisis has also exposed a number of underlying and deeper vulnerabilities of the banking system that need to be addressed through a phase of deep restructuring. In particular, on the liability side of the banking system, the crisis has demonstrated that the excessive external wholesale funding of several Kazakh banks is not a sustainable business model. Banks will need to start relying more on domestic funding, in particular by expanding their deposit base. On the asset side, the crisis has shown that Kazakh banks have only to a limited extent been able to successfully intermediate their (ample) foreign funding into a diversified portfolio of profitable domestic projects. Instead, many banks built up an over reliance on a limited number of sectors, in particular in construction and real estate and mortgage lending. These weaknesses also imply that risk management in and corporate governance of Kazakh banks, while high in comparison to other Central Asian countries, have been less sophisticated than previously thought. Finally, the crisis has exposed the limitations of the financial supervisor. The long-awaited Anti-Money Laundering Law was finally adopted by both Chambers of the Kazakh Parliament in June 2009 and signed by the President in August 2009.

Insurance and other non-bank financial services
The legislative framework for insurance almost meets the IAIS standards, although the regulator is not perceived to be fully independent and its enforcement capacity needs further strengthening. The insurance market remains relatively small. The development of private pensions has taken off in recent years, with mandatory pension schemes operated by privately managed funds. Pension fund legislation requires further revisions, in particular in the areas of investment guidelines, fee structure and compensation related to investment returns. The state-owned pension fund management company is yet to be privatised. The scale of leasing operations remains limited.

Access to finance for micro, small and medium-sized enterprises (MSMEs)
Improvements are needed to ensure a more efficient delivery of financing to MSMEs. A special focus should be on enterprises located outside Almaty and Astana as most banks and their branch networks remain focused on catering to MSMEs in the two main cities. The implementation of bankruptcy laws remains an important challenge. A geographically unified collateral registry is in place and credit information services are provided by a private credit bureau. The financial crisis has increased aversion to lending to the MSMEs in the country.

Private equity and capital markets
The securities legislation continues to show some serious weaknesses. A private equity culture is slowly (re-)emerging, with two relatively well-run private equity funds now established in the country, and with some cross-border activity of Russia-based funds. The government remains involved in the private equity sector through the National Innovation Fund (NIF), and its six venture sub-funds, and the Investment Fund of Kazakhstan (IFK). The main challenge is to allow further entry into the industry, to make (potential target) companies more transparent, and to limit government involvement in the sector. While total trade volume on the Kazakhstan Stock Exchange (KASE) is substantial, most trade is in repos and FX. Equity capitalisation and turnover are very low and local issuance of equity as a source of finance remains unattractive.

Enterprise sector

Agribusiness
While the agriculture sector is relatively developed compared to the rest of Central Asia – for instance, only Kazakhstan has a functioning warehouse receipt programme in place – quality standards and control remain largely inadequate, competition and restructuring remains slow, the necessary transport infrastructure is often lacking. The competitiveness of the agricultural sector is negatively affected by the high degree of land fragmentation that results from the land privatization process. The new Land Code, in combination with a functioning warehouse receipt programmes, allows for the collateralisation of land. Quality standards and control (in particular in the dairy and meat sector) are inadequate, which is a major bottleneck for the development of a modern livestock food chain. The lack of appropriate infrastructure affects the sector

along the whole food value chain. Kazakhstan suffers from the underdevelopment of transport and storage infrastructure, in particular the lack of specialised wagons for cereal shipments, as well as out-of-date assets for storage and processing. Due to the lack of adequate transport infrastructure connecting the south and north of the country, the fruit and vegetable production potential in the southern areas cannot be realised. Modern retail is still in early stages of development.

General industry
In recent years, strong growth in domestic demand buoyed by very rapid credit growth in the natural resources sector and a boom in the construction sector has supported the development of general industry, especially in those sectors with high transportation costs such as construction materials. A number of companies have raised capital through overseas listings, which has somewhat improved transparency and corporate governance standards. Disclosure of beneficial owners however, remains a problem and local corporate governance legislation requires further improvements. Privatisation of large enterprises has stalled for some time and the appetite of the government to set and implement industrial policy has increased. So far state activism has not improved productivity and business standards. The reduction of barriers for the entry of new enterprises remains a significant challenge.

Natural resources
In the natural resource sector, the state remains in control through the prevalence of unreformed and non-transparent state companies. Low tariffs together with slow progress in enterprise restructuring mean that energy efficiency challenges remain huge, particularly in the industrial sector. Kazakhstan has the largest recoverable crude oil reserves in the Caspian region, significant gas reserves and extensive mineral resources (uranium, chromium, lead, zinc, manganese, copper, coal, iron, and gold). The growing petroleum industry accounts for some 30 per cent of the country's GDP and more than half of its export revenues. Coal is the dominant fuel, accounting for half of primary energy demand, followed by gas and oil. KazMunaiGaz (KMG), the vertically-integrated state-owned oil and gas company, plays a key role in the oil and gas sector. The pipeline network remains generally underdeveloped with limited export options and few current connections, which limits competition for export. KMG owns and operates almost two thirds of the country's refining capacity, as well as a large share of the fuels distribution segment. IOC involvement is extensive upstream, but in partnership with the state using the PSA approach. The regulatory regime in the oil and gas sector remains challenging. A law concerning Caspian Sea PSAs was passed in May 2005 by the parliament, limiting foreign participation in such ventures to 50 per cent with no guarantee of operator status. In addition, KMG acquired pre-emption rights over the sale of strategic assets. In November 2007, further amendments to Kazakhstan's subsoil law established that the government will be free to cancel oil projects if developers do not meet their contractual obligations. Limited progress has been made in terms of tariff reform, while tariff streams remain non-transparent. No PSA has been published. A large number of companies have signed up to EITI in Kazakhstan and the government should provide strong encouragement to all extractive companies to participate in EITI and follow its requirements. The National Oil Fund is largely transparent and well defined, but audits are not published.

Property and tourism

After a boom in Kazakhstan's construction industry between 2005 and 2007, capital inflows and construction of residential property have come to a sudden stop due to the global financial crisis. As a result, property prices are declining and nonperforming loans are rising despite large-scale government support for the construction sector. The long-term growth potential in the commercial property sector remains strong due to the lack of modern warehousing stock, high quality office space and modern retail formats especially in regional cities. In the tourism sector, the demand for international standard hotel rooms with high quality management and service levels, particularly for mid-range hotels, remains unfulfilled. A new law introduced substantial changes to the property registration system, creating a unified registry for all land and buildings and establishing public service centres to handle property transactions in major cities. The process for obtaining construction permits remains inefficient, non-transparent and very costly. Foreign citizens and legal entities can own property, but ownership of agricultural land is limited to residents of Kazakhstan and legal entities established under Kazakh law, including those that are fully or partially owned by foreign persons.

Telecommunication

Kazakhstan's telecoms regulator is an independent body, responsible both for policy and regulation, but there is a high degree of political interference in decision-making processes. The government holds a 51 per cent stake in Kazakhtelecom which still dominates 90 per cent of the fixed-line market. In July 2007, the Agency for Natural Monopolies Regulation approved tariffs for Kazakhtelecom's connection of IP-telephony operator networks to the Public Switched Telephone Network (PSTN) as well as for transit of related IP-telephony traffic. A new mobile operator, NeoTelecom, a subsidiary of Kazakhtelecom, launched its mobile service in early 2007 as the fourth mobile network operator. The Internet is one of the fastest growing segments of the telecoms market, but its uptake has been hindered by inadequate local infrastructure.

Energy and infrastructure

Sustainable energy

Together with Ukraine and Uzbekistan, Kazakhstan ranks among the most carbon intensive countries among all parties to the UN Framework Convention on Climate Change (UNFCCC). Low tariffs and slow progress with enterprise restructuring mean that energy efficiency challenges remain huge, particularly in the industrial, municipal and residential sectors. A law on supporting renewable energy was signed by President in 2009, but needs to be supplemented by core legislation to be effective. The Government of Kazakhstan and the EBRD launched a Sustainable Energy Action Plan (SEAP) in June 2008 to promote the conservation and rational use of energy resources as well as the efficient and sustainable supply of power and energy. An important SEAP element is to work towards a system of financial incentives for rational energy use, through tariff regulations for electricity and heat that cover all justified costs, including those of carbon and local emissions. As yet, energy tariffs remain low, some are still not costs reflective, and generally do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently. Incentives to improve environmental and energy performance up to the best available technique (BAT) standards are also not fully embedded in the traditional regulations, such as laws on environmental permitting. The new renewable energy legislation is expected to introduce feed-in tariffs, a power purchase obligation and priority dispatch, but project developers may remain concerned for some time about its enforceability. Practical implementation will need to demonstrate that project developers can count on transparent, fair and predictable tariffs, access to the national grid, and licensing procedures. Kazakhstan has signed and ratified the Kyoto protocol. Remaining challenges include the creation of legal framework for energy efficiency, the development of project development capacity, and the introduction of an adequate RE legal and regulatory framework to attract project developers. Further increases in energy tariffs and gradual introduction of environmental cost to energy prices (e.g. through carbon/energy taxes or cap-and-trade systems) are also needed to provide incentives for a more efficient energy use and RES development.

Municipal and environmental infrastructure (MEI)
Most water and district heating services are owned and operated by municipalities but without transparent contractual arrangements between the companies and the owners. Economic regulation of tariffs is undertaken by an autonomous national regulator (Agency for Regulation of Natural Monopolies) and its regional branches, overseeing all utilities across the country. While regulatory legislation is relatively good, political interference in the regulatory process remains significant. Although tariffs can be set at cost recovery level (legally) in practice they are mostly below cost recovery and water/waste water and district heating companies are loss-making. There is one private water/wastewater company (Shymkent) with relatively good operational performance. In urban transport, trams, trolley-buses and in some cases large public buses are owned by municipalities and operated by unreformed municipal transport entities. The companies are largely loss-making as tariffs are regulated by municipalities (political considerations are significant). There is noteworthy private sector participation in bus and mini-bus services, which operate without subsidies.

Power
The power sector has been unbundled, commercialised and partly deregulated. Generation is still dominated by state owned companies (60 per cent of total capacity), while distribution companies have been partly privatised. In 2007, the government re-bundled all state shares in generation into SK. This notwithstanding, so far private generation companies have been granted non-discriminatory access to the national grid. The sector regulator regulates transmission, distribution and end-user tariffs, while wholesale tariffs which used to be largely unregulated are now subject to considerable de facto regulation. The institutional capacity and independence of the regulator is weak and there is significant government interference in the regulatory process.

In 2008, a price-cap regime for different types of generators was introduced which combines a base rate with individual investment tariffs for generation plants which have committed to approved investment programs. Neither these efforts of centralised planning nor partial deregulation of wholesale generation market have generated appropriate price signals to stimulate investment in much needed new generation capacity. Government recognized the need for market based mechanisms that provide effective incentives to investors to deliver new generating capacity. Therefore, remaining challenges include introduction of an incentive-based distribution tariff methodology and establishment of a competitive generation market attractive to new independent investors that could bring new capacity and rehabilitate old, inefficient and polluting plants. A remaining challenge is also to provide regulatory and price incentives to the state owned and private thermal generators to undertake projects up to the best available technique (BAT) standards, despite higher initial capital costs and lack of local technical experience with BAT technologies such as CCGT or super-critical. Renewables legislation is yet to be developed in line with best international practice, and the current regulatory framework does not enable private investments in tapping the country's significant potential of renewable energy.

Transport
A Railway Law was enacted in 2001 and the Kazakhstan State Railways (KTZ) was incorporated as a joint stock company in 2002. The core railway businesses have been largely unbundled and ancillary services have been divested, but institutional restructuring is still ongoing. There is limited private sector participation (e.g. provision of wagons) from domestic operators, but there is significant presence of foreign (mainly Russian) operators. A price regulator (AREM) was established but is still not fully independent. Railway labour productivity is relatively high but it is still lower than at the beginning of transition. The Kazakh authorities signed a MoU with the EBRD to collaborate on reform of the railways and the restructuring of the national railway company Kazakhstan Temir Zholy with a focus on the refurbishment of rolling stock, including acquisition of wagons and locomotives, including through private sector participation. In roads, construction and periodic maintenance of state roads are contracted out to the private sector. Foreign companies are increasingly involved especially in the construction of major road projects. Road user charges have increased significantly and cost recovery (excluding capital costs) was achieved. Nevertheless, a state-owned company still monopolises the routine maintenance market. Contracts with road authorities could be improved. The ongoing PPP projects were subject to open tender, but it is important they are closed in a commercial and transparent manner.

2.3 Access to capital and investment requirements

After years of access to cheap borrowing from a wide variety of international (investment) banks as well as bond issuance, Kazakh banks and other companies are now cut of from most international borrowing. This means they are mostly unable to automatically refinance upcoming repayments, which has resulted in a painful process of de-leveraging.

The payment default by BTA, Alliance Bank and Astana Finance, and the subsequent need for debt restructurings is a major issue for the banking sector and the country as a whole. The extent to which banks and their creditors can reach a reasonable agreement will determine when Kazakh companies will be able to re-access the international capital and debt markets. With the 'Western' (investment) banks ruled out as a viable funding source for the time being, the Kazakh government has started an ambitious program of quasi-sovereign bilateral borrowing, the funds of which will be used to find the Kazakhs increased drive for an industrial policy. Among the main deals is a USD 10 billion loan from China, half of which will be channelled to the Development Bank of Kazakhstan (DBK). The other half will be used by state oil company KMG to buy –jointly with the Chinese government – a stake in the privately-owned MangistauMunayGas (MMG) oil company. Two other large deals include a USD 3.5 billion loan from Russia’s Vnesheconombank a USS$ 1 billion for a greenfield Islamic bank from the UAE.

FDI has proven rather resilient to the crisis as investment by oil and gas majors continues in the Tengiz, Kashagan and Karachaganak fields. Outside the hydrocarbon sector, investments from a number of Western, Asian and Middle-Eastern countries are expected to flow in as well.

In May, Standard & Poor's revised the outlook on Kazakhstan's sovereign ratings to stable from negative (BBB-minus for FX debt), saying it expects the government to limit potential liabilities arising from the banking system without compromising its fiscal position. In June, Fitch Ratings followed suit by affirming Kazakhstan's FX debt rating at BBB minus and removed it from rating watch negative, mentioning that the risk of a significant impairment of the sovereign's finances in the near term arising from the failures of two large banks has receded, while depositor confidence has proved reasonably robust to the bank failures and February's currency devaluation.

3. OPERATIONAL PRIORITIES

3.1 Bank’s Priorities for the Strategy Period

In contrast to the preceding strategy period, which began at the peak of the economic boom and ended in the midst of a recession, the new strategy period commences at a low point in the downward cycle, and encompasses the initial phase of the forecast recovery. The Bank’s strategic priorities thus reflect both the immediate need to help Kazakhstan weather the tail-end of the crisis, and the medium-term objective of helping the country tackle systemic deficiencies in the financial system and the real economy through institutional change, thus setting the course towards sustainable development.

The following four **primary** strategic priorities will guide the Bank’s business:

- **fostering diversification of the economy** through *inter alia* focusing on supporting value-added industries, including via promoting FDI, and supporting financial restructuring of economically-viable companies, including through participation in commercially-oriented investment funds;

- **contributing to the transformation of the financial sector** through shoring up partner banks’ Tier I and II capital, working with the restructured systemic banks, including helping them to restore private ownership, contributing to the development of local capital markets, and helping to bring about pension reform;

- **fostering modernisation in the infrastructure sector** by facilitating restructuring of the national railway company, and supporting viable PPP’s in the road sector, as well as by broadening the Bank’s new involvement in the municipal sector; and

- **implementing the Sustainable Energy Action Plan in the power and energy sector** through investment in modern and “clean” generation and transmission companies.

The Kazakh state's historical involvement in the economy has increased further with the crisis, currently amounting to over forty-five per cent of the GDP, and is unlikely to abate significantly in the new strategy period. With this in mind, while supporting the private sector will remain the Bank's first priority in the new strategy period, it will be vitally important for the EBRD to develop an appropriate level and form of **engagement with the National Welfare Fund Samruk-Kazyna** (which is a not a sovereign wealth fund, as the name may seem to suggest, but a state holding, through which the Kazakh State exercises ownership of national companies operating in a wide variety of sectors) (please, refer to section 3.3 for detailed discussion on co-operation with Samruk-Kazyna)

The Bank's success in reaching some of the above-stated objectives will undoubtedly depend on the authorities' political will to implement the necessary structural and institutional changes in the economy. With that in mind, the Bank will expand and intensify its policy engagement with the authorities, which will continue to be carried out on several levels – from sector reform, such as the transformation of the Kazakh banking system and the implementation of the Sustainable Energy Action Plan in the power and energy sector, to fostering a favourable investment climate and enabling environment for the private sector, through bilateral discussions and participation in the Foreign Investment Council. The Bank will co-operate with other IFIs active in Kazakhstan both in political dialogue and investment activities.

3.2 Sector Challenges and Objectives

3.2.1 Primary Priority Sectors

Enterprise Sector

In supporting Kazakhstan's enterprise sector the Bank will continue to pursue its main strategic objective to assist Kazakhstan in diversifying its economy. In the near term, this strategy will incorporate anti-crisis measures to help companies in value-added industries weather the downturn. To this end, the Bank's approach, which has traditionally emphasised capital expansion, will include rapid-response support for existing clients and creditworthy new borrowers, including provision of working capital, equity and balance sheet restructuring.

While emphasising immediate measures to combat the crisis, the Bank will pursue the overarching objective of supporting sustainable growth of the corporate sector, through promotion of diversification and targeting the enduring transition gaps in each sector. The Bank's efforts may be enhanced by the Government's five-year diversification programme. The EBRD may thus consider co-operating with the Government in co-financing some of the priority projects (with other private investors and/or the Government's own financing arms, such as the Development Bank of Kazakhstan) conditional on commercial viability and "bankability", compliance with EBRDs integrity standards, and compliance with the Bank's transition mandate.

The Bank's activities in the corporate sector are intertwined with its support of Kazakhstan's financial sector. Through its partner banks, the EBRD will continue its traditional support of MSME's, which have particularly suffered during the crisis, with an emphasis on supporting those in the regions, and will also provide financing for energy-efficiency projects. The Bank will evaluate different options for supporting micro- and low-end small enterprises, including through launching a dedicated micro-lending institution, whether through establishing a wholly new bank or transforming an existing bank. The Bank will also continue to contribute to the development of Kazakhstan's capital markets by taking equity stakes in Kazakh corporates either directly or through participation in investment funds.

The Bank will continue to promote its already extensive TAM/BAS advisory services in Kazakhstan, as well as strengthen their links with Banking.

The following industry sectors offer likely opportunities for strategic investment and institutional development:

Agribusiness: The Bank will continue to support this sector with a view towards further development of the entire value chain and will seek bankable opportunities in value-added segments, such as agrochemicals, modern dairy, packaging materials, and organised retail. In primary agriculture, the Bank will selectively support transparent grain produces and traders of integrity. To that end, the Bank will promote adoption of IFRS audit and consolidated legal structure for large traders. The Bank will foster initiatives where agribusiness-related activities are strengthened by investments in infrastructure projects (such as grain terminals, logistics and distribution centres, storage facilities or shared environmental facilities, such as the use of biomass for energy, shared water treatment facilities, etc), the lack of which represents one of the key transition gaps in the sector.

***General Industries*:** opportunities in the sector are relatively scarce, as Kazakhstan's economic development is skewed towards primary industries, but are important to further the goal of economic diversification, as well as of promotion of FDI in the non-oil sector. In this regard, the Government's recently adopted Five-Year Diversification, Industrialisation and Innovation Programme, which was conceived as an extension of the Government's crisis response programme, may present a window of opportunity for the EBRD to ramp-up its engagement in the sector. To that end, the Bank will seek to support potential foreign investors and local companies in the sub-sectors that GOK has designated as priority for the industrialisation and diversification purposes, and which are **also** those on which the Bank has historically focused in its engagement in the GI sector. These are basic construction materials (e.g., cement, asphalt, rock-wool, concrete), chemicals (particularly those utilised in the country's oil sector and metallurgy), fertilisers, pharmaceuticals (production, wholesale and retail), basic metal constructions (mostly producing basic components for the hydro-carbon industry, such as tubing), and rail transport components (freight wagons and components, as well as locomotives, production of which has recently attracted reputable foreign partners, such as General Electric).

Given the relative paucity of viable investment opportunities in existing industrial and manufacturing companies, many of these opportunities will likely present themselves in the form of green- and brown-field projects, which the Bank will consider subject to strong and high-integrity sponsors, proven technology, competent management, reasonably assured off-take, and viable financial structure. The Bank will also work with local commercial banks to identify existing companies in need of working capital and refinancing as a result of the financial crisis. Given the relatively small size of the sector, the Bank will also consider scaling–down in order to support smaller GI projects on a selective basis.

Financial Sector

Support of the financial sector will remain a leading priority for the EBRD, both during the financial crisis and the post-crisis economic recovery period. In the near term, the Bank will seek to support its main partner banks throughout the crisis, including *inter alia* through provision of equity and quasi-equity, senior debt, and trade finance facilities, and will position itself to assist partner banks in consolidation of the sector, should it ensue. With the syndication market unlikely to recover in the near-term, a certain scaling-down of the magnitude of support that the EBRD can mobilise should be expected.

The Bank has already started to co-operate with the National Bank of Kazakhstan and other relevant regulatory bodies to help formulate a new strategy for the development of a sustainable financial sector in Kazakhstan as well as to implement that vision via targeted investment and technical assistance, targeting structural deficiencies in the sector. In particular, the Bank will seek to contribute more to the development of the **domestic capital markets** through the following key elements:

- Helping develop longer term local currency funding and lending instruments jointly with the central bank and the regulator. While the Bank's ability to provide long-tem foreign currency financing to Kazakh banks makes it particularly additional in the crisis period in order to help the authorities strengthen the banking sector, and in line with the Bank's own recommendations to that effect, it is of particular importance that the EBRD develop meaningful local-currency lending capability and stimulates Kazakh banks to further deepen their deposit base.

- Support of the pension funds system and promoting pension sector reform. To that end, the Bank will continue to champion privatisation of the state-owned pension fund management company, GNPF

- Providing continuous support to local private equity funds, in order to develop a sustainable private equity sector

- Strengthening of the institutional capacity through technical assistance, and

- Supporting the authorities in their efforts to strengthen banking regulation and the monitoring activities.

Development of local currency money and capital markets will be part of the Bank's regional strategy to support the development of local currency money and capital markets in its countries of operations.

The Bank will continue to provide support to viable and systemically important banks via new debt, equity and quasi-equity products. The Government's temporary take-over of some of the systemic banks may afford opportunities for the EBRD to re-engage through investment and provision of technical assistance. To that end, the EBRD will work with the authorities to develop sound business practices and management teams with the intention to return these banks to the private sector. While support of SME's will continue to drive the use of the Bank's funds, additional opportunities to expand EBRD's relationship with its partner banks will be afforded by new products, such as the Kazakhstan Energy Efficiency Framework Facility. Support of trade finance through Trade Facilitation Programme (TFP) will remain an important component of the Bank's engagement. The EBRD will also look to establish a dedicated microfinance bank to address the endemic lack of funding available to the sector.

The Bank will seek opportunities to support funds or other institutions that have expertise in restructuring balance sheets of corporates that have become financially distressed as a result of the economic crisis.

It should be noted that at some point during the new strategy period the Bank's exposure to Kazakh partner banks may reach a level at which it will be more difficult for the EBRD to engage, as the universe of its partner banks is unlikely to increase, due to the high degree of concentration in the banking sector. It will be therefore even more vital for the EBRD to seek opportunities to expand its engagement with ***non-bank financial institutions*** in Kazakhstan, including leasing and insurance companies, and non-bank micro-lenders. To that end, the Bank will support financial services, including insurance and pension funds, which are still at an early stage of development in Kazakhstan. Immediate opportunities in the leasing sector, on the other hand, appear limited due to the specifics of the local market.

The Bank will support development of ***domestic capital markets*** through *inter alia* promoting pension reform. To that end, the Bank will continue to champion privatisation of the state-owned pension fund management company, GNPF. The EBRD will also provide continuous support to local private equity funds, in order to develop a sustainable private equity sector. The Bank will seek opportunities to support funds or other institutions that have expertise in restructuring balance sheets of corporates that have become financially distressed as a result of the economic crisis.

Sustainable Energy and Infrastructure

Power and Energy: the Bank's strategy for this vital sector, which is still suffering from a number of transition gaps, is underpinned by Sustainable Energy Action Plan (SEAP), the main components of which comprise institutional development, sector reform, and adoption of best practices as a basis for the Bank's financial involvement, including:

- Review and improvements of draft legislation
- Strengthening of regulatory agencies and specialized bodies
- Tariff levels, metering and methodology improvements
- Focus on priority investments and financings

While pro-actively seeking to help bridge regional energy imbalances and alleviate endemic power shortages in the country, the Bank will be thus selective in its investment strategy, and will channel financial investment into projects that comply with SEAP and support the transition to a low carbon economy by meeting the following key selection criteria:

- Utilise the best available technique (BAT) structured to meet EU environmental and energy efficiency performance for new and existing coal-fired power plants with strong industry sponsors

- Utilise associated gas, reduce gas flaring and improve efficiency of gas-fired power plants beyond current standard practice in the sector;

- Target significant efficiency improvements and power supply reliability through rehabilitation of existing plants or construction of new plants;

- Reduce commercial and technical losses, and improve efficiency in electricity and gas transmission and distribution networks

- Support renewable energy generation, namely mini-hydro and wind projects.

Activities in the area of renewable energy and climate change will form an integral part of the Bank's energy strategy and its operations across all sectors. The Bank will seek to support projects in renewable energy, primarily in mini-hydro and wind projects, which have the biggest potential in Kazakhstan. Recognising that many of the renewable energy projects are likely to be relatively small, the EBRD will use energy efficiency credit lines and may develop financing instruments under a framework facility similar to the Direct Lending Facility used in ETC countries or in Western Balkans. The Bank will continue to work with its partner banks to expand their participation in the Kazakhstan Sustainable Energy Financial facility (KazSEFF), which is targeted at energy efficiency elements in projects in such sectors as GI, agribusiness, natural resources as well as small renewable energy projects. Seeking to yield tangible benefits for Kazakhstan's from its recent ratification of the Kyoto Protocol, the Bank will work to develop Carbon Finance investment projects if Kazakhstan becomes eligible to host such projects. The Bank will aim to bring about additional incentives to save energy, such as creating financing structure for investments in public buildings to save energy and creating markets for energy efficiency companies.. The Bank will work to launch ESCO's in Kazakhstan, for which purpose it has already engaged consultants.

The Bank will seek opportunities to utilise concessional funds under the Clean Technology Fund (CTF), under which USD 250 million is available for Kazakhstan, to leverage private financing of sustainable energy projects in a non-distortionary way.

Implementation of the institutional component of SEAP will continue to form the basis for the policy dialogue in the sector, and will be supported by technical assistance. Thus the Bank will focus on strengthening regulatory agencies, such as appointment of an independent sector regulator, and will continue to champion adoption of viable tariffs via tariff methodology improvements. The Bank will continue to assist in the development of the Renewable Energy Law and Energy Efficiency Law, support development of a framework for thermal power plants rehabilitation, and sponsor a least-cost study for generating companies. The Bank will support strengthening regulations and policies that support market penetration of best available techniques in the power sector. In the area of climate change, the EBRD will seek to contribute to the development of the Carbon Finance Framework under the Kyoto Protocol, following which it will move to help Kazakhstan establish national carbon finance legislation. The Bank will seek to disseminate examples of best practices between its partners through sponsoring work-shops and round-tables.

Natural Resources: Although singularly important for Kazakhstan's economy, the sector is one where the Bank's engagement to-date has been relatively limited, owing primarily to the prevailing lack of transparency in the extractive industries, particularly the hydrocarbon segment. Kazakhstan is, however, committed to implementing EITI and has made significant progress to that end. The EITI Board will consider the results of the independent validation in 2010 to decide whether Kazakhstan is eligible to be given 'Compliant Country' Status. In the mean time, the Bank will seek to ensure that all projects financed in the extractive industries meet the requirements of the EITI. In particular, the EBRD will selectively pursue projects that increase private sector participation and transparency, demonstrate operational and energy efficiency benefits and improve environmental standards, as well as health and safety. In particular, the Bank will pursue debt and equity participation in private sector upstream E&P and mining companies, will engage with local partners to promote good governance, including disclosure of payments made to the Government, support properly-structured joint venture arrangements, support introduction of new environmental practices and technologies, in particular measures to reduce environmental imprint of extractive industries and reduce externalities, such as gas flaring. Additional emphasis will be made on projects with energy efficiency improvements

As part of the policy dialogue in the sector, the EBRD will seek to support measures in public law and in business practice of public enterprises to increase fairness and openness of access, stability of contracts and regulatory process and protection of minority rights, including stable PSA legislation, consistency of application of Local Market Obligation and reduction/elimination of price differentials, improvements in openness of public procurement and tariff regulations for the sector.

Transport: as **first priority**, the Bank will stay actively engaged with the railway sector, which is undergoing transformation, underpinned by the ongoing reforms and restructuring of the national railway company, KTZ, through provision of financing and technical assistance to its freight and container subsidiaries. Following a programme approach to KTZ, the Bank will pursue opportunities in refurbishment of rolling stock, including acquisition of wagons and locomotives, which would also encourage private sector participation.

The Bank will also continue to seek opportunities to engage in road PPP's, to which end it is providing technical assistance to the Ministry of Transport and Communications and the PPP Centre of Kazakhstan to develop quality concessions. In parallel, the Bank will work with potential bidders to explore the possibility to provide financing to the concessionaire. In doing so, the Bank works closely with other IFIs, in particular with the ADB and the World Bank. In exceptional cases, e.g., where warranted by considerations of regional integration and improved links with Kazakhstan's large neighbours and trading partners, the Bank may consider rehabilitation and development of life-line international corridors, for which sovereign support would likely be required, provided the financing package is accompanied by sector reform. To that end, the Bank will seek to co-finance with other IFIs and coordinate policy advice and technical assistance.

Policy Dialogue in the transport sector will focus on supporting the ongoing reform in the railways sector, underpinned by the restructuring of KTZ, including corporate governance and anti-corruption measures, as well as promoting private sector participation in the road maintenance, and promotion of viable PPPs, including through technical assistance, with the goal of helping the Government maximise value for the money by avoiding short-cuts, while promoting transparency and a level paying field for concessionaires and operators. In the marine and aviation sectors, the Bank will seek to promote competition and private sector participation in ports and airports.

MEI: in this sector, the focus will be on investments which bring operational and financial improvements, including energy efficiency improvements and improved environmental standards. As its **first priority,** the EBRD will continue to pursue municipal projects, largely based on project support agreements with the Kazakh municipalities (whereby relevant sub-sovereign authorities would commit to provide capital support to their municipal services companies for credit enhancement purposes) due to their legal inability to borrow or guarantee third party debt. The Bank will look to assist eligible municipalities with bond issuance to finance priority infrastructure projects. In parallel, the Bank will provide input to the Government's plans for reforming the municipal sector.

As part of policy dialogue and institutional development in the sector, the EBRD will support the Communal Services Sector Reform, which may include development of a new Law on Communal Services, procedures for supporting eligible projects from the Communal Services Fund, development of alternative mechanisms for financing sector projects, procedures for PPPs in the communal services sector, and improvements in tariff regulation.

3.2.2 Secondary Priority Areas

The Bank will consider engagement in the following sectors, as well as in certain segments of the previously discussed priority sectors, subject to availability of resources, and in cases where such engagement would demonstrably contribute to closing the transition gaps, as follows:

Telecom, Informatics and Media (TIM): the Bank will consider financing innovative and technology driven business, In particular, the EBRD will entertain bankable projects aimed at developing infrastructure for Broadband Access, both cable and wireless, and will support further development of fixed and mobile telephony. The EBRD will selectively consider financing of private advertising channels, including in printed media, commercial entertainment TV, and outdoor advertising, particularly where it promotes a level playing field and competition in the sector. In the informatics segment, the Bank will seek projects aimed at integration.

Property and Tourism: the Bank will consider supporting development of modern office and retail space, particularly in the regions, and residential space aimed at the middle-class, and business- and tourist-class hotels and apart-hotels, particularly outside the two main cities, with financially strong and experienced sponsors and professional management companies with a track record in the region.

In Transport*: secondary priorities* within the otherwise first priority Transport Sector include the **maritime segment**, where the EBRD will look to support port operators servicing Caspian off-shore operators, including as part of the envisaged Kazakhstan-Caspian Transportation System, such as Kuryk, if proved potentially viable. Additional opportunities with shippers may develop as Transcaspian Transport System comes on-stream. Opportunities in **aviation**, including airports, are likely to be even more sporadic and relatively limited due to the opacity of ownership and less-than-efficient structure within Samruk-Kazyna (e.g., it may be necessary to bundle all airports into one holding company). Projects with transparent ownership and reputable operators will be selectively considered. Additional opportunities may exist in aircraft financing, including leasing, for private operators.

In MEI: as its *second priority* within the sector, the Bank will consider opportunities to engage with **private operators** to promote good governance and operational efficiency, and, having preliminarily identified a number of interested potential private operators, would aim to support properly-structured PPPs, where appropriate.

3.3 Engagement with Samruk-Kazyna and National Companies

With the Kazakh State as its ultimate beneficial owner, the National Welfare Fund Samruk-Kazyna controls close to 50 percent of the country's GDP through whole or partial ownership of entities, including wholly-owned national companies, in the following areas:

- Finance (e.g., Development Bank of Kazakhstan, Kazyna Capital Management Damu, Investment Fund of Kazakhstan, etc)
- Power and Energy (e.g., KEGOC, Samrukenergo)
- Oil and Gas (e.g., KazmunaiGaz)
- Metals and mining (e.g., Tauken-Samruk, Kazatomprom)
- Chemicals and pharmaceuticals (e.g., United Chemical Company, SK-Pharma)
- Infrastructure (e.g., national railway company KaztemirZholy, national maritime shipping company Kazmortransflot, Air Astana, several airports and ports)

While abstaining from engagement at the holding company level, the Bank will selectively pursue opportunities for co-operation with Samruk-Kazyna at the individual project level, including in the finance, corporate, transport and power sectors. This will only be done when deemed consistent with the Bank's transition mandate, i.e. in situations where such projects are fully based on sound market principles and where the Bank's involvement contributes to greater commercial viability, higher standards of corporate governance and transparency, and subject to the usual integrity considerations. Power sector projects, in particular, will need to be undertaken on a fully commercial basis, without compromising competition among generation companies and must be structured to meet EU BAT standards to deliver demonstration effects of new replicable efficiency and environmental performance presently unknown to the sector.

In working with Samruk-Kazyna, the Bank will thus aim to develop the basis for eventual diversification of ownership of the economy by promoting sector reform (as witness the Bank's involvement in the restructuring of the national railway company, KTZ), supporting commercialisation, improvement in corporate governance, procurement practices, as well as utilisation of modern and environmentally-friendly technologies in the state-controlled segment of the power and energy sector (as in the rehabilitation of Actobe CHP, owned by SK's energy subsidiary, Samrukenergo), even in those cases where privatisation may not be imminent, but sector reform is proceeding nonetheless (as in the Bank's support for the restructuring of KTZ), or transition gaps are being narrowed via modernisation (e.g., alleviation of the North-South energy gap via the Bank's support of the state-owned transmission company's investment programme), as well as in those where it is likely (e.g., in the power sector, where privatisation of state-owned generating companies, including Actobe CHP, is envisaged).

The EBRD will also selectively consider possibilities to co-finance with such SK-owned institutions as the Development Bank of Kazakhstan, as well as through co-investing with SK in investment funds, provided this cooperation strictly meets the EBRD standards of due diligence, transparency, corporate governance, integrity, and provided that such co-investments are additional and do not interfere with the activities of the private equity sector in the country.

4. CO-OPERATION WITH OTHER IFIS

The Bank will continue to co-operate and co-ordinate with other IFIs active in Kazakhstan (the World Bank, IFC, Asian Development Bank, Islamic Development Bank) in its policy dialogue efforts and in seeking opportunities to mobilise IFI co-financing particularly in the infrastructure sector, where opportunities for commercial financing are currently limited.

One of the more salient recent examples of the IFI co-operation in the infrastructure sector in Kazakhstan is the Western China–Western Europe Road Project., a life-line corridor connecting Kazakhstan with its two big neighbours, Russia and China, which was co-financed jointly by the EBRD, the World Bank, IDB and ADB. Although, in the new strategy period, the EBRD will not actively pursue sovereign projects as a matter of priority, except in certain defined cases, there are other opportunities for co-operation in the infrastructure sector, particularly in the area of PPP's, and renewable energy. In that regard, one of the key areas of IFI coordination will be the improvement of legal framework for PPP projects, as well as the Energy Efficiency and Climate Change topics, including co-operation with the World Bank's Clean Technology Fund.

The Bank will look to continue to co-operate with ADB on infrastructure projects, both transport and power/energy, as well as in the area of municipal infrastructure and utilities. Additional co-operation with ADB is possible on selected private sector transactions in oil and gas services sector (with focus on environmental improvements) and manufacturing. In addition, the EBRD will continue to co-operate with ADB within the framework of the Foreign Investors Council to develop an environment conducive for the private sector.

As IFC continues to increase its presence in Kazakhstan, the Bank will seek opportunities for co-operation in power and energy, infrastructure, agribusiness (food processing as well as primary agriculture going forward), and other industries. An example of successful coordination with IFC to-date is EBRD's equity investment in the leading private power generation and distribution group CAPECO, where IFC intends to follow EBRD's example and co-invest into this company.

The EBRD has likewise cooperated with the IMF and the World Bank on macroeconomic and financial sector development issues, such as the development of financial sector in Kazakhstan. As Kazakh authorities develop a new concept for the country's financial sector, the Bank will look to co-ordinate with IMF in its policy advisory endeavours.

The Bank has extended its co-operation with UNDP into the area of climate control and energy efficiency, and will continue to co-operate on such undertakings as the provision of legal support to Ministry of Energy, including in drafting secondary legislation, as well as on providing assistance in Kyoto Protocol implementation. Another possible area of co-operation is in establishing an ESCO model for energy efficiency investments. The UNDP has been instrumental in organising donor meetings, usually with sector specific agendas, where respective sector specialists of the Bank have participated.

In 2009 the European Investment Bank obtained a mandate to finance projects in Kazakhstan (still subject to the signing of a Framework Agreement). The EBRD will continue to co-ordinate with EIB as it progresses towards establishing presence in Kazakhstan. Cooperation on energy and environmental projects is envisaged once the EIB becomes operational in the country.

The Bank will continue its participation in the Ministerial Conferences and Sector Coordination meetings of Central Asia Regional Economic Cooperation (CAREC) Programme, which focuses on developing and coordinating infrastructure projects in the Central Asian region. Since March 2000, the ADB hosts the CAREC secretariat.

(See Annex V for details on multilateral and bilateral donor activities in Kazakhstan)

ANNEXES

Annex I: Political Assessment

Compliance with Article 1

Kazakhstan is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank, although the implementation of these principles in the previous Strategy period has been uneven.

The 2010 OSCE chairmanship is an important event as Kazakhstan will be the first Central Asian country and the first former Soviet republic to hold this distinguished position. The upcoming chairmanship prompted amendments to the laws on elections, political parties, media and local government. These changes were assessed by representatives of the international community as being only a modest step towards the implementation of the commitments made for acquiring the OSCE chairmanship.

The strong presidency is not sufficiently balanced by the country's legislature or judiciary and pervasive corruption remains a problem, as acknowledged by the authorities. Despite some progress during the pre-election period and in certain aspects of the voting procedure, the last parliamentary elections fell short of a number of international standards and resulted in the ruling party winning every seat in the lower chamber of parliament.

An area of concern is the recently amended Internet-related legislation, which was qualified by the OSCE Representative on Freedom of the Media as a setback in the democratisation of Kazakhstan's media governance.

Political Accountability

According to the Constitution, the Republic of Kazakhstan has a presidential form of government with the presidency exercising significant influence over the legislature and judiciary. In 2005 Nursultan Nazarbayev, who has been in power since Kazakhstan's independence in 1991, was re-elected President for a second seven-year term with an overwhelming majority of 91 cent. Two years later, in May 2007, the Constitution was amended to remove the two-term limit for the First President of the Republic, thus allowing Nursultan Nazarbayev to run again and stay in office after the end of his current term in 2012.

The OSCE/ODIHR characterised the 2005 presidential election as failing to meet a number of OSCE commitments and other international standards for democratic elections, despite some improvement in the administration of the election in the pre-election period.

The country's parliament is elected for five years and consists of two chambers: Majilis (lower house) and the indirectly elected Senate (upper house). In May 2007, following the recommendations of a state committee on constitutional reforms organised at the initiative of the President, the Constitution and the Election Law were significantly amended to increase the number of Majilis deputies from 77 to 107, increase the number of appointed senators, reduce the presidential mandate from seven to five years (starting in 2012), remove term limits for the First President of Kazakhstan, permit the President to engage in political party activity, alter the composition of the Central Election Commission and introduce a new party-based system for electing the Majilis.

The political party landscape in Kazakhstan was seriously altered by a prohibition on parties forming electoral blocs, forcing them to adjust their campaign strategies by merging party structures. Anticipating an increased role for political parties, and well in advance of constitutional changes, in late-2006 the three pro-presidential parties Asar, Agrarian and Civic merged with the governing Otan to become Nur Otan, with President Nazarbayev acquiring the leadership of the strengthened party. In June 2007 the opposition Nagyz (Genuine) Ak Zhol merged with the All National Social Democratic Party (ANSDP). In July, the moderate opposition Ak Zhol merged with Adilet.

The August 2007 Majilis election followed the early dissolution of parliament elected in 2004 to allow the new constitutional amendments to take effect. Although seven political parties were registered to contest these elections, only Nur Otan managed to gain seats in the lower chamber, leaving all other political parties, except Nur Otan, outside parliament.

The OSCE’s ODIHR monitored the election and concluded that, despite some progress during the pre-election period and in certain aspects of voting, the election did not meet a number of OSCE commitments, in particular with regard to elements of the legal framework as well as the vote count and tabulation. A significant problem was observed in the counting of the votes, with the latter reported to be flawed in 43 per cent of the polling stations visited.

The observation mission stated that the seven per cent threshold for obtaining representation in Majilis was high for the OSCE area and, as a result of this strict requirement, only the governing Nur Otan passed the threshold, thus obtaining all 98 directly elected seats in the 107-member lower chamber. The declared intention of the authorities in moving from the single constituency-based system to the party-based electoral system was to ensure a gradual transition from a strong presidential form of governance to a more balanced presidential-parliamentary political system. Instead the last parliamentary elections produced a single party legislature.

To rectify the situation the Law on Elections was amended in February 2009 to guarantee representation of at least two political parties in parliament when one of the parties does not gain sufficient votes for reaching the required 7 per cent threshold. The new rule stipulates that if several parties break the 7 per cent barrier all of them participate in the legislature, but if only one party passes the barrier, then the party which comes second will be given seats in parliament, irrespective of the votes gained.

Although such directed pluralism will indeed guarantee the representation of at least two political parties in the legislature, representatives of organisations with relevant expertise, including a number of civil society organisations, argue that the same objective could have been reached by lowering the excessively high threshold to something like 3 or 4 per cent.

Rule of Law and Human Rights

The independence of the judiciary is significantly constrained by the strong influence of the executive branch of power and corruption is evident throughout the judicial system. As Kazakhstan is preparing to assume the chairmanship of the OSCE in 2010, the country has moved to amend the laws on elections, political parties, the media and local government directed at implementation of the OSCE commitments and enhancing democratic governance and the rule of law.

The amendments to the law on elections were primarily aimed at introducing guarantees for representation of political parties in the legislature, but they fell short of reducing the excessively high threshold for representation in parliament. Other changes included some decentralisation of the authority of the Central Election Commission in favour of local election commissions and the latter now acquired greater authority in organising the electoral process.

The law on political parties contains some positive changes, including the provision that the discovery of invalid signatures cannot serve as basis for delaying or denying a party's registration if sufficient valid signatures are provided. 600 members in each of the country's regions and 40,000 (10,000 less than before) signatures are now required for setting up a political party. Arguably, this is still a large number of signatures to be collected in a geographically vast country.

The law on local self-government codified local self-governance in various administrative subdivisions of the country and is aimed at increasing the role of maslikhats (local elected legislatures) and improving the relationship between maslikhats and akimats (local executive branch). The proposed amendments, however, do not significantly alter the centralised system of government administration.

The law on the media addressed some of the concerns voiced by the media community by seeking to provide a more level playing field for the protection of journalists and ensuring greater self-regulation. At the same time this law did not decriminalise slander and libel.

A disconcerting development in the area of freedom of the media and freedom of expression is the latest legislation on "Issues Related to Information-Communications Networks", signed by the President into law in July 2009. The law classified blogs, discussion forums, chats and similar "Internet resources" as regular media. This effectively extended to bloggers administrative and criminal liability now applicable to journalists. The OSCE Representative for Freedom of the Media urged the authorities to revise the law as it contravenes OSCE commitments and international standards by allowing for unjustified limitations of freedom of the Internet and limits access of Kazakhstani citizens to foreign Internet resources.

On the positive side, Kazakhstan's Constitutional Council, a body overseeing the compliance of government policies with the Constitution, ruled on 11 February 2009 that the amendments to the law on religious freedom are inconsistent with the articles of the Constitution and contravene protection of religious diversity and tolerance, historically intrinsic in Kazakhstan. If adopted, the amendments would have significantly restricted the right to freedom of thought, conscience and belief.

According to independent human rights monitors, Kazakhstan's human rights record requires improvement in a number of key areas. Review of the draft laws by international organisations with relevant expertise and closer involvement in the revision process of political parties, Kazakhstani NGOs and international civil society organisations could improve the quality of the legislation and practice of its implementation with the benefit of better protection of human rights, including in the areas of religious freedom, freedom of expression, freedom of assembly and Internet-related regulation. The implementation of the 2009-2012 National Human Rights Action Plan would be a useful framework to continue the process of democratic reform in Kazakhstan.

Annex II: Environmental and Social Developments

EBRD's environmental and social approach in Kazakhstan

EBRD's new Environmental and Social Policy entered into force on 12 November 2008. Together with the Public Information Policy and revised Project Complaint Mechanism, the new Environmental and Social Policy establishes a set of 10 Performance Requirements (PRs) for the Bank and its clients so as to integrate environmental and social considerations in business operations. These requirements help EBRD's clients to introduce best practice for the management of environmental, occupational health and safety, labour and other social issues. In particular, the Bank adopts a rigorous approach to labour and working conditions issues which are one of the areas of concern in Kazakhstan. The application of a specific Performance requirement (PR2) covers assessment of such areas as labour conditions, fair wages, non-discrimination, gender equality, retrenchment policies, trade unions and collective bargaining practices. Stakeholder engagement is now a requirement for all projects and is expected to be carried out in a meaningful manner proportionate to the risks and issues involved.

All EBRD operations in Kazakhstan are subject to the Bank's environmental and social appraisal and incorporate, where appropriate, Environmental and Social Action Plans into the legal documentation. Issues raised during due diligence, are thus able to be addressed, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investments. All these measures are intended to help guide companies' operations in Kazakhstan towards better performance standards in line with the Kazakhstan and EU environmental standards, ILO core labour conventions and other international best practice.

The Bank is facing many environmental and social challenges within the framework of its diverse activities in Kazakhstan and addresses those accordingly, making sure that appropriate safeguards are being built into every project to minimise any negative environmental and social impacts and to maximise potential benefits. The Bank is committed through its projects to help Kazakhstan to abate air, soil and water pollution, to implement energy efficiency measures, to manage its natural resources in a sustainable way and to be in compliance with international environmental standards and best practices. In addition to that, significant environmental implications and opportunities are introduced in many other EBRD's initiatives and activities, including technical cooperation funds and training.

EBRD will also continue to finance sustainability initiatives in different sectors of the Kazakhstan economy. In accordance with the direction of Kazakhstan state environmental policy there are potential opportunities for projects in the area of water resources procurement and infrastructure, land reclamation in old mining and oil exploration sites, solid waste and waste water utilisation and disposal, sustainable agriculture, power and energy projects, public transport, tourism and construction. Additionally, EBRD will consider climate change and adaptation issues in projects appraised and, where appropriate, will work with clients to address climate change issues and opportunities, particularly in sectors such as agriculture, infrastructure, natural resources, power and energy sectors, including energy efficiency improvements and development of renewable energy sources.

The Bank has pursued a number of Technical Cooperation initiatives to support practical identification of the best environmental solutions and capture environmental opportunities within its projects. It has also supported institutional capacity building and fostered the development of economically viable and environmentally sustainable business opportunities. Most recent examples include identification of financial structures and instruments to promote biodiversity in the steppe ecosystems of the Eurasia region, assessment of improvements in power sector and supporting improved environmental management in maritime transport through a comprehensive training programme.

Environment legislative framework in Kazakhstan

An overarching legislative framework on environmental issues in Kazakhstan has recently been adopted (Ecology Code, 2007). It is supported by the provisions of the Law on changes into other legal acts on ecological issues adopted in 2007. These two documents update the Law on Environmental Protection (1997) aimed at preventing pollution and encouraging the rational use of the environment and natural resources. The law calls upon local communities and other stakeholders to become involved in the management of natural resources, and institutes the “polluter pays” principle in Kazakhstan’s environmental policy. The Forest Code sets the framework for the protection, restoration, and rational use of forests. Since its initial adoption in 1993 the Code did not include regulatory mechanisms and ties to the Civil or Criminal Codes, and has not been implemented efficiently. This has resulted in serious negative consequences for the forests, including the loss of over 10 per cent of the nation’s forest cover over the past 10 years. The Forest Code was, however, updated by a new draft in 2002 which was approved by the Parliament in July 2003. Specific matters pertaining to the protection of forests and biodiversity are now governed by regulations made under the Code. The Law on Protection, Reproduction and Use of Wildlife (1993) promotes the sustainable use of wildlife, provides specific guidelines on inventorying, establishes the authorities of government agencies, defines the rights of society, and provides for enforcement measures. The Law on Specially Protected Areas (1997) that classifies various types of protected areas with reference to international standards, was updated by a new version adopted in 2006. The Land Code (2003) establishes state ownership of lands for defence purposes, protected areas, forests and waters. The Water Code (2003) promotes the use of water resources in a manner that optimizes economic use opportunities for the betterment of conditions for the population while safeguarding the environment. The Code deals with trans-boundary waters, waters of particular significance.

The state system of environmental protection is of central importance but unfortunately it is operating under a significant shortage of funding and other necessary resources for effective environmental control. A state environmental policy has not been developed and adopted in the country, and environmental laws’ enforcement needs significant improvement.

One of basic controls of nature management in Kazakhstan is the use of state cadastre of natural resources created in 2000 and representing an automate information system of collection, systematization, storage, treatment and imagery of spatially-coordinate status data of natural resources of Kazakhstan, used for administrative decision-making, industrial and scientific goals, which connected with protection, restoration and preservation of natural resources. Moreover, the Ministry of Environment Protection runs a Register of ecological problems of Kazakhstan with necessary mitigation measures, responsible parties and regular updates on implementation status. The Ministry also issues a quarterly updates on ecological situation in the country.

Kazakhstan and international cooperation in the environmental sphere

Kazakhstan is a signatory to a number of international conventions and protocols related to environment protection. The country accepted the UNESCO World Heritage Convention in 1994, but has not yet ratified it. Kazakhstan is an active member of the United Nations Convention to Combat Desertification since 1997. The country ratified the United Nations Framework Convention of Climate Change in 1995, but adopted the Kyoto Protocol only in June 2009 which has recognised the importance of the topic to the water scarce and land degraded Kazakhstan. In 2000 the country signed the Espoo Convention on environmental impact assessment in transboundary context and ratified the Aarhus Convention on access to information, public participation and access to justice in environmental matters. Kazakhstan ratified the Basel Convention on Hazardous Waste Management in 2003.

Environment remains the focus of many other organisations working in Kazakhstan. EU, UNDP, UNEP, and the World Bank are co-founders of regional umbrella Caspian Environment Programme (CEP) developed for and by the five Caspian littoral states, Azerbaijan, Iran, Kazakhstan, Russia and Turkmenistan, aiming to halt the deterioration of environmental conditions of the Caspian Sea and to promote sustainable development in the area. World Bank implements in Kazakhstan its GEF Biodiversity Conservation Projects that might have beneficial application for EBRD’s clients and operations. With support from the Global Environment Facility (GEF) the Bank is pursuing grant funding for renewable energy promotion and energy efficiency in power sector of Kazakhstan.

Annex III: Commercial Laws of Kazakhstan

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Kazakhstan, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Company Law and Corporate Governance

The principal legislation governing corporate governance in Kazakhstan is the Law on Joint Stock Companies (JSC Law) dated 13 May 2003 (Law No. 415-II dated 13 May 2003), as amended.

A voluntary Corporate Governance Code was approved by the Council of Issuers on 21 February 2005 and by the Council of the Association of Financiers on 31 March 2005. The Code was revised in July 2007. Both the JSC Law and Stock Exchange Listing Rules refer to the Code but companies are only recommended to transpose the code's recommendations in their by-laws. No compliance statement is required.

The EBRD's 2007 Corporate Governance Sector Assessment[1] assessed the quality of corporate governance legislation in force in November 2007; Kazakhstan was found to be in "medium compliance" with the relevant international standards (the OECD Principles of Corporate Governance). The major shortcomings were found in the legislation on "disclosure and transparency" and on "ensuring the basis for an effective corporate governance framework".

When assessing how corporate governance legislation works in practice in 2005,[2] the EBRD found that the effectiveness of legal procedures for obtaining disclosure in Kazakhstan are undermined by their complexity, the difficult of enforcement and the length of the proceedings. Complexity was also identified as a problem for redress procedures. When considering the institutional environment, while the survey evidenced that company information is generally of good quality, the statutory auditors fairly independent and the legal framework on related party transactions adequate, partiality of judgements and corruption are considered major problems. As a result, enhancing the experience and competence of courts, prosecutors and market regulators should be tackled as priorities.

[1] Read more on this initiative at http://www.ebrd.com/country/sector/law/corpgov/assess/index.htm

[2] Read more on this initiative at http://www.ebrd.com/country/sector/law/corpgov/lis/index.htm

Concessions

As a result of a PPP promoting policy Kazakhstan has recently undertaken notable efforts in reforming concession enabling legislation, in particular, by upgrading in 2008 its 2006 Concessions Law No. 167-III (the "Concession Law"). In addition, a National PPP Unit was set up in 2008 under the Ministry of Economy ("MoE") to improve the PPP institutional framework.

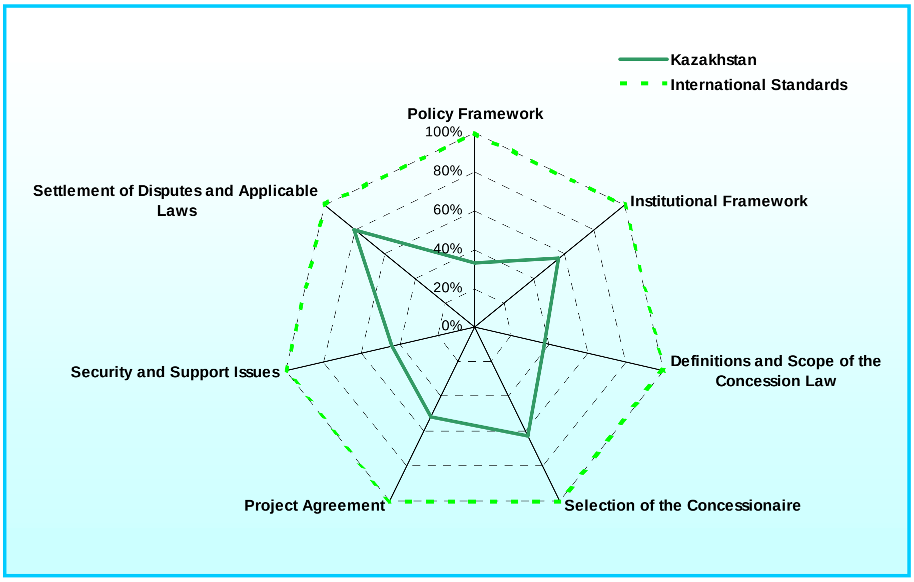
The current Kazakhstan Concession Law enables the implementation of concession in infrastructure including those based on open tendering. The July 2008 amendments to the Concession Law addressed a number of major flaws, relating to definitions, model contract provisions, register of concessions, deadline period to conclude concession contract, and limits to state guarantees.

Overall, the amended Concession Law is seen as adequate, however, the law still fall short in certain aspects of internationally acceptable standards. The main areas for improvement remain as follows:

- security issues may present a significant obstacle to the bankability of potential projects as pledge of assets is still not allowed (although it may be possible to pledge shares in a concessionaire);
- the delineation of powers of certain authorities in the tendering process is still not sufficiently clear;
- the list of assets referred to in the Concession Law is to be approved by the Government which adds uncertainty, in particular for unsolicited proposals;
- the qualification requirements are merely factual/quantitative rather than quality criteria that would allow selection based on expertise. It is not clear at this stage whether the grantor is allowed to further qualify the requirements in the tender documents as practice so far has been restrictive. The methodologies are still to be developed by the PPP Unit and approved by the MoE;
- the Concession Law still limits the negotiation time for entering into agreements to no more than 90 days which may hamper the financing on the part of IFIs.

The authorities appear to be aware of remaining issues and have chosen to proceed with initial concessions first by way of testing the market and collecting potential bidders views as to what is necessary to be addressed through any further legislative amendments in order to make the regime more attractive.

Quality of concession legislation – Kazakhstan (2008)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2007/8

According to the EBRD 2007/8 Concessions Law Assessment Kazakhstan Concession Law is medium compliant (i.e. over 50%) in core areas of concession legislation in relation to international best practice.

Insolvency

Bankruptcy and insolvency are governed by the Law on Bankruptcy, as amended (the "Insolvency Law"). This law scored "medium compliance" when compared with international standards in the EBRD's 2006 Update Insolvency Sector Assessment but is amongst the strongest of the insolvency laws in central Asia.

The Insolvency Law appears to be relatively weak in addressing reorganisation processes, liquidation processes and the treatment of estate assets. A number of flaws were noted, including: the requirement that a debtor's debts must be three months past due before they can be used as evidence of insolvency; there is no separate court or division to deal with insolvency cases; creditors are not individually notified about the commencement of insolvency proceeding and a failure to address international insolvencies. Recovery of assets may be difficult due to lack of obligation on the debtor and third parties to supply information and assets of the debtor to the insolvency administrator and unclear rules regarding avoidance of transactions, as well as limited investigation powers of the insolvency administrator with a view to recovering all assets of the estate.

In the attempt to improve the regulation of insolvency office holders and contribute to the growth of this profession, the Government has approved a Government Decision providing for Rules on licensing the activity of property management for insolvency debtors in insolvency proceedings, Nr. 615, dated 20 July 2007, as well as Rules on appointment and dismissal of rehabilitation manager and other office holders, approved by the order of the Ministry of Finance No. 396 dated 12 August 2008. These acts provide detailed guidance on entering the profession, appointments and removal of insolvency office holders. This is a welcomed step providing more clarity regarding envisaged processes, including necessary education, other licensing and registering requirements for insolvency administrators. However, there is a need for less formalistic and more client friendly approach. There should be more flexibility regarding education and experience suitable and needed for various cases, similarly, the creditor and debtor should have a say in the choice of insolvency office holder.

Another important addition to the insolvency framework is the adoption of the Order of the Ministry of Finance of Kazakhstan dated 12 august 2008, Nr. 401, regarding the Rules for coordination of application of rehabilitation procedure regarding an insolvent debtor. The rules provide for the ability of the debtor to seek approval of a rehabilitation plan outside formal insolvency proceedings. Such plan must be agreed among the creditors and then approved and confirmed by the Committee for dealing with insolvent debtors that is part of the Ministry of Finance. This mechanism may prove a useful tool for a business to avoid entering formal insolvency proceedings. There may be however a need for more details and safeguards in order to enable efficient realisation of the plan. In particular this may include details on enforcement of such plan against creditors, a certain percentage of creditors (in value) whose approval of the plan is necessary as opposed to 100%, additional safeguards for creditors who agreed to finance the debtor during the plan. Time will tell whether these additions to the framework will help improve the fate of companies in difficult financial situation.

Secured Transactions

Security rights over property are governed by the Civil Code of the Republic of Kazakhstan, adopted in December 1994 and other laws.

There are two main types of security over movable assets (pledges) under Kazakh law: possessory (where the possession of the collateral is transferred to the creditor) and non-possessory (where the debtor may retain the collateral during the life of the security and use it). The registration system is two-tier: there is a mandatory registration, which applies to specific types of assets such as motor vehicles, aircraft etc. These assets are registered in specific registries and the pledge should be registered there too (e.g. the policy for pledges over motor vehicles). For all other types of assets, pledge registration is voluntary only and is conducted in the Centres for Registration of Immovable Property and their subsidiaries. There is no centralised registry but 16 separate Centres in two major cities, Astana and Almaty, and in each region. The registries are supervised by the Registration Service Committee under the Ministry of Justice in Astana. Most of the registries have computerised databases which are accessible through the respective registrar.

Based on EBRD assessment, the secured transactions legal regime is adequate, although not particularly enabling for sophisticated transactions. Some transactions remain complex to achieve. For example, a pledge over assets described generally would not be a viable option to secure a transaction since the law provides that the pledge agreement must *specify* the assets and their value or a method for their valuation. If the pledge is registered, a list and description of the pledged assets must be entered in the registry. General description would be possible for pledges over goods in circulation and processing (merchandise stock, raw materials, materials, semi-finished products, finished products and the like), where the debtor could change the composition and natural form of the pledged assets provided that their overall value would remain the same as prescribed in the pledge agreement. Such condition would be difficult to fulfil as the debtor who would have to renew its stock at all times. Practitioners have expressed some concerns on the efficiency of the registration process - bureaucratic and corrupt environment makes it hard to use the system. Search requests take up to five days, depending on work load, but considerable delays are also reported. The Bank has in the past experienced unacceptably long delays in perfecting its security rights over the borrower's assets.

Finally, the means of enforcement provided by the law seem adequate on the books, yet in practice, enforcement is reported to be problematic due to deficiencies of the court system, uncertainty regarding the enforcement mechanisms, incidents of non-compliance of the government with enforcement rules and decisions, difficulties in locating and ensuring control of the pledged assets and possible application of exchange control rules to repatriation of enforcement proceeds. Serious delays could occur due to the right of the court to postpone the sale of the pledged property up to one year upon the debtor's request. EBRD surveys have highlighted serious problems, in particular the high risk of court corruption and the lack of training of key enforcement officers, such as the bailiffs.

Security over immovable assets (mortgages) is covered primarily by the 1995 Presidential Decree (having the force of law) on Mortgage of Immovable Property. The Kazakh residential mortgage market has expanded considerably in the last few years and, generally speaking, the legal framework has supported such expansion. There is no specific form required for a mortgage agreement but parties often have the agreement notarised. Mortgage agreement must specify the principal obligation, its amount and the due date which makes it impossible to secure a debt described generally or a fluctuating debt. An enterprise can be charged by way of a mortgage, where the security will cover all the enterprise's movable and immovable assets, claims and exclusive rights, including those obtained during the mortgage period, "main and circulating funds", and securities on its balance sheet.

To be valid, the mortgage must be registered in the Real Estate Register, which is maintained by the Registration Service Committee - a state enterprise under supervision of the Ministry of Justice which has local registration offices across the country. The Register is paper-based and not centralised. The application for registration must be accompanied by a deed confirming ownership title to the mortgaged property. It is frequently the mortgage creditor who applies for registration in which case he must present a power of attorney signed by the mortgagor. The process is cumbersome and it takes about 3 weeks, however, banks reportedly disburse mortgage credit prior to completing registration.

Mortgage right enjoys priority in the mortgaged property from the moment of its entry in the Register. In the event of bankruptcy priority of a mortgage right is superseded by preferential claims for damage to health and alimony.

In case of the mortgagor's default the mortgage right can be realised in judicial procedure or in an out-of-court sale by means of a public auction carried out by a trustee who is either determined in the mortgage agreement or by decision of the mortgage creditor. Enforcement is reported to work efficiently. As for pledges, difficulties may arise with debtor's obstruction, which can significantly prolong the procedure especially if postponement of enforcement by up to one year has been granted by a court.

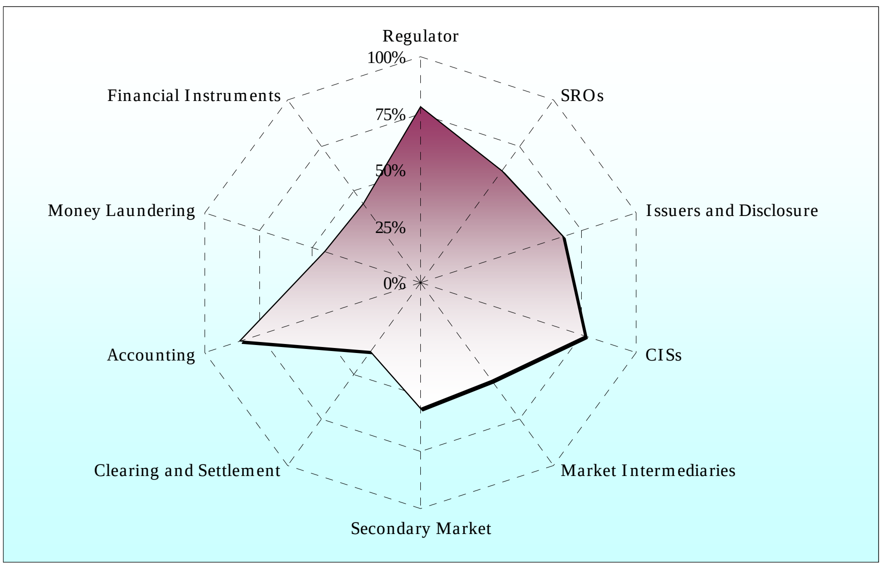
Securities Markets

The basic legislation on the securities markets in Kazakhstan is contained in the Law on Securities Market (Law No. 461-II dated 2 July 2003), in the Law on Investment Funds (Law No. 576-II dated 7 July 2004), in the Law on Joint-Stock Companies (Law No. 415-II dated 13 May 2003) and in several acts of the secondary legislation issued by the regulator.

In February 2006, the Regional Financial Centre of Almaty (the "RFCA") was created. The RFCA is a Government initiative to create a financial market operating to internationally recognised standards of market regulation and best practices. It is a separate trading platform of the Kazakhstan Stock Exchange with simplified access for non-residents and its own listing rules. The RFCA is managed and supervised by the Agency of the Republic of Kazakhstan for regulation of the activity of the RFCA, which reports directly to the President of the Republic of Kazakhstan. Disputes between RFCA members are solved either through the specialised financial court of RFCA or court of arbitration.

The securities market regulator is the Agency for Regulation and Control over the Financial Market and Financial Entities (the "Agency"), which is responsible for regulation and supervision of banks and entities performing certain types of banking transactions, insurance companies, securities market entities and accumulation pension funds.

Quality of securities markets legislation – Kazakhstan (2007)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2007

According to the EBRD Securities Markets Legislation Assessment conducted in 2007, the country was found to be in "medium compliance" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) – see chart above - showing a number of shortcomings in the securities markets legal framework, especially in the "clearing and settlement", "money laundering" and "financial instruments" sections. Since the completion of the EBRD assessment, a number of improvements have been introduced. In particular, a new Anti-Money Laundering Law was adopted by both Chambers of the Kazakh Parliament in June 2009 and signed by the President in August 2009, and on 12 December 2008 a set of provisions addressing derivatives was incorporated into the Civil Code.

In 2007 the EBRD assessed how securities markets legislation works in practice.[3] The survey revealed that although many Kazakhstan companies have carried IPOs, only a few placements have been done nationally. Financial reporting is in line with IFRS but no official translation of these standards is available. Doubts are cast over the reliability of prospectuses due to the mild sanctions for providing inaccurate or misleading information. The Agency is in charge for the supervision of prospectuses and underwriters but there is little supervision of the IPO process in Kazakhstan. The Agency's sanctioning powers are limited: it can issue sanctions against an issuer only if an investor makes a complaint about a specific failure to publish a notice or provide a prospectus upon request.

Telecommunications

Institutional framework: Until 2007, the telecommunications sector (the "Sector") in Kazakhstan was regulated by three separate entities: the Agency for Communications and Informatics (AIC) which regulated technical matters and universal service; the Agency for Natural Monopolies (AREM), which regulated interconnection; and, the Committee for the Protection of Competition (CPC), responsible for assessment of dominance and application of retail tariff regulation. (The CPC was replaced by the Agency for Protection of Competition (APK) in 2008.) In 2007 all relevant powers to regulate the sector were transferred to AIC. AIC is also now responsible for Sector policy making and Informatisation issues.

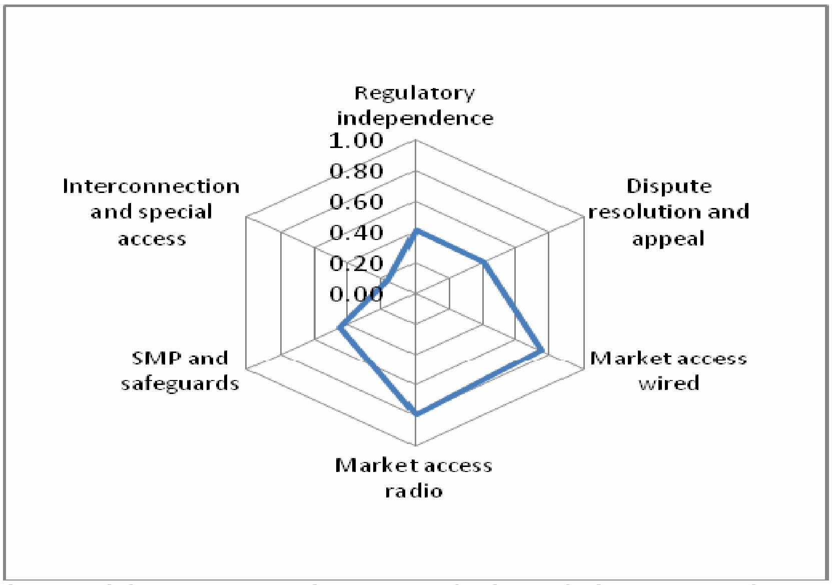
Regulatory independence: Since 2007, AIC has attempted to take independent action but meaningful reforms have yet to be implemented. The Government of Kazakhstan (the "Government") maintains control of 51% of the dominant incumbent operator, KazakhTelekom (KTC), through its Samruk Holding organisation, which also owns 100% of one of KTC's main competitor, TransTelekom. The sector regulator AIC has produced progressive regulatory proposals for retail tariff rebalancing, market access and interconnection charging but these have not yet been implemented by KTC. Thus,

[3] Read more on this initiative at http://www.ebrd.com/country/sector/law/capital/survey/index.htm

as the necessary market remedies have yet to be implemented, regulatory independence is still only a theoretical concept in Kazakhstan.

Assessment: In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime in Kazakhstan was deemed to have "Low Compliance" when measured against international best practice.

Telecoms Regulatory Assessment: Kazakhstan (2008)



This spider diagram includes six main group indicators. For each indicator, the diagram presents the scores as percentages of the maximum achievable score. The scores begin at zero at the centre of the chart and reach 1.00 at the outside, so that in the overall chart, the wider the web, the better the score in the assessment.

Regulatory spider diagram

(*see http://ebrd.com/country/sector/law/telecoms/assess/index.htm for more details).*

ANNEX IV: TAM/BAS in Kazakhstan

The TAM/BAS Programme supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises and contributing to the development of sustainable infrastructures of local business advisory services in the EBRD countries of operation.

Previous TAM experience

TAM supports the introduction of international best practice in small and medium sized enterprises with the potential of becoming future leaders in their market through the introduction of international Advisors from developed countries with 15-20 years of professional experience in the relevant sector. TAM projects typically last around 18 months. The Programme also carries out seminar and training activities promoting international best practices by disseminating successful case studies to entrepreneurs.

Since inception in 1998, TAM has secured a total of €3.2 million in donor funding. The largest donors of TAM projects have been Japan with €1.9 million, and the EU with €800,000 under TACIS. Additional funding for projects came from Switzerland, Belgium, the EBRD Special Shareholders Fund and Austria. The Programme has carried out 51 projects throughout Kazakhstan of which 12 are still in progress. Projects have been mainly focussed on the Food/Beverages, Manufacturing and Energy sectors and mostly located in Almaty, East Kazakhstan, Kustanay and South Kazakhstan. Currently, projects are being carried out in all of these provinces.

Previous BAS experience

BAS acts as a facilitator for the use of local, private-sector consultants by MSMEs to obtain a diverse array of services. BAS works on both the demand and the supply side. By assisting individual enterprises to engage with local consultants on narrowly-based, specific projects with a rapid payback, it stimulates demand and the understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services, through targeted market development activities. BAS supported projects typically last around four months.

Since October 2001, BAS Kazakhstan has secured a total of €9.3 million in donor funding. The first and largest donor has been Japan with €7.6 million, additional funding came later from Switzerland and the EBRD Special Shareholders Fund. The Programme has undertaken a total of 684 projects with MSMEs, engaging 240 consultants– 94% of which were local. Projects have been carried out from the 5 BAS Kazakhstan offices: Almaty, Ust Kamenogorsk, Kostanai, Shymkent, and Aktobe and more than 56 % of the projects were located in rural areas; this tendency has been rapidly growing over time. The industry spread of projects has been wide, but there has been a focus on Food/Beverages, Wholesale/Retail Distribution and Construction/Engineering. Most projects were targeted at improving Computerized Financial and Management Information Systems as well as Quality Management & Certification. In terms of cross-cutting issues, BAS Kazakhstan has been mainly focused on facilitating rural development through its regional presence and active work in rural areas.

The BAS Programme in Kazakhstan has also undertaken a number of market development activities geared to the development of the local consultancy industry. It has carried out workshops on "Business development through usage of consulting services." to promote the benefits of advisory services to MSMEs and, in cooperation with the Kazakhstan Association of Management Consultants, it has introduced “Core Consultancy Skills” and “Consulting Ethics” courses from the UK and Canada via trainings-of-trainers. Course deliveries are now taking place on a commercial basis. The objectives of this work have been to increase the professional competence of business advisors in Kazakhstan and ensure the long term sustainability of the local advisory services sector.

Linkages with banking

To date, three TAM/BAS-assisted companies in Kazakhstan have attracted four investments from the EBRD or EBRD related financial intermediaries, mobilising a total EBRD Financing of over €68 million. In addition to investments, TAM/BAS has referred over 20 companies to other banking teams.

The MSME sector

Kazakhstan’s MSME sector accounts for 99% of registered businesses as of mid-2009 (94% small and 5% medium-sized businesses). According to Global Entrepreneurship Monitor, Kazakhstan ranks well on entrepreneurship (16th out of 42 countries) and the participation of women entrepreneurs is relatively high. Entrepreneurs have on average less formal education than the overall population. The highest rate of entrepreneurship is in Southern Kazakhstan, which includes Almaty, while the lowest is in Western Kazakhstan, characterized by large natural resource industry. Tax systems, lack of innovation despite the government’s efforts to promote it and imported counterfeit goods constitute primary constraints on entrepreneurship in Kazakhstan.

In spite of the relatively large number of entrepreneurs, the economy’s diversification is limited and the MSME sector in Kazakhstan is not very competitive. Mining and Fuels, which are usually produced by large companies, make up more than 80% of Kazakh merchandise exports, and their share has been growing in the recent years. For comparison, in other transition countries Mining and Fuels make up around 20% of exports[4].

One of the weakest contributions to the Kazakh economy comes from medium-sized companies with 50-250 employees, which contributed only 4% of the GDP in 2008, while in CEE countries these figures fluctuated around 20% in 2007. Small firms accounted for 28% of GDP in 2008. Although this figure has been declining, it still close to a developed economy, in which small firms typically account for 30-40% of

[4] WTO, EBRD Transition Report 2009

GDP[5]. Firms are not able to grow organically and 'graduate' into the medium-sized category.[6] The crisis hit the MSME sector especially hard, because most of them operated in the construction and real estate sector. In 2009, the MSME contribution to the GDP almost halved from 32% to 17% (16% from companies <50 employees and 1% from companies with 50-250 employees)[7].

The Business environment

The four main obstacles to business cited by entrepreneurs in the latest BEEPS study (2008) were 1) high taxes, 2) access to finance, 3) an inadequately educated work force and 4) corruption. Medium-sized companies complain more about access to finance and work force qualifications than small-sized companies: access to financial and human capital are most important when firms grow. The sources of finance are concentrated in Almaty and Astana, and most banks and their branch networks remain focused on catering to MSMEs in the two main cities. The implementation of bankruptcy laws remains an important challenge, but the law does authorise parties to agree on out-of-court settlements. A geographically unified registry is in place and credit information services are provided by a private credit bureau (the bureau's coverage rate is 29% of the adult population)[8].

In Transparency International's Corruption Perception Index, Kazakhstan scores significantly below the transition country average and ranks 145th out of 181 countries. Although an intention to join the Extractive Industries Transparency Initiative has been declared by the authorities, this initiative has yet to materialise.

Existing Business support services

According to the recent EBRD Management, Organization and Innovation Survey, management quality is very poor in MSME's, when compared with other transition companies. The World Economic Forum's annual Global Competitiveness Index indicates that Kazakhstan falls in the bottom third of the 125 countries included in the survey for indicators based on managerial skills and knowledge. Business service providers, individual consultants and trainers, government agencies (particularly at the local level) and corporations are in particular need of training and advice. In addition to BAS efforts, the jointly funded USAID-Government of Kazakhstan "Kazakhstan Small Business Development Programme" tries to fill this gap by offering training opportunities and encouraging private-public partnerships. Training comprises a "Business Essentials" MSME toolkit and a "Consulting Essentials" course targeted mostly at start-up entrepreneurs and NGOs offering business services. Education and training needs are further being addressed through continuing education programmes (Kazakhstan Institute of Management, Economics and

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[5] Statistical Agency of the Republic of Kazakhstan, European Commission, Directorate Enterprise and Industry.

[6] De Haas, R (2009): www.ebrdblog.com

[7] Preliminary data, first half of 2009 only. Source: Statistical agency of the Republic of Kazakhstan.

[8] Doing Business 2010 data-The World Bank Group

Strategic Research) and mini-MBA programmes (International Business Academy, Forum of Entrepreneurs of Kazakhstan).

Government support

The government is co-funding the USAID Kazakhstan Small Business Development Programme and actively takes part in public-private partnerships. Study tours and visits from international experts targeted at the government as well as private and non-governmental MSME stakeholders provide exposure to international best practice. DAMU (Entrepreneurship Development Fund), which has been providing financial support to small and medium businesses through several programmes, is now changing its strategy to include a training component. DAMU is planning a one time 2 day training at the national level for MSMEs on core business skills carried out by university professors. The Government's assistance has focused mainly on MSME financing rather than advisory services.

International Donor Programmes

Several international donors are providing assistance to MSME development. Besides the above described USAID Kazakhstan Small Business Development Programme, the World Bank and the Ministry of Agriculture help improve access to finance by providing micro-credit programmes. Japan provides some consulting services by Japanese consultants through JICA. However donor presence in Kazakhstan is shrinking and USAID for example is phasing out after the end of its MSME programme.

TAM/BAS will focus on addressing these gaps by continuing its operations in Kazakhstan. However, the extent of the Programme's activities is very much dependent on funding availability.

Continuation of TAM

In light of the low level of development of the local consultancy market, business advice from international experts is highly relevant in Kazakhstan. The main impediments faced by Kazakhstan MSMEs, which will be addressed by the TAM Programme assistance, relate to:

- low quality of products and manufacturing
- lack of transfer of technologies to reach international standards
- poor management skills (operational, marketing, export , M&A)
- deficiencies in long term business planning, and restructuring

TAM will continue delivering assistance responding to the above as well as focusing on energy efficiency and environmental issues. In terms of sectors, agribusiness, energy, textiles, manufacturing and pharmaceuticals would benefit from international industrial expertise, especially when it comes to technological know-how. With regard to Kazakhstan's land-locked position, transportation will be will be given a higher priority, as it impedes the competitiveness of the Kazakh MSME sector. TAM will continue its regional scope beyond the main cities where management advisory services are not available.

Continuation of BAS

Stakeholders in the enterprise sector unanimously believe that Kazakhstan entrepreneurs could benefit strongly from the help of business advisory services. The main advantage of BAS is that it contributes to the creation of a viable infrastructure of business support by operating on both the demand and the supply side of the market. Evidence shows that the local advisory market is still at a very low level of maturity so while the BAS grant will remain the key component, targeted market development activities will also play a significant role in BAS assistance to Kazakhstan.

A Grant Guideline Matrix is proposed in Kazakhstan in order to prioritize intervention, avoid duplication of efforts from international donors and focus on the areas where Kazakhstan businesses have needs and no access to such services. Depending on funding availability, higher grants will be allocated according to:

- *Location*: higher grants will be given to enterprises outside of the main cities, particularly in the Western and Eastern regions
- *Type of advisory service*: higher grants will be given to support projects aiming to improve market performance and to improve environmental management and energy efficiency.

TAM/BAS assistance at the enterprise level will be complemented with the following market development activities in order to maximise the Programme’s transition impact in Kazakhstan:

- *Visibility and dissemination*: The BAS Programme will take steps to promote the use of business advisory services (for example by disseminating successful case-studies to entrepreneurs) especially in more rural regions where consultancy is not considered as an option. TAM/BAS will organise more seminars related to international best practices to demonstrate the potential benefits for local entrepreneurs.
- *MSME and consultancy training:* Capacity building for consultants will be organised to help broaden the country’s supply and quality of local advisory services. The BAS team will continue to address existing gaps in the supply of advisory services by offering trainings covering industry-specific skills, HR policies, international best practices and QMS/certification. For example, BAS will continue sponsoring training-of-trainers to teach consultants how to deliver a “Core Consultancy Skills" (CCS) course that meets international standards which have already been delivered in 7 cities for a total of 185 participants.
- *Support to and development of existing local institutions:* BAS Market Development Activities will continue supporting local institutions that contribute to the development of SMEs and markets for business advisory services. These can include the Forum of Entrepreneurs, which partners with the BAS Programme in policy dialogue, the Kazakhstan Association of Management Consultants, the Independent Association of Entrepreneurs and the National Business Forum, which BAS sponsors in its semi-annual platform for public-private sector policy dialogue.
- *Contribution to policy dialogue*: The TAM/BAS Programme will continue to engage in dialogue within Kazakhstan to encourage further economic diversification in particular by addressing MSME access to finance issues,

especially prevalent outside the main economic hubs, and encouraging further linkages with EBRD banking in industries such as agribusiness.

TAM/BAS focus on addressing cross-cutting issues

In order to address cross-cutting issues that are pertinent to Kazakhstan's MSME sector development, the TAM/BAS Programme will focus its effort on projects targeted at areas outside of the main cities. In Kazakhstan, where distances and market accessibility are a handicap, TAM/BAS will continue targeting rural development initiatives in industries related to manufacturing and agribusiness especially in the north and the eastern part of the country where there is potential for firms to develop because of the presence of heavy natural resources industries. Moreover, TAM/BAS will also devote efforts to supporting measures that increase energy efficiency and environmental management especially in those areas. Finally, TAM/BAS will also devote efforts to supporting women entrepreneurs and encouraging women's access to middle management and executive positions primarily by the continuation of targeted initiatives. Trainings that specifically target needs and skills shortages of women in business, young entrepreneurs and rural businesses will be organised.

Contribution to policy dialogue

By thoroughly analysing the business environment and clearly identifying the challenges faced by the MSME sector, TAM/BAS further strengthens the EBRD's policy dialogue toolkit. Future challenges for the government (among others) are identified as improving law enforcement, administrative corruption, improving tax administration and improving the educational system.

ANNEX V: IFIs and Donors Active in Kazakhstan

The World Bank Group

IBRD

The WB commenced operations in Kazakhstan in July 1992 and has since provided 33 loans worth a total of over US$ 4,2 billion (US$ 1.7 billion disbursed). Since 1997 activities have focused on public resource management, sharpening the focus of welfare and social protection policies, and increasing the potential savings mobilisation of the country.

Although adjustment lending accounted for more than fifty per cent of the total portfolio in the previous decade, World Bank lending support nowadays is exclusively focused on investment projects, bulk of which are concentrated in infrastructure, environment, and agriculture. Currently, the portfolio is being expanded by the projects in social and science intensive sectors.

On the non-lending side, the WB provides a wide range of analytical and advisory services through the Joint Economic Research Program (JERP) with significant co-financing by the Government of Kazakhstan (over 60% in the last 3 years). The WB support through JERP has mainly focused on helping the Government to avoid fiscally risky general bailout strategies in the wake of a financial sector crisis, to balance macroeconomic and monetary stability with sustainable growth objectives, to make concrete improvements in the competition regime, as well as to launch administrative reform and medium-term performance-based budgeting.

WB Country Partnership Strategy adopted in 2004 is built around the pillars of the Government development strategy: (i) managing the oil windfall and improving public institutions and policies, ii) developing an appropriate role for the government to foster competitiveness and facilitate business, iii) investing in human capital and infrastructure, and iv) safeguarding the environment. The new Government appointed in 2007 reconfirmed its desire to maintain the WB engagement in each of the four pillars.

IFC

Kazakhstan became a member of IFC in 1993. As IFC’s largest client in Central Asia, Kazakhstan has received commitments of more than $780 million of IFC’s own funds and over $282 million in syndications. IFC's investments in the country have been mainly in the financial, oil and gas and general manufacturing sectors. IFC’s efforts in Kazakhstan are directed to foster a private sector led growth, particularly in the non-extractive sectors and frontier regions. This includes ongoing support to the financial sector and when possible, investments to promote SME development as well as investments in manufacturing, infrastructure, and the service sector. As the global financial crisis has deepened, we are selectively working with financial institutions through which IFC could make a stabilizing impact on the financial sector in Kazakhstan and with which we can effectively increase access to finance in the priority sectors in the economy.

The European Union (EU)

A Partnership and Co-operation Agreement entered into force in 1999. The EU encourages Kazakhstan's accession to the WTO and continues to take measures to encourage EU trade and investments in Kazakhstan, in particular by supporting economic and legislative reforms through technical assistance. Kazakhstan is now the EU's largest trade partner in Central Asia, and the EU is Kazakhstan's second largest trade partner after the CIS countries.

After expiration of TACIS in 2006, the EU's main support for Kazakhstan since 2007 is provided through the DCI instrument with an allocation of between 11m€ and 13m€ per year on average. The current cooperation programme with Kazakhstan is based on the Strategy Paper 2007-2013 and the Indicative Programme 2007-2010 for Central Asia, which consists of i) a regional programme and national priorities for each country. Currently, major projects under implementation and/or in the pipeline for Kazakhstan are in the following sectors: Environment, Health, Vocational Education, Justice, Economic Diversification, Public Private Partnership, support to WTO accession, regional development. In parallel, a strategy review (2009) will determine priorities for the years 2011/13.Kazakhstan also participates in regional programmes in the fields of Transport, Energy, Border Management, Migration, Water, higher Education and others.

Apart from programmes implemented in direct cooperation with the Government, the EC is funding a significant number of smaller projects in a variety of fields such as human rights, environment, health and education, poverty reduction, implemented by national and/or international NGOs.

The EU Regional Strategy Paper for Central Asia 2009 - 2013, envisions cooperation with IFIs, in particularly the EIB and the EBRD.

European Investment Bank (EIB)

It is expected that the EIB will sign a Framework Agreement with Kazakhstan in the first quarter of 2010. This agreement, once ratified by Kazakhstan (expected within 3 months after signing), will allow the EIB to start its operations in the country. The EIB will focus on energy and environment projects in the country and will work with both public and private promoters as well as banks (for dedicated credit lines). First operations are expected already in 2010, no permanent local presence is planned.

Asian Development Bank (ADB)

Kazakhstan has been a member of the ADB since 1994. Since joining ADB, Kazakhstan has received 20 loans (includes 3 private sector guarantee transactions), commitments $1,391 mln 67 TCs total $28.1 mln.

The ADB's Country Strategy and Programme Update (2006-2008) for Kazakhstan (CSP) was approved in September 2005. The CSP recognises the rapid economic growth in Kazakhstan, its improved fiscal position, and sets knowledge transfer as the main thrust of the ADB's collaboration with Kazakhstan in the medium term.

ADB's Strategic Focus in Kazakhstan

Private sector operations will expand and focus on urban and rural infrastructure as well as the financial sector development. ADB private sector operations in infrastructure focus on water, wastewater, roads, rail, and oil and gas operations. In the financial sector, the Bank's operations focus on equity investments in local banks, credit enhancement for securitization, as well as loans or credit lines. ADB support will also be routed via country-focused and sub-regional public sector programs. The assistance will be through lending or non-lending products. The broad areas of support are:

- Private sector development, through investments in rural development, infrastructure, financial sector
- Human development, through investments in rural water supply
- Natural resource management, through investments for improved management of water resources and continuing advisory work in environment management
- Sub-regional economic linkages, through investments in trade enhancement measures, energy and transport sectors.

Islamic Development Bank (IDB)

As of 26 July 2009, IDB has approved a total of 20 projects for US$ 420 million, both in public and private sectors. 14 projects have been completed, including Syzganov's Surgery Centre, Almaty-Gulshad and Karaganda-Astana roads, and several technical assistance grant operations. The IDB also participated in the modernization of postal services to KazPost by providing modern equipment and machinery to improve postal saving system. In 2009, IDB approved an amount of US$186 million for reconstruction of 58 km road section of South-Oblast-Taraz under Western-Europe – Western China Road. In private sector, the IDB's first direct investment was a US$ 5 million equity investment in the Central Asian Investment Company, which has already invested in several projects in Kazakhstan and the Kyrgyz Republic. The Islamic Corporation for the Development of Private Sector, the private sector arm of IDB, also provides project financing to private sector entities in the country. The IDB has extended US$150 million of lines of financing to commercial banks KKB, BTA and Halyk Bank. At the same time, the Islamic Trade Finance Corporation of the IDB Group provided a trade finance credit line in Kazakhstan.

The IDB provides assistance in introduction of Islamic Banking Principles and establishment of a laboratory for Halal certification of food. The IDB has organized several study tours and seminars for the concerned governmental authorities and commercial banks. IDB, through its regional office in Almaty, participate actively in various regional and international organizations, such as CAREC, ECO, TRACECA, SPECA for the promotion of regional co-operation and integration, particularly in the areas of energy/water, transportation, trade and food security matters. Several projects in these areas have been financed in cooperation with other IFIs.

Annex VI: Selected Economic Indicators

Kazakhstan

	2003	2004	2005	2006	2007	2008 *Estimate*	2009 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	9.3	9.6	9.7	10.7	8.3	3.2	-1.3
Private consumption	11.8	13.9	11.4	14.3	14.0	6.1	na
Public consumption	8.9	10.6	11.8	18.0	18.5	15.0	na
Gross fixed capital formation	8.0	22.5	11.9	24.0	18.6	13.5	na
Exports of goods and services	7.5	10.9	1.4	7.1	5.4	3.9	na
Imports of goods and services	-7.6	14.8	13.3	13.7	14.5	9.7	na
Industrial gross output	9.1	10.4	10.3	11.1	4.5	2.1	na
Agricultural gross output	2.1	-0.3	7.3	6.0	8.4	-5.6	na
Employment[1]			*(Percentage change)*				
Labour force (end-year)	3.5	2.4	0.8	1.6	2.5	2.4	na
Employment (end-year)	4.1	2.8	1.1	2.0	3.1	3.0	na
			(In per cent of labour force)				
Unemployment (end-year)	8.8	8.4	8.1	7.8	7.3	6.6	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	6.4	6.9	7.6	8.6	10.8	17.3	8.5
Consumer prices (end-year)	6.8	6.7	7.5	8.4	18.8	9.5	8.0
Producer prices (annual average)	9.3	16.9	23.7	18.4	22.7	36.8	na
Producer prices (end-year)	5.9	23.8	20.3	14.6	31.9	18.6	na
Gross average monthly earnings in economy (annual average)	13.8	21.7	20.5	19.7	30.6	14.1	na
Government sector[2]			*(In per cent of GDP)*				
General government balance[3]	3.0	2.5	5.8	7.2	4.7	1.1	-2.1
General government expenditure[4]	22.3	22.7	22.3	20.2	24.2	25.5	na
General government debt	15.0	11.4	8.1	6.7	5.8	6.6	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	34.2	68.2	26.3	78.1	25.9	35.4	na
Domestic credit (end-year)	38.1	81.1	52.3	76.5	58.8	2.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	21.1	27.8	27.2	36.0	36.0	39.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	7.0	7.0	8.0	9.0	11.0	10.5	7.0
Treasury bill rate (3-month maturity)[5]	5.9	3.3	3.3	3.3	7.0	na	na
Deposit rate[6]	10.9	9.3	9.1	9.8	11.1	na	na
Lending rate[7]	14.9	13.7	13.0	12.2	14.8	na	na
			(Tenges per US dollar)				
Exchange rate (end-year)	144.2	130.0	134.0	127.0	120.7	120.8	150.4
Exchange rate (annual average)	149.6	136.0	132.9	126.1	122.6	120.3	150.3
External sector							
			(In millions of US dollars)				
Current account	-272.6	454.9	-1,036.8	-1,987.2	-8,219.0	6,850.0	-4,200.0
Trade balance[8]	3,679.0	6,785.4	10,371.2	14,530.0	14,142.0	33,750.0	16,100.0
Merchandise exports	13,232.6	20,603.1	28,350.0	38,650.0	47,350.0	72,250.0	43,500.0
Merchandise imports	9,553.6	13,817.7	17,978.8	24,120.0	33,208.0	38,500.0	27,400.0
Foreign direct investment, net	2,213.4	5,436.0	2,123.0	6,663.0	7,100.0	3,400.0	5,400.0
Gross reserves, excluding gold (end-year)	4,962.0	8,600.0	6,200.0	17,900.0	15,900.0	18,100.0	na
External debt stock[9]	22,920.6	32,946.0	43,430.0	74,100.0	96,700.0	106,100.0	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)1[0]	4.5	5.5	2.9	6.5	4.3	4.3	na
			(In per cent of exports of goods and services)				
Debt service	35.2	36.2	37.0	32.3	33.2	33.3	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	15.0	15.1	15.1	15.4	15.5	15.6	15.7
GDP (in billions of tenges)	4,612.0	5,870.1	7,591.0	10,214.0	12,850.0	16,052.9	15,074.0
GDP per capita (in US dollars)	2,062.3	2,862.5	3,785.8	5,261.1	6,748.1	8,580.0	na
Share of industry in GDP (in per cent)	25.3	25.4	24.2	23.4	22.6	22.3	na
Share of agriculture in GDP (in per cent)	8.8	8.1	7.9	7.6	7.6	6.9	na
Current account/GDP (in per cent)	-0.9	1.1	-1.8	-2.5	-7.8	5.1	-4.2
External debt - reserves (in US$ million)	17,958.6	24,346.0	37,230.0	56,200.0	80,800.0	88,000.0	na
External debt/GDP (in per cent)	74.3	76.3	76.0	91.5	92.2	79.5	na
External debt/exports of goods and services (in per cent)	153.4	145.8	142.0	178.7	190.0	139.1	na

[1] Data based on labour force surveys.
[2] General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.
[3] Government balance includes quasi-fiscal operations and transfers to the National Fund. Balance excludes privatisation revenues.
[4] Expenditures include extra-budgetary funds.
[5] Average effective yield of short-term National Bank of Kazakhstan notes.
[6] Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.
[7] Lending rate refers to weighted average of interest rates on credits extended to legal entities, excluding banks in tenge by maturity.
[8] Exports at declared customs prices. They are not corrected for under-invoicing of oil and gas exports.
[9] Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.
[1]0 Excludes National Fund.