Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

For more information, go to:
https://www.ebrd.com/publications/country-diagnostics

European Bank
for Reconstruction and Development

Kazakhstan diagnostic paper: Assessing progress and challenges in developing sustainable market economy[1]

Executive summary

This paper assesses the progress in Kazakhstan towards a well-functioning, sustainable market economy, and the challenges ahead. It provides a basis for the design of the forthcoming EBRD Country Strategy for Kazakhstan and for the structure of ongoing and future investment activities and policy advice/advocacy in the country.

The report singles out **five** key constraints that are holding back private sector growth in Kazakhstan. In order of importance, these are the following:

- A better defined and executed role of the state and a gradual reduction of state presence in the economy would make the economy more competitive and well-governed;
- Improved access to finance and a more robust financial sector would support diversification of the economy and make growth more resilient;
- The economy's integration with neighbouring countries and with the wider global economy would be helped by improving the ease of crossing the border, which would improve export opportunities, and by reducing the costs of trade, thus increasing competition;
- The greening of the economy is a critical requirement for a sustainable growth of private sector, particularly in the long-run, with focussed efforts on creating conditions for achieving this required now;
- In addition, improved skills of the workforce are needed to allow the private sector to achieve its potential and make economic growth more inclusive.

Whilst addressing these constraints is critical for all sectors of economy, the General Industry sector – a key source of exports in the non-extractive sector – would benefit the most.

The report also benchmarks Kazakhstan according to the newly proposed EBRD methodology for measuring transition, whereby each country of operations is assessed along six desirable qualities of a sustainable market economy: competitive, integrated, well-governed, resilient, green and inclusive economy. The report provides clear evidence that, since independence, the country has shown notable progress along all six qualities. Whilst the precise methodology for calculating scores for each quality is yet to be developed and approved internally at the EBRD, Annex 1 of the report provides insights into the relative strength of development of Kazakhstan along these dimensions.

[1] Prepared by Agris Preimanis and Nino Shanshiashvili, Department of Economics, Policy and Governance, EBRD. The views in this paper are those of the authors only and not necessarily of the EBRD.

Introduction

This paper assesses the progress in Kazakhstan towards a well-functioning, sustainable market economy, and the challenges ahead. It identifies five critical constraints that currently hold back the development of a vibrant private sector. It also benchmarks Kazakhstan according to the new EBRD methodology for measuring transition, whereby each country of operations is assessed along six desirable qualities of a sustainable market economy: competitive, integrated, well-governed, resilient, green and inclusive economy.

Sections one and two of the report describe Kazakhstan's economic endowment and recent performance, and the political economy context, respectively. Section three provides in-depth analysis of five key constraints to the development of a sustainable market economy. Annex 1 presents a brief overall assessment for each of the six sustainable market qualities.

1. Unique endowment and economic performance

Kazakhstan's economy faces special challenges and opportunities due to its natural endowment and history. The abundance of natural resources, including the 12th largest proven oil reserves in the world and the 2nd largest known recoverable resources of uranium, the vast geographic size (9th largest country in the world by size with and 14th largest arable land[2]) of the land-locked country combined with a population of only 17 million, its location at the heart of Central Asia, its proximity to Russia and China and the legacy of the Soviet Union, have all shaped the country since 1991. The development of China's Belt and Road initiative, and Chinese Foreign Direct Investment ("FDI") more generally, the gradual recovery of commodity prices and the prospects for economic recovery in Russia and other countries of the Eurasian Economic Union ("EEU") represent the key external anchors for growth.

Kazakhstan has enjoyed significant GDP growth since 1991, reaching the highest income per capita levels among the CIS countries in 2015, but well below the levels observed in developed countries. Annual GDP growth has averaged 5.5 per cent over last 10 years, with income per capita[3] reaching US$ 11,580 in 2015. While these growth rates are impressive and living standards are the highest among the Commonwealth of Independent States ("CIS") countries, income per capita remains below the average of US$ 16,238 observed in the eight EBRD countries of operation that are members of the OECD ("OECD-8 countries").[4] Given Kazakhstan's ambition to achieve OECD standards and in the light of the signing of the Enhanced Partnership Agreement with the OECD in 2015, the eight countries from the EBRD region that are members of OECD provide a particularly relevant benchmark sample, when considering the current level of Kazakhstan's progress towards establishing a sustainable market economy. It is also well below the average of US$ 37,428 observed in the entire OECD.

The country remains vulnerable to global commodity price shocks as extractive sectors continue to dominate the economy. Despite previous efforts at diversification and recent oil price declines, exports of non-extractive sectors were just 12 per cent of GDP and 39 per cent of total exports in 2015, compared to oil exports at 16 per cent of GDP and 52 per cent of total exports. Notably, the share of oil exports in GDP has declined since 2000 (24 per cent), notwithstanding the increase in oil prices between 2000 and 2015, whilst the share in total exports has remained largely unchanged (50 per cent). In the short-run, the share of oil in

[2] Kazakhstan is also the second largest exporter of wheat flour in the world.

[3] GNI per capita, Atlas method (current US$), World Bank 2015, International Comparison Program Database.

[4] "OECD 8 countries": Estonia, Greece, Hungary, Latvia, Poland, Slovakia, Slovenia and Turkey.

total exports can be expected to increase further, given the expected significant increase of oil production in the Kashagan oil field – one of the largest new oil fields discovered in the last 30 years – from 2017 onwards. The vulnerability of the country to commodity price shocks has been most recently illustrated by the negative impact of the 2014-15 oil price collapse on GDP growth in Kazakhstan, which fell from 6.0 per cent in 2013 to 1.2 per cent in 2015.

The micro, small and medium-sized enterprise ("MSMEs") sector is more important than in CIS peers, but less so than in OECD-8 countries. In 2015, Kazakhstan's MSMEs employed 52 per cent of total employed and contributed 47 per cent of value added in the economy, which is above the average levels observed in other CIS countries (42.7 and 34.7 per cent respectively). The MSME sector, however, is comparatively less important than in the OECD 8 countries (74.7 and 61.9 per cent respectively).

Productivity in Kazakhstan compares well with other CIS countries, but significantly lags OECD-8 and other OECD countries. In 2014 GDP per person employed (at constant 2011 PPP prices) stood at US$ 46,769 in Kazakhstan, compared to US$ 22,929 on average in other CIS countries, US$ 57,757 in OECD-8 and US$ 81,444 in OECD member countries. The labour productivity of MSMEs in Kazakhstan is roughly half that of large companies in the country.

Access to credit and foreign investment is below CIS peers and more advanced countries. Private sector credit to GDP in Kazakhstan is around 30 per cent, which is only slightly below the level in CIS countries excluding Kazakhstan (39.5 per cent), but very low compared to the average across OECD-8 countries (63 per cent) and all OECD countries (147 per cent) in 2015. More than US$ 130 billion has been invested into the country by foreign investors since 1991, with around 60 per cent of inward FDI (over 2001-15) going into the extractive sectors. However, the stock of FDI per capita in 2014 at US$ 436 was lower than the average (US$ 523) for OECD-8 countries and (US$ 2,225) for all OECD countries.

The state sector is prevalent in several key sectors. The State-owned and Quasi-State-owned enterprises (collectively referred to in this report as "SOEs") constitute as much as 50 per cent of GDP in Kazakhstan, which is considerably above the average across the OECD-8 countries and all OECD countries (19 and 15 per cent respectively). Companies owned by Kazakhstan's National Holding "Samruk-Kazyna" ("SK Holding") in particular retain a significant and often dominant role in many important sectors of the economy, such as mining and quarrying (60 per cent of sector by assets), electricity, gas steam and air conditioning supply (42 per cent), transportation and storage (31 per cent), and information telecommunications (30 per cent). The agriculture sector is also characterised by a strong state presence, with the Food Contract Corporation (fully owned by the state through the National Holding KazAgro) is the largest trader and exporter of grain.

The SK Holding companies and other SOEs play a critical role in creating a framework for private sector development through shaping the competitive landscape and investor perceptions, providing infrastructure and public services, and procuring goods and services. At the same time, the authorities have for many years implemented ambitious state support and industrialisation programmes, with more than US$ 97 billion provided since 1997. There is currently a clear understanding at the level of the Government of Kazakhstan that it is critical to improve the effectiveness and reduce the role of the state in the economy, including through privatisation of SOEs.

There are opportunities for a substantial increase in FDI. A significant expected increase of investment from China, including development of the Belt and Road initiative, combined with an expected recovery of FDI from the EU and other countries, can be expected to boost growth and, more broadly, provide a platform for creating better connectivity and growth (including in the non-infrastructure sectors) in the country. In addition to trade and investment ties to traditional partners, links with expanding markets such as Iran can also provide a boost to growth.

2. Political economy and the reform environment

The political and institutional context for private sector-friendly reforms is complex but favourable. Kazakhstan's independence following the breakup of the Soviet Union was the starting point for the country's political and economic transition. The country has been one of the most successful ex-Soviet republics on the path of economic transformation but political transition throughout the last two decades has been slow. Despite this, the country continues to benefit from a political leadership committed to sound policy making and equipped with expertise to design appropriate policies. Attracting foreign investment and creating favourable conditions for investors are crucial elements of successive government programmes. On the other hand, vested interests, both in SOEs as well as in large private companies, constitute a significant obstacle to the effective implementation of certain reforms. Corruption also remains a serious issue: Kazakhstan ranks 159th (out of 215 countries/territories) in the Control of Corruption sub-indicator of the World Bank's Worldwide Governance Indicators (2015).

Reform momentum has picked up pace more recently. The pace of reform, which slowed in 2000s has picked up again, with a number of successful economy-wide and sector-level reforms introduced or in preparation since early 2014. The Government has introduced a new Investment Law; Private Public Partnership ("PPP") legislation has been improved; ambitious utilities tariff reform in regulated sectors is under way; and the monetary policy framework has been strengthened. The "privatisation programme 2016-20" is expected to result in the transfer of a large number of SOEs and their assets to private ownership, and other initiatives are under way. Kazakhstan completed its accession to the WTO in 2015, and is anchoring a significant part of its current reform process within the framework provided by the Enhanced Partnership with the OECD. However, the transition to a well-functioning market economy is far from complete.

> **Recent monetary policy reform and its impact:**
>
> By Q2 2016, the exchange rate has stabilised and trust in the local currency is gradually returning, helped by the NBK introduction of an unlimited borrowing /lending window for commercial banks at a base rate +/- 1 percentage point, clearer NBK guidance on future evolution of the base rate, and monthly reporting of its trading activity in the FX market.

3. Key binding constraints to developing a sustainable market economy

Since independence, Kazakhstan has made significant progress on moving from a planned to a market economy, showing notable progress along all six qualities of a sustainable market economy. In this section we present an in-depth analysis of five key constraints that are holding back the private sector from developing its full potential. In the Annex, we provide a snapshot of each of the six qualities.

1) **The role of state: prevalence of SOEs, underdeveloped state support programmes and insufficient capacity of civil service adversely affect the potential of private sector companies. (Competitive/Well-governed)**

The improvement in the functioning of Kazakhstan's SOEs is critical for private sector development. Whilst a significant progress has been made with improving Kazakhstan's SOEs, including through the "Transformation" process[5] of SK Holding and its companies, at present, the direct interactions between SOEs and private sector companies, through activities such as procurement, are inefficient and hold back the development of a competitive private sector. They also limit the creation of an effective infrastructure by such SOEs as KazTemirZholy (railways, logistics) and KazakhTelecom (telecommunications, internet), in turn inhibiting the development of a competitive private sector that relies on such platforms. More indirectly, SK Holding and its companies have a big influence on foreign investor perceptions of the country, and therefore improvements in the running of these SOEs will directly translate into an improved ability of private sector companies to attract FDI. Some obstacles (e.g., the inability to earn profits due to utility tariffs below cost recovery levels) make transfer of ownership of "natural monopoly" companies to private hands particularly challenging.

> "Many government tenders contain conditions that are intentionally set unrealistic and pre-set in the interests of particular companies and providers, requesting even technical specifications which only a particular provider is able to meet within realistic deadlines."
>
> **EBRD client**
>
> "State procurement law regulations are too hard on SMEs, because bid payments are made in up to 90 days, which is unacceptable for many good quality providers. Sometimes they require 100 per cent cost of tender amount to be pledged, and repay this back only once tender amount is wired. This requires overwhelming high liquidity. So we end up investing twice more before the procurement."
>
> **EBRD client**

Several aspects of Kazakh SOEs give cause for concern, which is holding back private sector development: poor corporate governance, inefficiency, insufficient quality of corporate strategy, poor HR practices, procurement practices that are not in line with best international standards, and a weak regulatory framework governing their activities. An external expert analysis carried out for SK Holding and the underlying design of the "Transformation" process of SK Holding and its companies identified the following three areas as particularly problematic: (i) the activities of SK Holding companies do not produce sufficient value added; (ii) the structure of SK Holding's portfolio of companies and the approach of SK Holding to managing its investment activities are sub-optimal; and (iii) the authorities and responsibility in the management system of SK Holding and its portfolio companies need to be redistributed and clarified.

The regulation of SOEs remains underdeveloped. The tariff-setting methodology, the capacity of the regulator, and other aspects of regulation in natural monopoly sectors such as electricity transmission and distribution and water and wastewater, all remain underdeveloped, although steps have been taken (for example, adoption of the new utility tariff methodology, which is now being piloted) to enhance the regulation. For example, a detailed assessment highlights the following key barriers to power sector development: (i) the lack of an effective functioning wholesale electricity market, which could provide sufficient investment signals for new generation; (ii) challenges in ensuring effective and independent regulation; and (iii) distortions due to cross-subsidies and tariffs for consumers that do not ensure cost recovery. The EBRD Evaluation Department's analysis of the EBRD's

[5] The key purpose of "Transformation" process, which was launched in 2014, is transition SK Holding from the position of administrator of state assets, to the role of active investor. The process focuses on increasing value of the Holding companies, increasing efficiency of the Holding companies, and implementing new principles of corporate governance. The transformation covers SK Holding and its companies KazakhstanTemir Zholy, Kazpost, KazMunayGas, KEGOC, Samruk – Energy, Kazatomprom and Samruk-Kazyna Contract.

involvement with SOEs confirms the problems identified by SK Holding and its external consultants in the preparation of the "Transformation" process.

Procurement practices at SK Holding companies and other SOEs remain problematic. Although precise data are not available, interviews with enterprises and other stakeholders suggest that the key negative perceptions of the private sector towards SK procurement practices are caused by artificial entry barriers (overly stringent technical specification criteria, and sometimes significant financial pledges required from tender participants), weaknesses in decision making (lack of transparency, subjectivity, favouritism and corruption), and unbalanced contracts. The country has embarked on the process of negotiating accession to the WTO's General Agreement on Procurement, and there have been improvements in the procurement framework over recent years. These include the introduction of mandatory e-procurement in July 2012, but practical implementation has not been effective. SK Holding approved new procurement rules for its holding companies in September 2015, but again their ultimate impact will depend on implementation. Further efforts are essential to promote transparency and the use of e-platform and open tenders, to increase competition by strengthening conflict of interest/affiliation rules and removing arbitrary limitation to subcontracting (including local content requirements) which disadvantages foreign companies), and to further streamline procedures to avoid unfair and unnecessary costs.

Efforts to privatise SOEs have had mixed results to date. Gradual sale of stakes in SOEs to local and international investors is a critical part of making these companies more efficient and more competitive, and ultimately transferring them to majority private ownership. However, previous privatisation efforts have had limited success. For example, under the People's IPO programme announced in 2011, out of initially planned five companies, only stakes in KazTranOil (in 2012) and KEGOC (in 2014) were sold on the local stock exchange ("KASE"). Also, under the "2014-16 privatisation programme", where the plan was to sell stakes in 106 companies, only 37 companies were sold over 2014-15.

New impetus can be provided by the "comprehensive privatization plan for 2016-2020". The design of this programme drew on lessons learned from previous privatisations. For example, the programme does not stipulate that only domestic retail participants can take part (as in the People's IPOs). Also, no administratively prescriptive timelines and method of sale have been set (as in the "2014-2016 privatisation programme"), which will allow the authorities to attract a larger pool of investors and take the required time to prepare the assets for sale and carry out a due sale process. At the same time, there are strong additional pre-conditions for success when compared to previous privatisation rounds. Blue-chip assets have been put up for sale; Chinese investors are likely to show interest; and the Astana International Financial Centre ("AIFC") is likely to provide a more effective platform for sale than the KASE.

The limited capacity of the civil service constitutes a major obstacle for the enactment of effective legislation and regulations and the design and implementation of government policies and specific projects. Improving the capacity of the civil service is of paramount importance for ensuring that the State plays a strong positive role in creating an effective platform for private sector development, including through a well implemented structural reform agenda. On a more micro level, the ability of the authorities to effectively manage projects is one of the key challenges when considering participation in the tenders for projects under State support and industrialisation programmes and those carried out by SOEs. One of the key value-added components of EBRD projects with local municipal companies is the support provided for project preparation and management of delivery, where standards are typically well below required levels. It should be noted that this challenge has been recognised by the Government and steps to improve capacity of civil service are being taken, including by utilising such domestic institutions as the State Civil Service Academy, and through a highly successful Boloshak program, under which thousands of Kazakhstanis have studied at universities abroad (with part of them returning to the Civil Service posts in Kazakhstan).

Few emerging markets have pursued industrial policies to diversify their economies as persistently as Kazakhstan (but there is little evidence that these policies have had the intended effects). Between 1997 and 2015 subsidies of different types worth over US$ 79 billion have been provided to firms. These programmes have played an important role in supporting the economy through economic downturns, being among the main sources of new credit since the 2008 crisis. An econometric analysis[6] shows that in sectors benefitting from state aid in the form of direct subsidies (typically non-extractive activities dominated by private corporates), value-added and FDI flows increased in recent years, since 2011.

At the same time, none of the policy interventions (trade policy measures or financial production incentives) seems to have achieved their key stated objective of increasing exports. Whether import restrictions, export incentives, trade liberalisation or more direct financial state aid, the econometric analysis did not find evidence that Kazakh policy interventions boosted exports at the sectoral level to trading partners since global trade fell in 2009. In contrast, Kazakh exports were found to be sensitive to foreign policies. Put differently, although direct financial support was linked with greater output and FDI for targeted sectors, these effects did not translate into larger exports. More likely, state aid attracted firms to supply the domestic market, while implying a limited capacity to benefit from scaling up or competing in world markets.

This is worrying not only because of the high fiscal cost of these programmes, but also because they have brought distortions to, among other, the banking sector, as financing is typically provided at subsidised rates. For example, under the Business Road Map 2020 programme, the cost of credit to the end borrowers, at 7 per cent, is well below the 15-20 per cent market rates. The significant difference between the subsidised and market rates has reduced the incentives of market participants to develop market-based financing mechanisms (e.g., the issuance of bonds in the market), therefore making it more difficult for such mechanisms to be established. Also, at times, not sufficient consideration has been given to the credit quality of MSMEs and other recipients of the support provided under the programmes. It should be noted, however, that the most recent lending support provided to companies and banks through the National Pension Fund is priced at what can be considered market rates, thus supporting normalisation of the financial system and a gradual move to market rates overall.

[6] The study was conducted based on an extensive survey of Kazakh industrial policies, assembling a comprehensive database of financial and policy support measures covering 5 economic strategy statements, 27 targeted sector programmes and 592 government policy interventions. The survey covered a wide range of instruments, including import tariffs, loans and subsidies, export taxes and restrictions, liberalising measures, quota, tax exemptions etc. The study covers the years 1997-2015, although the frequency of interventions increases remarkably after 2007, making this period more interesting and the statistical analysis more reliable, also due to data quality and availability for more recent years. The study relates different categories of policy interventions (explanatory variables) to different outcome (dependent variables), particularly sectoral output measured as value-added, sectoral FDI inflows, and sectoral exports. Regression equations were specified according to the dependent variable, but generally included standard controls such as oil price changes and fixed effects.

A comprehensive review of Kazakh industrial policy also indicates room for the Kazakh government to strengthen evidence-based policymaking for the strategic planning and implementation of industrial policies. The process of identifying sectors and/or activities to be supported as well as the analysis of obstacles that affect their growth have not been sufficiently rooted in an understanding of firm and sector-level characteristics and the wider regional and global context. The findings from the econometric study illustrate that, among a range of policies and financial measures, only direct production incentives (soft loans, guarantees, state aid etc.) were correlated with outcomes in targeted sectors, and the effects were limited to output and FDI, not translating into stronger exports. Industrial policy support would also have benefited from being more closely linked to improvements in the recipients' performance to incentivise competitiveness at the company level. (There is ample evidence, for example, from implementation of the EBRD's Sustainable Energy Financing Facilities across countries, that conditioning the provision of grants to companies on the achievement of actual energy efficiency improvements improves the chances of reaching the desired outcome.) Should the Kazakh government continue to devote large sums to such measures, then the capacity of the civil service to design, execute, and evaluate industrial policy should be strengthened accordingly. An independent body for the design and evaluation of industrial policy in Kazakhstan would also support monitoring, as well as facilitate learning from past experiences.

2) **Underdevelopment of the banking sector, and particularly problems with access to finance, continue to constrain the development of a more diversified and <u>resilient</u> economy.**

The banking sector is not sufficiently resilient. Reported capitalization of banks is adequate, with a Capital Adequacy Ratio at 16.4 per cent as of December 2016 (vs. 12 per cent regulatory minimum). However, capitalisation may be under pressure due to a number of factors, including off-balance sheet liabilities and crystallisation of losses from restructured loans. The Tenge liquidity situation in the market, whilst improving in 2016, is still very challenging, reflecting the high level of dollarization and tight monetary policy of the NBK, as well as the significant underdevelopment of local money markets. Improving resilience of the banking sector is critical for further development of the private sector, particularly in the non-extractive sectors, bearing in mind the detrimental impact of the 2008 and 2014-15 crises.

An underdeveloped banking sector and non-existent capital markets are putting particular pressure on firms in non-extractive sectors, with MSMEs being the most affected. Whilst SK Holding companies and other SOEs source the majority of their financing from external foreign lenders and from the State (National Fund, Pension Fund, etc.), private sector companies must rely on the underdeveloped domestic banking sector as the sole source of funding. As a result, the gap in MSME access to finance is large when compared with other transition countries. The share of credit-

"Financial institutions dictate their conditions and requirements to small businesses, and if larger entities are capable of insisting on somewhat better terms of lending, smaller entities do not have enough capacity. After applying to several banks we have been offered more than 20 per cent interest rate, nobody agreed to discuss its possible lowering. Besides, when we applied to a bank they have requested us to transfer all other corporate accounts into this bank."

EBRD client

"Overwhelming requirements to loan security (pledge) became a reason for our suspending the investment project on production of medical appliances, which are desperately demanded at the Kazakhstan market at the moment."

EBRD client

constrained MSMEs as a per cent of MSMEs needing a loan stood at around 67 per cent in Kazakhstan, compared to 54.4 per cent in the CIS excluding Kazakhstan, and to 35.7 per cent in the OECD-8 countries.

Borrowing has declined in recent years. Overall, there has been a significant reduction in recent years in the proportion of firms that had loans outstanding, with 19.2 per cent of all firms, the majority of them MSMEs, reporting that they had a loan or a line of credit in BEEPS 2013-14 compared to 33.2 per cent in BEEPS 2008-09. Firms outside Almaty and Astana face particular difficulty in accessing finance. Companies in the construction and retail and wholesale trade sectors have better access to finance than those in other sectors. Also, total private credit in Kazakhstan, which stands at 30 per cent of GDP, while higher than in other countries in Central Asia, is low when compared to countries in emerging Europe. Complex procedures, high interest rates and stringent collateral requirements are the top three factors that have discouraged firms from obtaining credit in BEEPS 2013-14.

The 2008-09 crisis has left the legacy of high non-performing loans, which continue to pose problems despite efforts to resolve them. In 2008-09 Kazakhstan experienced a banking crisis, which required bailouts of several banks and resulted in NPL levels across the sector that exceeded 30 per cent, with NPL levels in some of the largest banks well-above average in the sector. The NPL ratio at end-2016 stood at 6.7 per cent, which is well below the 30 per cent or so level that persisted over the period 2008-13. This reduction is a result of steps taken by the NBK, commercial banks and other stakeholders, including the splitting of BTA-KKB, the bank with the highest level of NPLs, into two banks: a "good" (KKB) bank and a "bad" (BTA) bank, with the banking licence of BTA rescinded. The most recent fiscal support to the banking sector, which amounted to Tenge 500 billion or around 1.5 per cent of GDP, was used primarily to support the work-out of the NPLs of BTA. However, since this support to BTA was channelled through KKB, the exposure of KKB to the performance of the NPL portfolio of BTA has not been eliminated. Similarly, off-balance sheet structures have absorbed the legacy NPLs in some other banks. Therefore, the underlying asset quality of the system remains a concern, even though reported NPLs are now below the 10 per cent threshold.

3) **Cross-border and domestic soft and hard infrastructure, as well as quality of logistics are the key obstacles that constrain the development of a more <u>integrated</u> economy.**

Kazakhstan has made significant progress with improving infrastructure and lowering "soft" barriers to trade; however, cross-border connectivity remains underdeveloped; the costs of crossing the border are high and the quality of logistics insufficient. In terms of cross-border trade, Kazakhstan has particularly high trade costs with its neighbouring countries. The costs of trade in manufacturing goods are as high as 50 per cent ad valorem when trading with Russia and over 200 per cent in the case of Armenia. This compares to, for example, the costs of trading between Russia and Belarus of 38.3 per cent or between neighbouring countries within the EU of 20-25 per cent. High transport costs are detrimental to private sector development because they constrain the ability of local companies to export and acquire production inputs at competitive terms and they act as a protectionist measure against imports, hence reducing competitive pressures on local companies.

"Soft infrastructure", such as customs regulations, capacity of customs officials, for trade across borders remains particularly problematic, affecting logistics and weighing heavily on private sector prospects. The WEF's 2014 Global Enabling Trade Index ("ETI") provides a clear indication that "soft infrastructure" (customs procedures, etc.) is a particularly significant bottleneck, with hard infrastructure also requiring improvements. In the 2014 ETI, Kazakhstan is ranked as low as 127th (out of 138 countries) in the border administration component and 108th in market access. Kazakhstan's performance in the World Bank's Logistics Performance Indicators ("LPI") confirms the challenges in logistics systems that can be used by the private sector, with Kazakhstan ranking 77th (out of 160 countries) in the 2016 LPI rankings. While changes introduced to export and import procedures in 2015 (these included reduction in number of documents required for export and import) most likely improved the situation, the scope for further reform remains substantial. Enhanced approaches to border inspections, and increasing the application of risk-based approaches, could also help improve the situation.

> "All carriers and freight forwarders suffer at cross-border stations, wasting lots of time because all, and even transit cargo are being inspected in-depth. Therefore there are clients who look for workaround solutions."
>
> **EBRD client**
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> "Using a status of an "authorised economic operator" has significantly facilitated our customs clearance activities and helped make imported good quickly available for distribution across the country. New more restrictive entry requirements to acquire and retain the status of an authorised economic operator, including the deposit of up to one million euros with the Customs or complete liability insurance concern us and may increase our costs."
>
> **EBRD client**

The road sector remains not fully reformed and is in need of investment. Considering that Kazakhstan is a land-locked country, roads play a key role in the economy and provide the backbone for private sector activity. The quality of roads requires further improvement and in places it is deteriorating, in part due to harsh weather conditions but also due to the lack of proper maintenance and quality control. Therefore, new construction alone will not unblock trade bottlenecks; more structural changes are needed. In particular, capacity building needs to continue in Kazavtozhol, the state road agency responsible for implementation of technical and regulatory policy in the road sector and the management, construction and repair of roads. This includes strengthening of its key functions; improving effectiveness of interaction with the Government; improving corporate governance and organisation; and strengthening the asset management and procurement capacity and practices. In addition to routine maintenance, private sector participation can be enhanced in the following areas: PPPs associated with road construction/rehabilitation and tolling operations; privatising routine maintenance functions; and outsourcing ancillary operations such as tolling operations and service area management.

Regional and local roads are a particular source of concern. While major parts of international road corridors have been built in the last decade, investment and maintenance in regional and local roads lag behind. This affects the ability to develop a competitive private sector outside of main cities and constitutes an obstacle to achieving more inclusive growth. The EBRD's price survey suggests that, while prices in Almaty and Astana are largely equal, price disparities between urban and rural areas are substantial, which among other factors can be explained by sub-standard connectivity between major urban and rural areas.

The railway sector has gone through significant transformation over recent years, but significant challenges with tariff setting and rules of access remain. KazTemirZholy, a state-owned railway company, is a natural monopoly in the rail infrastructure and it continues to have presence in such segments as the freight forwarding and rail cars, both of which are open to competition from private operators. Overall, private participation in the Kazakhstan rail industry is currently limited to ownership, leasing and operation of railcars. In recent years, KazTemirZholy has worked on improving its governance, strategic planning and efficiency, including improvements of energy efficiency of its operations; however, there remain significant challenges in relation to the structure of tariffs, which are not costreflective, and cross-subsidies between the passenger and freight operations. Resolving the issues with tariff structure is key to creating more commercially driven operations of KazTemirZholy, as well as to increasingly opening different segments (e.g., locomotive haulage) to competition, including from international companies. Rules of access to regular railway container freight services of KazTemirZholy, particularly those provided by its subsidiary KTZ Express, are not yet sufficiently clear and create distortions in the competitive environment of the sector.

Access to financing in the transport and logistics sector remains a constraint. According to the BEEPS 2013-14, 83 per cent of firms in the transport and logistics sector do not have any loans outstanding, which is in line with the situation observed across the full sample of firms in Kazakhstan (although it should be noted that the sector-level sample is not large enough to draw robust sector-level conclusions from BEEPs data). However, the constraint is considerably more significant than on average in the EBRD region, where only 40 per cent of firms do not have any loans outstanding. This insufficient access to finance constrains ability of firms to finance expansion of transport and logistics operations, with the private sector operators most affected.

Corruption in the transport and logistics sector increases the costs and risk of trading. According to BEEPS 2013-14, the business community perceives corruption in the sector as one of the biggest obstacles to doing business, leading to higher costs and uncertainty about transport services. According to the results of anonymous interviews, there are several areas where the situation is particularly worrisome: (i) access to railway infrastructure and traction as well as railway-related services; (ii) mandatory use of customs brokers for customs clearance procedures as intermediaries between customs officials and traders, a costly practice that could be eliminated if all border crossing and custom procedures became simpler and more transparent; and (iii) a dual monopoly at the Aktau port, which not only is the only port on the Caspian Sea but is also managed by a state-owned monopoly.

The Belt and Road initiative is one of the key anchors for developing infrastructure and logistics in the country. The initiative brings new multi-billion US$ inward investment into infrastructure in Kazakhstan and other countries along the New Silk Road, which will help to improve infrastructure connectivity; it will also facilitate improvement of energy and telecommunications connectivity and improve commercial and financial linkages. Indeed, the Belt and Road initiative can facilitate alleviation of the connectivity constraints identified facing Kazakhstan, for example, by helping to improve the road infrastructure in the country. At the same time, reduced “soft barriers” to crossing the border and improved technical and management skills of employees will allow private sector logistics firms to take better advantage of improved infrastructure developed as part of the initiative.

4) The country continues to face challenges with respect to developing a framework for <u>greener</u> growth, which need to be addressed to create conditions for more competitive economy in the long-term.

Kazakhstan has been committed to introducing “Green Economy” principles in the country; in the long-run, greening Kazakh economy can become a key driver for creating favourable conditions for private sector growth. Kazakhstan’s COP21 commitments – to achieving an economy-wide emissions reduction target of 15 per cent (unconditional) to 25 per cent (conditional to receiving international funds) by 2030 compared to 1990 – and the “greening” of Kazakhstan’s main trade and investment partners, such as China and EU, will make it increasingly critical to implement the green economy framework, as the current environmental footprint is not sustainable. The private sector has a key role to play in increasing share of renewable energy in the country’s energy mix, increased energy efficiency of the public and private sector, the introduction of new financing mechanisms (e.g. dedicated credit lines for small-scale energy efficiency and renewable projects) as well in supporting adaptation of the general industry to more sustainable production methods through, for example, introduction of climate technologies. Over recent years Kazakhstan has made significant efforts on improving the regulatory framework governing Green Economy, including adoption of the Green Economy Law in 2016; however, significant efforts on improving the regulatory framework and, more broadly, creating conditions for private sector participation are required.

Kazakhstan is the largest emitter of greenhouse gases ("GHG") in Central Asia and its economy has one of the highest CO_2 intensities in the world. Kazakhstan's economy is twice as energy intensive – when measured per unit of GDP – as the average OECD economy and thus the potential for energy savings is very large in many sectors, notably the energy and industry sectors. Notably, the energy intensity in Kazakhstan (total primary energy supply over GDP at 0.88) is also higher than average across the CIS(0.84) and considerably above the OECD 8 countries (0.22). Carbon intensity in Kazakhstan (CO2 over GDP at 2.65) is also significantly higher than average across the CIS (1.82) and the OECD 8 countries (0.53). A switch from coal to natural gas and renewables in the power sector is key in reducing GHG emissions as the power sector is responsible for approximately 85 per cent of total emissions.

The country is likely to lose substantial state and private fossil fuel revenues in a global low-carbon scenario. According to estimates from Climate Policy Initiative for the EBRD, the highest losses would be to oil-sector related state revenues, which would fall by 23 per cent compared to the "business as usual" case between 2015 and 2030. Losses of revenues linked to coal production under the low carbon scenario will be also substantial, but concentrated in the private sector. In contrast, natural gas demand and revenues would remain fairly stable until the second half of the 2020s. These losses both in the public and private sector need to be offset by additional dynamism from moving to a greener and more competitive economy.

Despite significant progress over recent years, obstacles to developing a greener economy persist, not least because of vested interests. Vested interests, usually linked with energy inefficient and carbon intensive state- and locally-owned sectors, have stifled the development of Green Economy Transition by impeding the creation and implementation of legislation and regulations required for the development of Renewable Energy, Energy Efficiency, the emissions trading scheme ("ETS") and other elements of the Green Economy.

Emissions trading schemes are still in development. The Kazakh authorities have been working, with support from the EBRD, on the development of a domestic ETS. The legislation enacting the scheme, which is broadly comparable to the EU ETS, was enacted in December 2011. In January 2016, the Government approved the emission allocation plan up to 2020. However in April 2016, trading and penalties for non-compliance under the ETS were put on hold until January 2018. The work needs to continue to strengthen the ETS carbon market (institutions, regulatory and carbon exchange), so that it effectively sends the price signals that would reduce the carbon intensity of the economy in a cost effective way. Also, an increasing share of allowances needs to be auctioned (as opposed to being provided free-of-charge) to support the development of the carbon trading market.

To continue further improvement of renewable energy regulations in order to scale-up investment in the sector. The 2009 Law on the Use of Renewable Energy Sources established the legislative framework for renewable energy development (power and heat) but did not lead to an effective uptake of projects, due to a series of deficiencies. Those included the lack of a unified tariff for projects which were instead determined on a project-by-project basis and subject to annual change by the regulator. Subsequent amendments in 2013 and 2016 have improved the situation somewhat, including promoting technology-specific feed-in tariffs for selected renewable energy technologies, such as biomass, solar, wind, geothermal and hydropower, up to 35 MW, but challenges remain. These include the creditworthiness of the financial settlement centre responsible for paying the feed-in tariffs ("FITs") for renewables, grid connection issues and stability of feed-in tariffs against Tenge exchange rate volatility.

"On green economy and energy efficiency: until we have cheap coal, and current level of heat tariffs, unfortunately we won't switch to green economy and energy saving technologies"

EBRD client

"Development of renewable sources of energy is impossible without eliminating tariffs regulation, particularly now when USD exchange rate against Tenge almost doubled; now all foreign equipment became twice more expensive. Although every project has its individual specifics, payback period is long for all of them, thus making them unattractive for the investors."

EBRD client

Progress in improving energy efficiency has been slow. Energy efficiency targets exist and have been presented in successive legislative and planning documents, but these have not resulted in significant energy efficiency gains. For example, the energy intensity of Kazakhstan's economy has been relatively stable since 2003. Furthermore, the implementation of the secondary legislation underpinning these targets has been lagging. Energy tariffs are well below costs, especially for households; insufficient awareness of opportunities for energy intensity reduction, for instance due to the absence of data and benchmarks is an important barrier; and the financial sector, hit by successive crises and lacking necessary skills for energy efficiency investments, is not supportive of this type of investments, which is holding back private sector participation in energy efficiency improvement.

Air pollution is an increasingly important issue in major cities and industrial areas, with significant differences by region and by industry. This is creating health hazards for the population and affecting environment, and will require a long-term strategy that will inevitably affect operations of the SOEs and private sector companies, particularly in the sectors that are biggest pollutants. Outdoor air pollution is mainly caused by the combustion of petroleum products or coal by motor vehicles, industry and power stations. The workplace is the second area of air pollution exposure. Natural resource extracting and processing industries emit dust or hazardous fumes at the worksite. Such industries include coal mining, mineral mining, quarrying, and cement production.

"Of course, this costs our business money. You do the maths: it's ideal if you can hire someone who knows how to do the job on Day 1, but if you need to train them – and we usually do, for about one year on average – it costs us money."

EBRD client

"Our business is very complex. We are growing at 30 per cent a year at the moment and we need high-level technical skills across all areas in order to continue to innovate and grow. We even need our sales team to have considerable technical knowledge, so that they know how to sell our products to clients."

EBRD client

5) **Skills mismatches across sectors, with some regions particularly affected, constitute a key challenge for the development of more <u>inclusive</u> growth.**

Kazakhstan has made strides since independence with introducing modern skills base in the country, however, mis-match of skills has become a significant constraint. Firms are increasingly facing problems with acquiring workers with the required skills, a problem that can be expected to deepen further as new sectors of the economy develop and new sets of skills are required for non-extractive sectors to become more competitive. The gaps are creating real operational challenges such as high recruitment and training costs, lower productivity and constraints on innovation and new product development. In BEEPS 2013-14, 13.1 per cent of firms identified skills as a major constraint on their growth, and the share was as high as 20.1 per cent for manufacturing firms. The share of firms that identify skills as a major constraint is below average of the CIS excluding Kazakhstan (15.2 per cent), and in line with the OECD-8 at 13.0 per cent. Notably, 63 per cent of firms in Kazakhstan expected that total annual sales would increase if an inadequately educated workforce was no longer an obstacle.

Skills mis-match is also making growth less inclusive, with the regions particularly affected by lack of required skills. According to the BEEPS 2013-14, as many as 29.4 per cent of firms in East Kazakhstan, 18.9 per cent in West and 18.5 per cent in North report that inadequate education of the workforce is a major constraint on doing business, compared to less than 5 per cent of firms in Almaty and Astana. Low levels of labour mobility have also exacerbated skills gaps, with two-thirds of the population remaining in the same place of residence since birth according to the 2009 census.

Employees are more educated than ever, but employers report difficulties in sourcing the highly skilled professionals that they want. The percentage of employees with a university degree increased from 33.8 per cent in BEEPS 2008-09 to 44 per cent in BEEPS 2013-14, which was higher than the Central Asian average and about 14 percentage points higher than the BEEPS average across the whole transition region. However, the Ministry of National Economy reports a deficit of 61-77 per cent in technical specialists. In the 2013 national employer survey, the largest categories of unfilled vacancies related to "higher skilled experts" (25.8 per cent of total), followed by "skilled workers qualified in industrial engineering, construction, transport, communications and geology" (15.6 per cent). Interviews with EBRD clients and other companies in manufacturing and construction confirm that they found it difficult to source highly skilled professionals such as engineers with relevant experience and knowledge of the latest technologies. There is also evidence of a gap in non-technical skills across all industries,, with graduates said to be lacking the non-cognitive skills needed to adapt to quickly changing technologies and commercial environments, including project management, leadership, and teamwork. Challenges in relation to skills mismatch in Kazakhstan will likely affect mining sector disproportionately if necessary responses are not developed in a timely manner given that the mining sector is forecast to be one of the sectors with the highest employment growth rate over 2015-20.

Concerns about skills constraints are most acute amongst large firms, but constraints are increasingly reported also by MSMEs. Large enterprises report more often the problem of an inadequately educated workforce, according to BEEPS 2013-14, and more than half of them provide formal training to their employees, Small firms (5-19 employees) report skills constraints less frequently and only about 20 per cent provide training to employees; within these firms, training was offered to just under one half of the workforce.

Existing skills mismatches are not a result of lack of access to education, but rather failure to acquire job-relevant skills and competences. A lack of required skills is often reported notwithstanding the fact that as many as 80 per cent of employees in manufacturing received some training or education before or after joining the firm and can thus be considered as skilled. In addition, there is a high proportion of young people in tertiary education and Technical and Vocational Education and Training: some 38 per cent of youths were in some form of post-secondary education in 2013. One reason for remaining mis-matches is that the involvement of the private sector in vocational education and other formal training remains insufficient.

Skills standards and verification mechanisms are outdated and do not fully reflect employer requirements. The National Qualifications Framework was adopted in 2012 and, to date, 183 professional standards have been developed under this framework, representing only one-third of the total required. These standards form the basis for the development of course offerings and curricula, and therefore they form an important part of the resolution of skills-mismatches in the country. It will be critical to ensure employer input into the development and further improvements of standards, particularly in priority sectors such as manufacturing and construction.

Annex 1: Qualities of sustainable market economy

Competitive

Kazakhstan has over the last decade improved its competitiveness, and it is now ranked 42nd (among 140 countries) in the WEF's global competitiveness index 2016, with many features of a competitive economy in place. However, clear challenges remain.

- As discussed in detail in Section 3, the **role of SOEs** has been identified as a critical constraint holding back the development of a more competitive and commercially-oriented economy, because of their strong direct and indirect impact on the private sector. Several aspects of SOEs give cause for concern: poor corporate governance, inefficiency, insufficient quality of corporate strategy, poor HR practices, procurement practices that are not in line with best international standards, and, at times, a weak regulatory framework governing SEOs' activities.

50 per cent of GDP contributed by SOEs

91st in business sophistication ranking among 140 countries

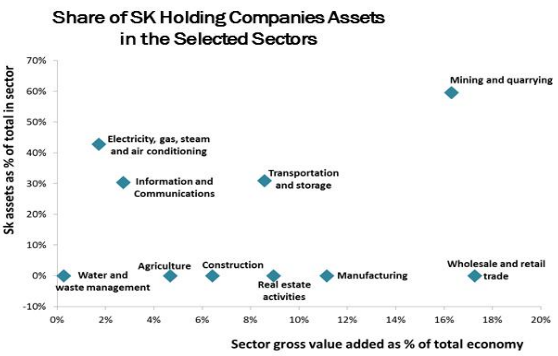
41st in ease of doing business 2016 among 189 countries

62nd in quality of overall infrastructure among 140 countries

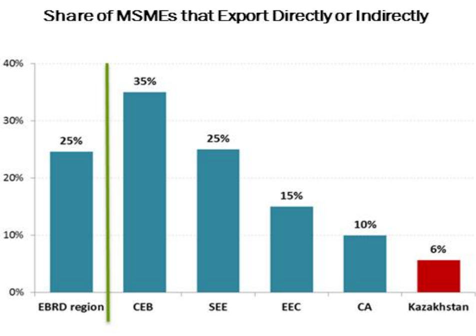
82nd in global innovation index among 141 countries

Other challenges include:

- **Productivity** across the economy is above the average level of the CIS countries; however, it significantly lags productivity in the OECD 8 and OECD countries.
- Key to improved productivity is the need to increase **product and process innovation**, particularly in the low-tech sectors. According to BEEPS 2013-14, only 2 per cent of firms innovate in-house, which is low compared to the other EBRD countries.
- SMEs in Kazakhstan are underdeveloped and they do not have sufficient **export capacity**, with only 6 per cent of SMEs in the country directly or indirectly exporting.
- The **competition regime** is largely based on sound principles, but enforcement is patchy; enforcement needs to move from being largely prescriptive to effects-based and focused on tackling the underlying causes of competition problems.
- (Unfair) competition from the **informal sector** represents one of the key constraints holding back private sector growth.
- As shown in Section 3, competitiveness is also affected by weaknesses under other qualities, including **government effectiveness and regulatory quality, skills mismatches and quality of infrastructure**.



Source: EBRD calculations



Source: BEEPS V, EBRD calculations

9

Well-governed

Further progress towards improving governance in the country is required, as recognised by the authorities, making this one of the key reform priorities.

The capacity of the civil service and the state support and industrialisation programmes have been identified as two critical areas of governance that require improvements to facilitate increased and more sustainable growth, and private sector development in particular.

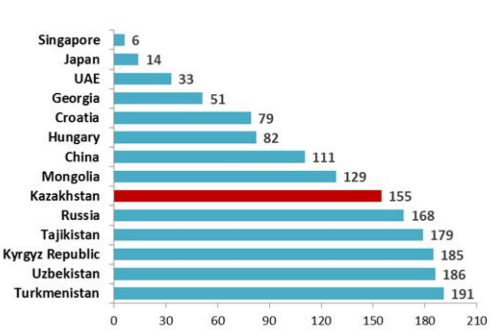
- Weaknesses in the **capacity of the civil service** are hindering the ability of the State to play a strong and positive role in creating an effective platform for private sector development, including through a well implemented structural reform agenda.
- With respect to the **state programmes**, between 1997 and 2015 subsidies of different types worth over US$ 79 billion have been provided to firms. Section 3 shows that these programmes have played an important role in supporting the economy through economic downturns, being among the main sources of new credit since the 2008 crisis. However, none of the policy interventions (trade policy measures or financial production incentives) seems to have achieved their key stated objective of increasing exports and diversifying the economy.

> **57th** in the quality of institutions among 140 countries
>
> **70th** in property rights protection, **74th** in intellectual property protection, **86th** in judicial independence among 140 countries
>
> **98th** in government effectiveness sub-indicator among 215 countries
>
> **159th** in the Control of Corruption sub-indicator among 215 countries
>
> **22nd** in the strength of investor protection among 140 countries

Other challenges include:

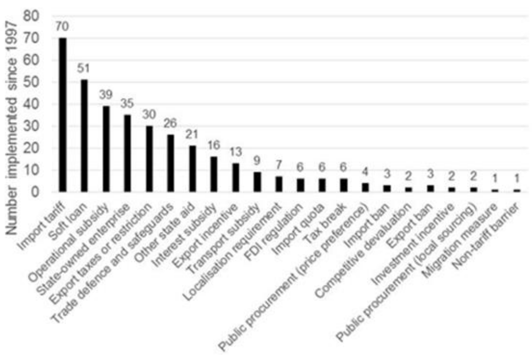
- The perception of weak **Rule of Law,** insufficient capacity of **Judiciary** and high **corruption** are affecting business confidence domestically, holding back growth, as well as negatively affecting the attractiveness of the country for foreign investors.
- The need to further strengthen the capacity of **institutions** (regulators, courts, etc.) and the quality of **public service delivery**, which will be a key pre-condition for enhancing Government policy implementation
- The **corporate governance** framework is improving, but it remains moderately developed and its implementation is very patchy. In terms of implementation, such areas as quality of the corporate governance code, institutional environment, and board effectiveness have been identified as the key weaknesses.

Control of Corruption indicator



Source: Worldwide Governance Indicators 2014

Industrial Policy Tools Used by the Kazakh State



Source: "Kazakh Industrial Policy: A Data-Driven Assessment".

Resilient

Financial stability and economic diversification remain particular challenges in the context of the country's resilience.

The country continues to depend heavily on oil exports (see figure below), which was most recently demonstrated by the negative impact of the 2014-15 oil price collapse on GDP growth (1.2 per cent in 2015, compared to 4.3 in 2014) and exchange rate (46 per cent depreciation over 2015) in the country. The vulnerability associated with the significant dependence on oil exports is somewhat mitigated by the ability to draw upon a US$ 64.7 billion (or 35 per cent of GDP) National Fund during periods of low oil prices.

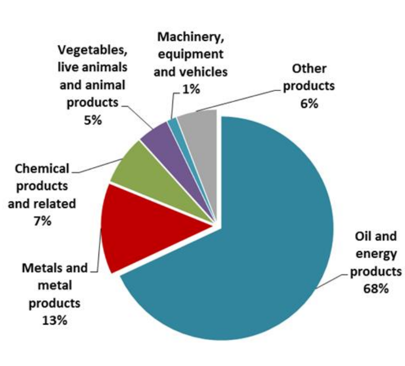
- Also, as outlined in Section 3 in detail, the **banking sector** is not sufficiently resilient. Reported capitalization of banks is adequate with the capital adequacy ratio at 16.4 per cent as of December 2016. However, capitalisation may be under pressure due to such factors as off-balance sheet liabilities and crystallisation of losses from restructured loans. An underdeveloped banking sector and capital markets – with Kazakhstan ranking 98th on the WEF's financial sector indicator – are putting particular pressure on real ecnomy.

> Oil and gas exports accounting for **16 per cent** of GDP and **52 per cent** of total exports in 2015
>
> The current account went into deficit in 2015 for the first time since 2009 at around **3 per cent** of GDP
>
> **44th** largest share of NPLs in 2015 among 123 countries
>
> **98th** in financial sector development among 140 countries

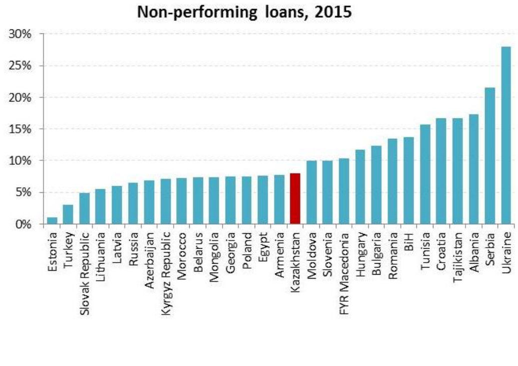
Other challenges include:

- The **exchange rate** is stabilising and the trust in new inflation targeting regime is increasing, reflecting steps taken by the NBK and an improving external environment. Enhancement of the money markets and of a set of inflation targeting policy tools, however, is required.
- **Capital markets** remain significantly underdeveloped, with only small number of companies actively trading on the stock exchange (KASE), a weak trading, clearing and settlement infrastructure, and a small local institutional and retail investor base. Stock market capitalisation of around 10-15 per cent of GDP is well below the levels observed in the OECD 8 and OECD countries.
- Due to large domestic reserves of oil and reliable supply of energy source to generate electricity, Kazakhstan faces low risks in terms of **energy security**. However, increasing move to low-carbon growth will require development of renewable energy sources.
- Whilst Kazakhstan is the second largest wheat flour exporter in the world, vulnerability to climate change remains a concern, with efforts required to enhance climate-resilience of the agriculture sector, which would help improve **food security**.

Composition of Economy – Exports by Sector in 2015



Source: office of national statistics of Kazakhstan



Source: national sources.

Integrated

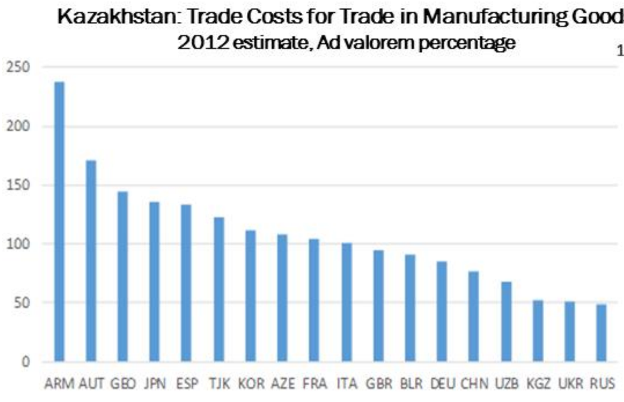
The quality of domestic and cross-border infrastructure and the country's openness to trade and investment are among the key determinants of growth in Kazakhstan, given the landlocked nature and geographic location of the country. Whilst significant progress has been made over recent years, underdeveloped cross-border connectivity remains a critical constraint on growth.

- Section 3 shows that barriers to, and costs of, trade, continue to make Kazakhstan's economy less integrated than optimal, thereby impeding business opportunities, increasing costs and reducing competition in domestic markets. Improvements in quality of **domestic and cross-border infrastructure**, including "soft" infrastructure, and **logistics** remain key priorities.

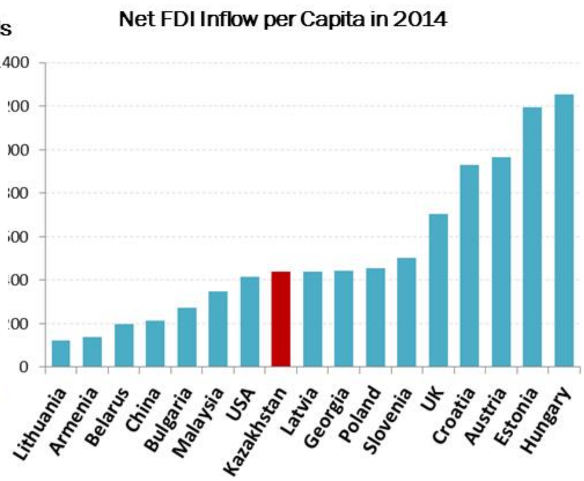
> **94th** in Global Enabling Trade Index among 138 countries
>
> **127th** in the border administration component and **108th** in market access among 138 countries
>
> **77th** in Logistics Performance Indicators out of 160 countries
>
> **101st** in trade tariffs among 140 countries
>
> **78th** in the Business impact of rules of FDI among 140 countries
>
> **111st** in prevalence of foreign ownership among 140 countries

Other challenges include:

- **Trade tariffs** with countries outside of the Eurasian Economic Union (EEU) increased significantly following accession to the EEU; however, under WTO accession (in 2015), Kazakhstan has committed to reduce tariff rates for all products to an average of 6.1 per cent, from the current average tariff of around 11 per cent.
- More than US$ 130 billion has been invested into the country by foreign investors since 1991, with around 60 per cent of **inward FDI** (over 2001-15) going into the extractive sectors. The stock of FDI, however, whilst favourable compared to other CIS countries, remains relatively low, when compared to OECD 8 and OECD countries.
- The country's **attractiveness for foreign investors** has improved with the adoption of the New Investment Law and other legislative changes, particularly since 2014. However, restrictions on foreign ownership remain, such as a 20 per cent ceiling on foreign ownership of media outlets, and a 49 per cent limit in air transportation services and fixed line telecommunications. These restrictions are expected to be removed in the context of commitments under WTO accession.



Source: World Bank and UNESCAP trade costs database



Source: World Bank, IMF WEO

Green

Kazakhstan remains the largest emitter of greenhouse gases ("GHG") in Central Asia and its economy has one of the highest CO2 intensities in the world. In response to this, Kazakhstan has made significant legislative improvements covering energy efficiency/renewable energy, and has introduced an ambitious strategic initiative – the Green Economy Concept. This initiative focuses on decarbonisation, which is required in most energy and carbon intensive sectors such as power, oil&gas, mining, manufacturing and transport sectors.

- In the long-run, **greening the Kazakh economy** can become a key driver for creating favourable conditions for private sector growth. Detailed analysis in Section 3 argues that despite significant progress over recent years, obstacles to developing a greener economy persist. A number of factors, such as vested interests, usually linked with energy inefficient and carbon intensive sectors, have stifled the development of Green Economy Transition by impeding the creation and implementation of legislation and regulations required for the development of Renewable Energy, Energy Efficiency, the emissions trading scheme ("ETS") and other elements of the Green Economy.

114th in CO2 emissions among 138 countries

124th in energy intensity (TPES/GDP) among 138 countries

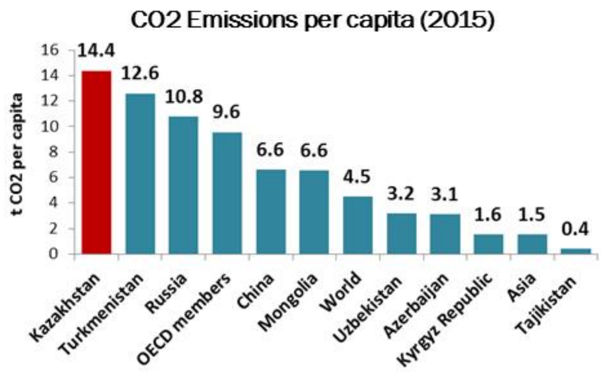
134th in carbon intensity (CO2/GDP) among 138 countries

Power sector accounts for approximately **85 per cent** of total emissions

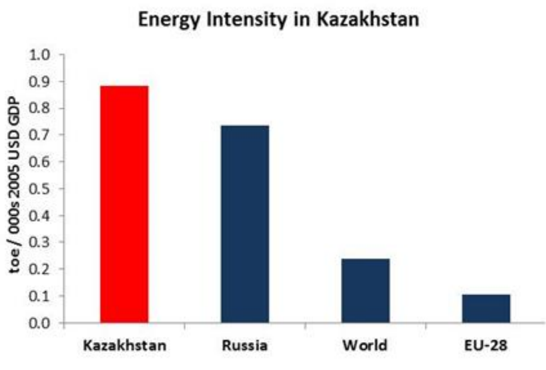
73 per cent of the power section is fed with coal, often with outdated technologies that have high emissions

Other challenges include:

- **Transmission and distribution losses** are high. Energy losses in industrial and domestic consumption are at 40-60 per cent. Upgrades of crucial infrastructure, improved payment collection and the introduction of an incentive-based distribution tariff methodology are needed
- **Water stress** varies considerably across the country and is most intense in the central and southern regions, a situation that is expected to worsen as a consequence of climate change. Irrigation is the biggest water consumer, accounting for 66 per cent of water extraction. Industry accounts for a further 30 per cent of water abstraction, specifically mining, oil/gas extraction and water-cooled thermal power generation.



Source: International Energy Agency. CO2 emissions from fuel combustion only. Emissions are calculated using the IEA's energy balances and the Revised 2006 IPCC Guidelines.



Source: International Energy Agency.

Inclusive

Gender equality, regional development, and opportunities for young people, underpinned by strong and diverse skills base across regions, age and gender groups, will increasingly play a key role in developing a sustainable growth model in Kazakhstan. Whilst the country compares well on the youth and gender elements of inclusions, significant gaps exist with respect to regional inclusion. Work on improving all three elements of inclusions needs to continue.

- As analysis in Section 3 shows, the **mis-match of skills**, particularly in some of the country's regions, has become a significant constraint to developing a competitive and inclusive economy. 13.1 per cent of firms identified skills as a major constraint on their growth, and the share was as high as 20.1 per cent for manufacturing firms. The skills gap is particularly pronounced in less developed regions of the country such as East Kazakhstan, Kostanay and Karaganda, where up to 30 percent of firms identify an inadequately educated workforce as a major constraint. Overall, 63 per cent of companies in the latest round of BEEPS report that they would expect annual sales to increase if adequate workforce were available.

52nd in UNDP's gender inequality ranking index 2014 among 188 countries

58 per cent of women and **65 per cent** of men aged 15 or over owned an account at a formal financial institution

27 per cent pay gap between men and women

9th best (lowest) in youth unemployment (**4.1 per cent**) among 174 countries

15th in terms of per cent of firms identified skills as a major constraint on their growth (**13.1 per cent**) among EBRD countries;

29.4 per cent of firms in East Kazakhstan identify skills as major constraint

Other challenges include:

- Most **working women** in Kazakhstan are employed in education, health care, trade, social welfare and services, many of which are public sector jobs and typically offer lower salaries than male-dominated occupations in extractives, construction and industry.
- There are explicit and implicit legislative restrictions on **female participation** in some sectors, such as mining. Also, even where legislative constraints do not exist, employers need to play a more positive role through HR policies and by proactively encouraging young women to take up education and training opportunities in sectors with better earning jobs.
- The company board level **gender balance** also remains an issue, and shareholders need to take pro-active steps to redress the imbalance.
- Kazakhstan scores well on **youth employment**, with the youth unemployment at just 4.1 per cent, below the overall unemployment rate across all age groups (5.0 per cent).