DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR KAZAKHSTAN

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I. EXECUTIVE SUMMARY

Over the two years since the adoption of the last country strategy, Kazakhstan has continued to make progress towards implementation of the principles envisaged in Article 1 of the Agreement Establishing the Bank. Visible progress has been made in market-based economic reforms, while political reforms were slower and did not match economic achievements. Strong presidential power is not adequately balanced by the legislature or judiciary, and pervasive corruption remains a problem. The registration of opposition parties and the abandonment of a controversial proposed media law were positive steps in the country's democratic transition. The parliamentary elections in September 2004 fell short of international standards, although they represented an improvement over previous parliamentary polls.

The economy continued to grow strongly during the strategy period, with an average growth rate of 9.5 per cent, driven by the combination of strong growth in the oil and gas extractive industries and high commodity prices. The National Fund – a vehicle to save and invest public sector surpluses abroad when commodity prices are high – continued to play an important role in prudent macroeconomic management. The public sector, including the National Fund, had an overall fiscal surplus of around 4.7 per cent of GDP in 2003. The transfer of funds into the National Fund also helped mitigate pressures on the real exchange rate. An increase in money demand eased inflationary pressure arising from the rapid expansion of money supply in recent years. The current account deficit narrowed from 5.4 per cent of GDP in 2001 to 0.2 per cent in 2003 due to improvements in terms of trade. Reflecting the prudent macroeconomic policies of recent years, Kazakhstan's sovereign foreign currency rating was upgraded by Moody's and Standard & Poor's to investment grade in September 2002 and May 2004, respectively. However, rapid asset growth of the banking sector in recent years warrants some caution. In this respect, preserving macroeconomic stability through the continuation of prudent fiscal and monetary policies and close monitoring of the quality of banking assets are of the utmost importance.

There has been some progress in transition during this strategy period. The banking sector has deepened and accordingly, financial sector regulation has advanced with the establishment of an independent consolidated agency. Under the new joint stock company law, higher capital base thresholds and corporate governance practices have been established. A new tariff methodology for the public utilities sector, such as water, electricity and municipal service, has been adopted and efforts to fully liberalise the telecommunications sector and to advance reforms in the railways sector have been renewed.

As with other natural resource-based economies, the challenge in the long term is to create an economic structure less vulnerable to fluctuations in oil prices. In this respect, ensuring that the economy remains diversified is of paramount importance. The authorities should take full advantage of the strong economic performance of recent years to further advance transition in the following areas during the forthcoming strategy period:

- Maintain their commitment to an open market economy through enhanced regional cooperation and the advancement of accession to the World Trade Organisation (WTO) in order to strengthen competition and the competitiveness of enterprises. Kazakhstan's cooperation with some of its immediate neighbours has deepened (e.g. transit agreement with Kyrgyz Republic) and Russia remains an important country for the transit of Kazakh exports. Enhanced cooperation with other Caspian neighbours and China will promote diversified access to the international economy. WTO accession will demonstrate the country's commitment to international standards and practices.

- Further improvement in the investment climate, which is fundamental to fostering private sector development. Over the years, confidence in the judicial system has grown. However, continued efforts are needed to fight corruption and increase administrative transparency, and there is a clear need for enhanced disclosure of Government officials' financial interests. The National Fund transactions should be made more transparent through the publication of its audits. There is also a need to improve enforcement of competition policies and remove barriers to entry. Continued development of the private sector will also help address rural poverty.

- Enhancement of financial transparency and corporate governance of local companies, both private and state-owned. These improvements will help increase local companies' access to both long-term debt and equity financing. Minority shareholders' rights must be effectively protected in order to attract savings accumulated in the local pension funds. Furthermore, improved transparency and corporate governance will facilitate much-needed foreign direct investment (FDI) in non-extractive industries.

- Facilitation of private sector involvement in infrastructure services while strengthening the capacity of the regulatory agency. Kazakhstan is one of the first countries in the Commonwealth of Independent States (CIS) to introduce the private sector in the provision of infrastructure services. However, the extent of private sector involvement is uneven across sectors. In order to benefit from the efficient provision of services, private sector involvement should be encouraged further. At the same time, the regulatory framework should be developed to ensure third-party access with tariff structures which are in accordance with international best practice.

The Bank is ready to play a crucial role in supporting Kazakhstan through the challenges ahead. The objective remains to expand its activities in the private sector, while public sector involvement will focus on projects where significant transition impact will be achieved, or which have a regional dimension. The creation of opportunities for local currency lending will be a priority for the next strategy period. Given the macroeconomic environment, the country's progress on its key structural reforms and main transition challenges, the Bank's activities will be based on the following operational priorities and objectives in the coming years:

- **Enterprise Sector** – In support of economic diversification and in order to advance transition and address increasing regional inequality, the Bank will focus on the following areas. The *Kazakhstan Small Business Programme* (KSBP) will remain the centrepiece of the Bank's SME operations, with new funding under the planned third extension, to strengthen the local financial sector and emphasise the development of rural and agricultural sectors. The *Trade Facilitation Programme* will further expand Kazakh enterprises' access to international markets. Support for the domestic agribusiness sector will be provided primarily through the *Grain Warehouse Receipts Programme,* which will continue to support the domestic agribusiness sector through the expansion of additional commodities used as collaterals. New structures, such as agricultural equipment financing facilities, will also be considered. The Bank is working with fledgling local agribusiness companies to develop financing proposals in food processing and consumer goods. To attract higher FDI inflows and to promote new capital investments the Bank, through its ongoing business development efforts, will co-finance projects sponsored by strategic foreign and local investors in the non-natural resources sector. The Bank will selectively support companies in the natural resource sector, including service and supply operations and in the oil and gas and mining sectors. Efforts will continue for the development of local businesses contracted to infrastructure and natural resource projects. The Bank will continue to link the provision of funding for investment activities to enhancements in transparency, integrity, corporate governance and effective regulation.

- **Infrastructure** – Promoting commercial principles and open, non-discriminatory access to infrastructure and supporting regional cooperation will remain key priorities for the Bank. Through existing operations in the transport, power and communications sectors, the Bank has established an important role in the provision of finance and technical cooperation (TC) advisory services to enhance the Government's approach of investing into and managing public infrastructure, including private sector participation. The Bank will continue to support the strengthening of the regulatory framework through the ongoing TC to the Agency for Regulation of Natural Monopolies and Promotion of Competition. Lending operations under development in transport, power and communications sectors will be undertaken in conjunction with appropriate regulatory and institutional reform, mainly on a non-sovereign basis, and will stress regional cooperation where appropriate. The Bank will continue to work with municipalities to improve their creditworthiness and to develop primarily non-sovereign, but also sovereign, operations in the modernisation of municipal infrastructure. The Bank will continue to finance sovereign operations in the road sector, where upgrades are required. In all cases, co-financing by other International Financial Institutions (IFIs) and commercial sources will be actively sought.

- **Financial Sector –** The financial sector has continued to develop quickly, providing a foundation for the enterprise sector, although scope remains for further development in support of economic diversification and macroeconomic stability. Involvement in the financial sector will focus on diversifying financial services, including provision of longer tenor and more sophisticated products. The Bank will develop suitable funding structures to enable it to provide local currency lending, especially for rural SMEs. Efforts to facilitate transition in the sector will focus on training for partner banks, further promotion of higher corporate governance standards through an increase of the existing equity investments and new participations in second-tier medium sized banks, extending the list of borrowing banks to increase competition; and supporting the expansion strategy of selected Kazakh banks in CIS countries where feasible, to increase synergies for existing and planned Bank projects. The Bank will also extend activities to non-bank financial institutions, in particular assisting in the privatisation of the State Accumulation Pension Fund and will support development of the mortgage sector, as well as leasing. In undertaking such operations, the Bank will pay close regard to the prospects for systemic vulnerabilities that may result from rapid portfolio growth and sudden macroeconomic developments. The Bank will also continue to work on integrity, transparency and anti-money laundering issues to encourage and support gradual improvements.

- **Policy Dialogue** – The Bank will continue to conduct policy dialogue on the investment climate through the Foreign Investors Council (FIC), and bilateral discussions. Coordination in terms of policy dialogue and complementarity of operations will be reinforced, in particular with the IMF, the World Bank, the Asian Development Bank and key bilateral donors, especially on regional cooperation initiatives.

The Bank will continue to ensure that all EBRD operations in Kazakhstan are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans. The proposed strategy responds to Kazakhstan's current transition challenges and is consistent with EBRD institutional objectives. It reflects the Bank's objective to continue expanding its activities in the country and to maintain an emphasis on non-sovereign operations.

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AIST	Civic and Agrarian parties (political parties in Kazakhstan)
AMA	Agency of Regulation of Natural Monopolies and Promotion of Competition
BAS	Business Advisory Service Fund
BEEPS	EBRD/World Bank Business Environment and Enterprise Performance Survey
BTA	BankTuranAlem
CAC	Central-Asia-Centre
CACO	Central Asian Cooperation Organisation
CAD	Canadian Dollar
CAREC	Central Asia Regional Economic Cooperation
CEEB	Central & Eastern Europe and the Baltics
CEP	Caspian Environmental Programme
CESO	Canadian Executive Services Overseas
CIDA	Canadian International Development Agency (Canadian Government)
CIS	Commonwealth of Independent States
CNPC	Chinese National Petroleum Company
CO_2	Carbon Dioxide
CPI	Corruption Perceptions Index
CRTCs	Caspian Environmental Programme's Regional Thematic Centres
DEFRA	Department for the Environment, Food and Rural Affairs (UK Government)
DEG	Deutsche Entwicklungsgesellschaft (Germany)
DFID	Department for International Development (UK Government)
DVK	Democratic Choice of Kazakhstan
EAP	Environmental Action Plan
EFF	Extended Fund Facility
EITI	Extractive Industries Transparency Initiative
ESCOs	Energy Service Companies
EU	European Union
FDI	foreign direct investment
FIC	Foreign Investors Council
FMO	Financierings-Maatschappij voor Ontwikkelingslanden (The Netherlands)
FSA	Financial Supervision Agency
FSAP	Financial Sector Assessment Programme
GBP	Pound Sterling
GDP	Gross Domestic Product
GWRP	Grain Warehouse Receipts Programme
IFIs	International Financial Institutions
IFC	International Finance Corporation
IFPT	International Finance Participation Trust (Canada)
IFRS	International Financial Reporting Standards
ILO	International Labour Organisation
IMF	International Monetary Fund
IDB	Islamic Development Bank
JICA	Japanese International Cooperation Agency
JSC	Joint Stock Company

JPY	Japanese Yen
KASE	Kazakh Stock Exchange
KDB	Kazakhstan Development Bank
KEGOC	Kazakhstan Electricity Grid Operating Company
KG	kilogramme
KMC	Kazakhstan Mortgage Company
KMG	KazMunaiGas
KOREM	Kazakhstan Market Operator for Electric Energy and Capacity
KPIC	Kazkommerts Policy Insurance Company
KSBP	Kazakhstan Small Business Programme
KTMF	KazTransMorFlot
KTZ	KazakhTemirZholy
LIBOR	London interbank offered rate
MIF	Mortgage Insurance Fund (Kazakh Government)
MIS	management information systems
MSE	micro and small enterprises
NBK	National Bank of Kazakhstan
NEAP	National Environmental Action Plan
NGOs	non-governmental organisations
ODIHR	Office for Democratic Institutions and Human Rights
OECD	Organisation for Economic Cooperation and Development
OSCE	Organisation for Security and Cooperation in Europe
PA	Parliamentary Assembly
PBs	participating banks
PPP	Purchasing Power Parity
PSA	Production Sharing Agreement
PSO	Public Service Obligation
R&D	research and development
REC	regional energy company
SACE	Servizi Assicurativi del Commercio Estero (Italian Government)
SAPF	State Accumulation Pension Fund
SECO	Secrétariat d’Etat à l’économie (Government of Switzerland)
SME	small and medium sized enterprises
TC	technical cooperation
TFP	Trade Facilitation Programme
TAM	TurnAround Management
UN	United Nations
UNDAF	United Nations Development Assistance Framework
UNDP	United Nations Development Programme
UNECE	United Nations Economic Commission for Europe
UNEP	United Nations Environment Programme
USAID	United States Agency for International Development (US Government)
USD	US Dollar
WB	World Bank Group
WTO	World Trade Organisation

II. Country Strategy

1. The Bank's Portfolio

1.1 Overview of Activities to Date

The Bank has been actively involved in Kazakhstan across a broad range of economic sectors in private and public projects. At 31 August 2004, the Bank's net cumulative business volume totalled EUR 1,018 million (EUR 949 million debt and EUR 70 million equity). Disbursements were 76 per cent of this amount for a total current portfolio of EUR 739 million. In volume terms, the private/state sector portfolio ratio is currently 57/43 per cent, which is lower than at the previous strategy. This is due to a few large public sector transactions which have reduced the private sector ratio. With regard to the number of projects, it should be noted that the majority signed have been in the private sector (77 per cent). The sovereign/non-sovereign ratio stood at 40/60 per cent (volume) at end-August 2004. Annexes 2 and 3 provide full details of signed Bank operations and the current portfolio. Annex 4 provides details of TC operations undertaken.

Table 1: Net Cumulative Business Volume by Industry (EUR million) as at 31 August 2004

Sector Business Group	Sector Team	No. of Projects	Total Project Value	EBRD Finance	Debt	Equity	% Share of Commitments
Energy	Natural Resources	1.0	188	67	67	0	7%
	Power and Energy	3.0	314	78	78	0	8%
Sub-total Energy		**4.0**	**502**	**145**	**145**	**0**	**14%**
Financial Institutions	Bank Equity	2.0	47	35	0	35	3%
	Bank Lending	10.3	400	301	301	0	30%
	Equity Funds	1.4	74	35	0	35	3%
	Non Bank Financial Institutions	2.5	9	9	9	0	1%
	Small Business Finance	1.4	113	113	113	0	11%
Sub-total Financial Institutions		**17.6**	**643**	**493**	**423**	**70**	**48%**
General Industry	General Industry	1.0	322	45	45	0	4%
Sub-total General Industry		**1.0**	**322**	**45**	**45**	**0**	**4%**
Infrastructure	Transport	5.0	466	238	238	0	23%
Sub-total Infrastructure		**5.0**	**466**	**238**	**238**	**0**	**23%**
Specialised Industries	Agribusiness	1.3	86	20	20	0	2%
	Property and Tourism	1.0	23	8	8	0	1%
	Telecoms Informatics & Media	2.0	111	70	70	0	7%
Sub-total Specialised Industries		**4.3**	**220**	**98**	**98**	**0**	**10%**
KAZAKHSTAN TOTAL		**31.8**	**2,153**	**1,018**	**949**	**70**	**100%**

Business volume is diversified but financial institutions retain the single largest portion of business volume at 48 per cent (which consists of bank lending 30 per cent, small business finance 11 per cent, bank equity 3 per cent, equity funds 3 per cent, and non-bank financial institutions 1 per cent), followed by infrastructure (23 per cent), energy (14 per cent), specialised industries (10 per cent), and general industry (4 per cent).

Considerable technical cooperation (TC) has been provided (EUR 32 million committed and EUR 28 million disbursed to over 97 TC projects), including through the TurnAround Management (TAM) programme and the Business Advisory Service (BAS) Fund.

1.2 Implementation of the Previous Country Strategy

The October 2002 Strategy for Kazakhstan outlined the following strategic priorities for the Bank:

- The promotion of economic diversification through support for domestic and foreign investors, SMEs, trade facilitation, and a further expansion of structured finance and leasing activities in agribusiness.

- The promotion of commercial principles and competitive access in infrastructure, including through non-sovereign lending.

- Further support to the financial sector to increase its capital base, enhance its stability, encourage prudent expansion of lending to the real economy and facilitate the diversification of domestic financial assets.

During the strategy period EUR 502 million in projects were signed across a broad range of sectors. This corresponded well with the stated objectives.

1.2.1 Enterprise Sector

The promotion of economic diversification has primarily been achieved through the support of programmes which enhance the business environment. One of the main vehicles for this is the Kazakhstan Small Business Programme (KSBP) which was designed to create swift access to finance for SMEs throughout Kazakhstan by building the necessary institutional capacity and credit skills in selected partner banks. The initial EBRD KSBP in the amount of USD 77.5 million was guaranteed by the Kazakh Government. In 2002 this programme was expanded and the Bank committed a further USD 75 million for KSBP II through direct non-sovereign funding, bringing the total EBRD funding to USD 152.5 million. Since then 5 additional projects have been signed under the KSBP II for USD 50 million (EUR 42 million) and the remaining part has been committed.

While considerable achievements have been made in this programme during the last strategy period, the demand for SME finance is still far from being fully met. To date the sovereign KSBP (USD 75 million) and the direct KSBP II (USD 75 million) have been fully committed. Including the revolving part of the sovereign funds, a total of USD 170 million has been disbursed to the participating banks (PBs) over the course of the past six years. Since 2002 the PBs have provided an increasing proportion of their own funds to support the growth of the sub-loan portfolio and at present 50 per cent of the outstanding sub-loan portfolio in the amount of USD 225 million is financed out of PBs' funds. The repayment performance on the sub-loan portfolio is stable at around 99.3 per cent. At present 600 loan officers, trained by KSBP, provide loans to SMEs across a network of 200 specialist SME departments set up by the EBRD programme. Based on the capacity built in all PBs for large scale SME lending, it is now planned to extend lending operations systematically to the rural regions of Kazakhstan, including the agriculture sector. Along with ongoing SME lending under the KSBP facility, the Bank has made two new syndicated loans: one of USD 25 million to KKB, including USD 15 million from EBRD; the other of USD 30 million to BTA, USD 10 million from EBRD, which were provided via domestic banks for on-lending to private sector enterprises.

Warehouse receipts successfully introduced under the Grain Warehouse Receipt Programme (GWRP) in 2002 are now used frequently as an instrument in secured lending transactions in Kazakhstan and the system is completing its second year of full operation. Overall, a total of USD 139 million, including USD 53 million on the Bank's own account and USD 86 million from the B-lenders, has been disbursed to PBs over the course of the past two years. This allows further support of the current growth trends in grain production and trade, facilitates confidence building in the Kazakh agribusiness sector through active participation of B-lenders and encourages further development of the warehouse receipt concept.

The Bank has signed 2 projects in the metallurgical sector, namely the long-standing Ispat Karmet Steel Works project and the Kazakhmys Environmental Facility, a USD 20 million environmental enhancement loan, for the upgrade of the Balkhash smelter. Although the Kazakhmys facility was signed, this facility was later cancelled for non-project related reasons (see Section 1.3.1 for further details).

In June 2004 the Bank also approved a USD 81.6 million financing for the Keniyak-Atyrau oil pipeline project. The Bank believes that this project addresses important transition challenges in the oil transportation sector in Kazakhstan through: i) setting higher standards for corporate governance and business conduct; and ii) supporting the development of institutions, laws and policies that directly promote the functioning and efficiency of the market.

1.2.2 Infrastructure

The Bank has signed a number of major infrastructure projects in Kazakhstan where the objectives of the transactions included improving commercial principles and efficiencies, telecommunications sector rehabilitation and tariff rebalancing policies, as well as the creation of a "universal service fund" mechanism.

The Bank signed a major road project in the Kazakhstan Road Sector Restructuring Project (EUR 119 million in debt). Implementation of the Bank's investment in the Aktau Port project has been successfully completed. Together with the sovereign guaranteed rehabilitation loan to Kazakhstan Temir Zholy (KTZ), the state railway company, and its participation in the Almaty-Bishkek road rehabilitation project, the Bank has made an important contribution to modernising essential transport infrastructure and rebuilding historic transit links between Central Asia and Europe. Ongoing policy dialogue related to the restructuring and regulation of the railway sector, aviation sector and for enhanced road sector management is currently being undertaken in support of new and recent operations in those sectors.

During 2003, the Bank strengthened its relationship with KazakhTelecom, the Kazakh national telecommunications operator. A USD 110 million syndicated loan facility (including the EBRD A-portion of USD 60 million) was provided to the company. This facility helped KazakhTelecom to execute its dynamic network expansion and modernisation programme to install advanced fibre optic connections across the country, connecting businesses and communities and facilitating industrial development. Progress towards the full privatisation of KazakhTelecom and implementation of a new regulatory regime has been slow. In telecommunications, the Bank has contributed through technical cooperation for the development of a programme, which envisages sector liberalisation, however this reform proposal thus far remains unimplemented and sector liberalisation has lagged behind other areas. The Government has shown interest in proceeding with the latest (third) stage of the Bank's technical cooperation project, which aims to develop and implement a regulatory regime that would provide for enhanced access to the domestic telecoms market and for effective competition.

The Bank has been closely involved with reform of the power sector in Kazakhstan, including through a sovereign loan to Kazakhstan Electricity Grid Operating Company (KEGOC) and an investment in the Karaganda Power Company. Power sector reform in Kazakhstan has shown mixed results. Early reform steps included unbundling of generation, transmission and distribution, setting up a regulatory body, introducing the private sector in some segments, and market liberalisation for large users. However significant challenges remained, including lack of predictable tariff adjustments and inadequate functioning of the regulatory body, especially at local level. Following several years of policy dialogue supported by technical cooperation from the Bank, a new tariff methodology has been adopted by the Government and implementation by the regulator, the AMA, commenced in 2003. In March 2004 the Bank signed a loan with KEGOC (EUR 48.9 million), on a commercial basis without a sovereign guarantee, for the financing of the first section of the entire North-South power transmission line. The Bank syndicated the loan to international commercial banks. The project is co-financed together with the Development Bank of Kazakhstan. This is in addition to the previously granted sovereign loan for modernisation of the national high-voltage grid.

In the municipal and environmental infrastructure sector, the Bank experienced serious problems with the implementation of its projects, resulting in the cancellation of all three projects signed in this sector. These problems were mainly related to a significant tightening of fiscal control by the central Government, which made the implementation of municipal investment projects practically impossible. Moreover, weak institutional capacity at municipal level proved to be a serious stumbling block for these operations to go forward.

1.2.3 Financial Sector

In 2003 EBRD made an equity investment of USD 31 million in Kazkommertsbank, the largest Kazakh bank and longest standing EBRD client in the local financial sector. EBRD investment strengthened the bank’s capital base and supported the bank in its efforts to become a truly international institution, by means of broadening its investor base and further advancing its corporate governance.

The Trade Facilitation Programme (TFP) has supported the access of Kazakh enterprises to foreign markets and is set to expand from a solid base. During the strategy period the overall TFP limits provided to Kazakh participating banks have grown by USD 51 million to USD 130.5 million, including the USD 37.5 million risk participation of Financierings-Maatschappij voor Ontwikkelingslanden (FMO), Deutsche Entwicklungsgesellschaft (DEG) and International Finance Participation Trust (IFPT); these funds were used to finance 74 transactions for a total amount of EUR 157 million.

The Bank has also expanded its support to the development of non-banking financial institutions through a EUR 4 million loan to BTA Ipoteka, to strengthen mortgage lending transactions and policies, and a EUR 1.2 million equity investment in Kazkommerts Policy Insurance Company (KPIC) to support business growth and to develop KPIC's product range.

EBRD continues a dialogue with the National Bank and the recently established Financial Supervision Agency (FSA) on issues of financial sector reform, including pension reform, development of a domestic insurance sector and the plans for implementation and enforcement of the EU Directives on the regulation and supervision of financial markets in Kazakhstan by 2007.

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

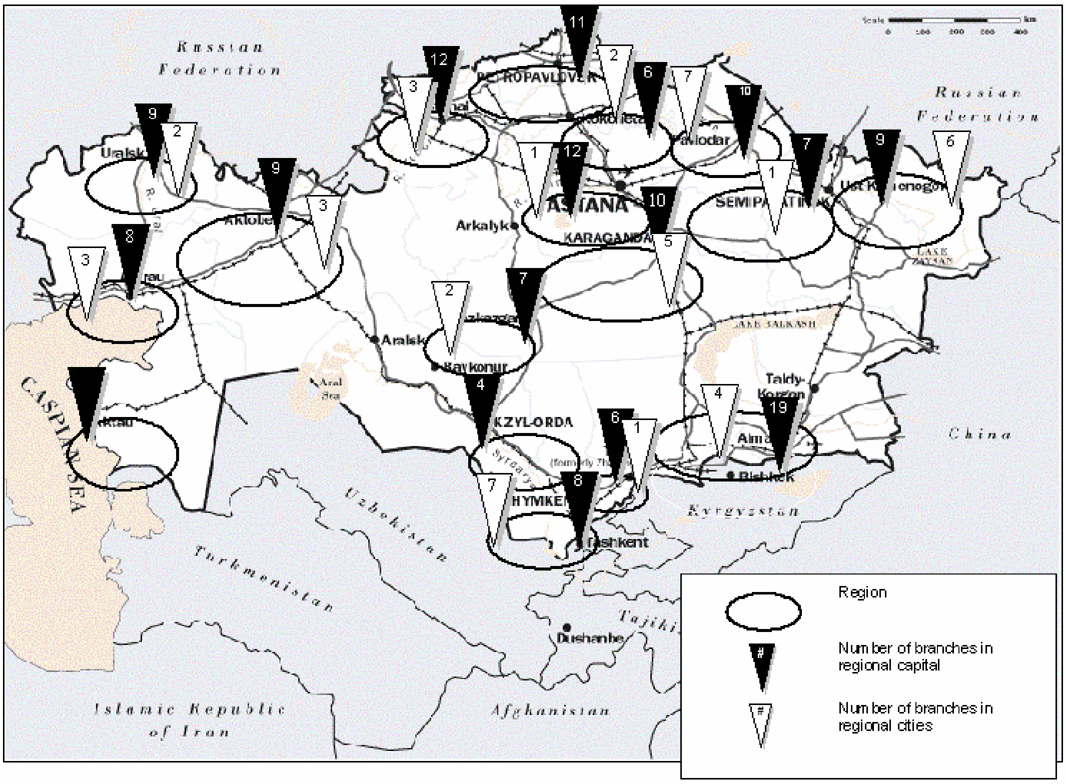
The Bank has remained an active participant in the transition process, as it has continued to innovate to suit emerging transition needs and to play a visible role in policy dialogue. The Bank's investments have had valuable demonstration effect and transition impact. Finance has been provided to a number of projects to support private sector development in banking, infrastructure, specialised industries and general industry. Through these investments, the Bank succeeded in improving corporate governance practices and enlarging policy dialogue.

Importantly the Bank has learned that transition is not a linear process and that despite notable progress in stabilisation, economic performance and reforms, opportunities to support transition remain significant for the Bank. The Kazakh economy remains vulnerable to a range of factors including external shocks, structural and institutional weaknesses, and policy uncertainties. In turn, this undermines both the investment climate in general and the prospects for individual investments. Therefore special attention should be paid to understanding the specific conditions of our transactions, the motivations and credibility of the commitments of our clients.

1.3.1 Enterprise Sector

The conditionalities set by the Bank have helped move companies towards stronger corporate management by encouraging transparency in accounting and contractual relations. The KSBP is one of the most successful SME support programmes in the region, providing funding to a wide range of previously "non-bankable" clients, including family businesses of all economic sectors, as well as larger SMEs (110,000 loans for USD 630 million disbursed so far). More than 85 per cent of the clients financed by KSBP have been first time borrowers in the formal financial sector. This indicator reflects the additionality of EBRD's programme, as does the high ratio of repeat clients, with more than two-thirds of all borrowers, once the first loan is repaid, taking out more than two loans. At the same time maturities on sub-loans have consistently increased and volumes of investment projects have grown rapidly. While the overall strong economic growth provides a favourable basis for SME development, the growth rates of KSBP's clients in terms of turnover and assets as well as number of employees demonstrate that it is possible to transform "non-bankable" clients into "core clients" and to effectively assist the formalisation of the grey economy.

190 SME Department Locations set up by KSBP Partner Bank's branches (September 2004)



The TFP has provided access to foreign markets for Kazakh enterprises and has created an excellent demonstration effect contributing to institution building and the development of the issuing banks' trade finance capabilities. Its success results from its comprehensive network of banks, fast, efficient operating procedures, and responsive, client-driven service levels. One goal of the TFP is support for intra-regional trade, helping not only job creation but cooperation and understanding between countries. It supports the restoration of traditional trade links. More than 45 transactions between Kazakhstan and other EBRD countries of operation in the amount of EUR 57 million have been facilitated.

In October 2002 a USD 20 million KTZ SME Support Facility was approved by the Board. This Facility was a credit line to local participating banks for on-lending to private SMEs providing goods and services to KTZ. However, this project has not been signed and will be cancelled due to delays in privatisation of leased assets to SMEs by KTZ which effectively deterred SMEs from seeking bank financing. A specific BAS Programme established to support SMEs targeted under this project was cancelled. This experience suggests that the project should commence following the Government's implementation of a privatisation process (i.e. KTZ Restructuring Plan).

The availability of working capital has been enhanced for upstream agricultural production through the expansion of the GWRP, where the Bank has worked closely with all interested parties to develop the legal and institutional framework (e.g. Indemnity Fund) as well as provide initial financing.

The financing of the Kenkiyak-Atyrau oil pipeline project addressed important transition challenges in the sector by improving environmental management standards, increasing financial transparency of MunaiTas and KazTransOil as well as transparency of tariffs and pipeline allocation for the Kenkiyak-Atyrau pipeline. Other aspects included facilitating institution building and market efficiencies through encouraging the Kazakh borrower and guarantor to cooperate with a long-term Technical Cooperation assistance programme for the Kazakh AMA.

Transition challenges in the metallurgical sector are related to the need for greater transparency of energy tariffs and export licenses as indicated by many investors. Despite the cancellation of the Kazakhmys Environmental Facility, due to extremely robust company cashflows in June 2004, a significant degree of transition impact was achieved in a number of areas: i) the company realised the importance of implementing projects to best international practice. Kazakhmys has continued to implement the environmental upgrade of the Balkhash Smelter to best international practice which will meet WB/EU standards (and will be one of about 6 in the world to do so, out of approximately 130 such smelters); and ii) the company continued implementation of consolidated international accounting standards, which is due for completion during 2004.

1.3.2 Infrastructure

Through the Bank's existing and new projects, complemented by focused technical cooperation, discussions with the Government have resulted in the adoption and implementation of new tariff methodologies for public utilities sector such as water, electricity and to a certain extent water. The Bank has provided extensive technical cooperation to develop a revised mid-term heat and power distribution tariff methodology, which the regulator adopted and started to implement in 2003. In the power sector, a USD 60 million syndicated loan to KEGOC, signed in March 2004, marks the first time that the Kazakh power sector gained access to significant long-term funding from commercial banks without the benefit of a sovereign guarantee.

Despite slow movement in reforms, the Government has renewed efforts to fully liberalise the telecommunications sector and advance reforms in the railways sector. Conditionalities set by the Bank have helped move the respective companies towards stronger corporate management. In telecommunications, the Bank has provided significant technical cooperation to the Kazakh Agency for Informatisation and Communication and its predecessor regarding sector liberalisation, tariff rebalancing and creation of a "universal service" mechanism.

Tariff issues have also been a central concern during the ongoing railway reform and the Bank has assisted this process through provision of TC. The restructuring of Kazakhstan Temir Zholy (KTZ) began at the end of 2003 and is due to be substantially completed by early 2005. It follows a model endorsed by the Bank, including access to infrastructure for independent train operating companies, the separation of freight and passenger operations, and introduction of Public Service Obligation (PSO) payments. The Bank expects to continue to be involved in railway restructuring through further lending to KTZ. Similarly the Bank is involved in the road sector with loans to improve infrastructure and TC to promote sector restructuring.

Transition impact has been limited in the area of municipal finance, although some progress was made in advising on financial management in two municipalities in the context of the Bank's investment. Limited fiscal decentralisation so far constrains the Bank's impact in this area. The Bank has offered further technical assistance to the Government for the purpose of resolving internal discussions related to reform of fiscal relationships between central and regional Governments.

The Bank will continue to support greater transparency in the natural resource sector by continuing its policy dialogue with the authorities in relation to the adoption and implementation of the principles of the Extractive Industries Transparency Initiative (EITI), which is also being pursued in other countries in the region, such as Azerbaijan and the Kyrgyz Republic.

1.3.3 Financial Sector

The Bank has had significant impact on the banking sector where, through its debt and lending facilities, it has contributed to the modernisation and strengthening of the sector. EBRD's relationship with the major domestic banks has grown over the years. The Bank has had a significant impact on the management of domestic banks, SME lending operations, setting standards of disclosure, corporate governance and risk management. Working with several domestic banks, as well as one foreign-owned (Citibank), EBRD has contributed to increased competition in the financial sector.

The Kazakhstan Small Business Programme has recruited and trained approximately 40 per cent of all lending staff in the banking sector and has established 200 SME departments, covering a major share of the entire system's branch network. KSBP has set new standards for credit assessment, portfolio performance, management information systems (MIS) and staff training, which are replicated throughout the banking sector, including non-partner banks. KSBP, through its donor funded institution building, has established micro and small loans ranging from USD 20 to USD 200,000 as mainstream products for all banks achieving competitive returns.

In the non-banking financial institutions sector, the Bank signed two transactions, one in mortgage finance (BTA Ipoteka) and the other in insurance (KPIC). With the BTA Ipoteka transaction the approval process was delayed by the apparent reluctance of the Government to increase involvement of the EBRD in the mortgage sector. This was caused by the adoption in April 2004 of the Government's new housing development programme, which provides for USD 1 billion in financing to support the Kazakhstan Mortgage Company (KMC), the Mortgage Insurance Fund (MIF), and the Housing Construction Savings Bank, as well as for the construction of affordable housing across the country. In spite of these challenges, the Bank considers its involvement in the sector complementary to the Government's efforts in the overall development of the mortgage sector. With regards to the Bank's equity subscription in KPIC, it is the EBRD's first investment in a Central Asian insurance company. Through the demonstration effect of this investment it is hoped that the Bank can attract alternative strategic investors into the market. However, there remain challenges, including the limited increase of insurance penetration and development of a life insurance sector, which remains nascent.

1.4 Financial Performance of Existing Portfolio and Mobilisation of Co-financing

Overall the quality of the Bank's portfolio is good, with performing assets representing 100 per cent of operating assets. The current portfolio in Kazakhstan has a weighted project risk rating of 5.08, compared with the average for Central Asia of 5.68, and 5.45 for the Bank as a whole. As at 31 August 2004, the Bank had signed 31.8 projects (on a net cumulative basis) with a total cost of EUR 2,153 million, including EBRD financing of EUR 1,018 million, or 47.3 per cent from the Bank resulting in an overall mobilisation ratio (total finance/EBRD financing) of 2.1. The Bank has played a catalytic role in the mobilisation of finance in Kazakhstan.

2. *Operational Environment*

2.1 The General Reform Environment

2.1.1 Political Environment

Kazakhstan is a presidential republic with many political parties, a two-chamber parliament and a developed network of non-governmental organisations (NGOs). Strong presidential power is not sufficiently balanced by the legislature or judiciary. The Kazakh President, Nursultan Nazarbaev, continues to be the dominant political figure of the country. His current term in office expires in 2006 and he has announced his intention of running for another seven-year term in office until 2013. The September 2004 parliamentary elections, as well as the presidential polls of 2006, are widely seen as a test of the authorities' commitment to democratic reform.

In April 2004, the Kazakh President rejected a controversial media law, following the Constitutional Council's conclusion that the law was unconstitutional. In May 2004, an opposition party, Democratic Choice of Kazakhstan (DVK), was registered as the country's tenth political party. Two more parties have been registered since then, bringing the total number of political parties to 12. Freedom of the media and unhindered participation of the opposition in the electoral process are essential elements for the elections to be consistent with internationally accepted standards. According to international observers, the 19 September 2004 parliamentary elections did not meet international standards for democratic elections, although they represented an improvement over past parliamentary polls.

The country's opposition groups and the vibrant local NGO community continue to raise demands for greater transparency in public finance. There is an ongoing US investigation into oil payments made by US companies to senior Kazakh Government officials. Corruption remains a problem, affecting the business and investment climate in the country.

2.1.2 Regional Issues

As the largest economy in Central Asia, Kazakhstan plays an important role in enhancing regional cooperation. Trade with the countries sharing borders remains important, accounting for around 37 per cent of total trade in 2003.[1] For this reason, Kazakhstan has been actively seeking both multilateral and bilateral cooperation with her regional neighbours. As a land-locked country with vast mineral wealth, key concerns are diversifying markets and transport routes. On the bilateral level, the country maintains strong traditional economic ties with Russia and good relations with other CIS countries. In recent years, cooperation with China has strengthened, culminating in an agreement to build a major oil pipeline connecting central

[1] Russia is Kazakhstan's largest trading partner, accounting for 25 per cent of total trade, followed by China with a 10 per cent share in 2003. Trade with other countries in Central Asia remained relatively small (4.3 per cent of total trade). The importance of Uzbekistan as a trading partner has declined (its share fell from 1.7 per cent in 1999 to 1.1 per cent in 2003). On the other hand, Tajikistan is gaining importance, albeit from a low base (the share of trade with Tajikistan increased from 0.03 per cent in 1999 to 0.4 per cent in 2003). Trade with the Kyrgyz Republic experienced a set-back in 2000 but overall trade with the country has increased in recent years and it accounted for 1 per cent of total trade in 2003.

Kazakhstan with western China. Kazakhstan is also planning to expand the rail interchange capacity at the Chinese border. There was a visible rapprochement in relations with the Kyrgyz Republic, reflected in the improved conditions for the transit of Kyrgyz goods. However, there has been less tangible progress on the issue of water-energy trade with the Kyrgyz Republic and Kazakhstan has suffered floods caused by the Kyrgyz Republic's release of water during winter months.[2] Relations with Russia remain strong, however the issue of discriminatory rail tariffs applied to Kazakh exporters needs to be addressed. Relations with Russia are also important in the Central Asia regional context when the capacity enhancement of the Central-Asia-Centre (CAC) pipeline which transports Turkmen and Uzbek gas to Russia through Kazakhstan is considered.

Besides the Commonwealth of Independent States (CIS), Kazakhstan is an active member of various regional security and economic organisations, ranging from the Shanghai Cooperation Organisation, to regional economic groupings such as the Central Asian Cooperation Organisation (CACO), the Eurasian Economic Community and the Single Economic Space. The effectiveness of these economic groupings in enhancing regional trade has been limited and the often inconsistent regional integration schemes might have created more barriers to regional trade. Regional economic cooperation schemes have also complicated the WTO accession process of their members, as they aim to coordinate common external tariffs. In the case of Kazakhstan, as it aims to achieve customs union with Russia, it implies that it adjusts its current tariff levels to those of Russia which are, on average, substantially higher.

2.1.3 Labour Issues

Fundamental rights of employees are protected under the 1999 Law on Labour. Kazakhstan has ratified all the fundamental International Labour Organisation (ILO) conventions on forced labour, freedom of association, discrimination and child labour. The Law on Labour that came into effect on 1 January 2000 replaced the 1972 Labour Code allowing for more flexible labour relations, while providing for prohibition of discrimination and forced labour, freedom of association, and setting a minimum working age of 16 years.

Under the 1999 Law, employers have the right to dismiss employees in the event of general downsizing, not only in the event of liquidation as was interpreted under the 1972 Labour Code. The mandatory notice period for dismissal is one month and minimum severance pay is the average monthly salary of the dismissed employee (the Law does not specify the time period from which the average is calculated). The regular working hours stipulated in the Law are 40 hours per week. Regular working hours for workers engaged in heavy and manual work and work in hazardous conditions are 36 hours per week. Workers' consent is generally required for overtime and the maximum allowed overtime per worker is two hours per calendar day. Workers are entitled to a minimum of 18 days of paid annual leave after completing one year of employment. Women are granted maternity leave with pay, for seventy calendar days before childbirth and fifty-six days after childbirth.

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[2] Under the Central Asia Regional Economic Cooperation (CAREC) initiative, IFIs and UNDP are encouraging both up-stream (Tajikistan and Kyrgyz Republic) and down-stream countries (Kazakhstan and Uzbekistan) of the Syr Darya river to address, inter alia, water-energy trade issues.

2.1.4 Social Conditions

Social conditions continue to improve but regional differences have widened. The percentage of the population living below the minimum standard of living (poverty line) has been declining since 1998, as strong economic growth has contributed to an increase in private consumption. According to official statistics, the percentage of the population living below the poverty line declined from 39 per cent in 1998 to 24.2 per cent in 2002. During the same period, the extent of inequality (measured by the Gini co-efficient[3]) has also declined. Compared to other CIS countries, the issues of poverty and inequality are less severe in Kazakhstan.[4] Other social indicators such as life expectancy and school enrolment have also been improving.

These positive trends mask an important rural / urban divide. Rural areas have a much higher incidence of poverty and inequality. The rural poverty incidence was 34.7 per cent in 2002, twice as high as in urban areas (15.6 per cent). According to a survey conducted by the UNDP Kazakhstan in 2002[5], the majority of rural respondents indicated that their living standards had not improved in the previous three years. The rural population is particularly disadvantaged with regard to access to clean water and heating systems. Regions with high poverty incidence were Atyrau, Kyzlorda, Taraz and Taldykorgan oblasts.

Kazakhstan has been providing targeted social assistance to alleviate poverty since 2002. State assistance is provided to those with incomes that are below the nationally defined poverty line.[6] However, according to a survey by the Statistical Agency, 60 per cent of the poor did not apply for state social assistance because they thought they would not qualify, or it was too difficult to obtain the numerous certificates required to verify their eligibility, or were not attracted by the size of the benefits compared to the costs of obtaining those benefits.[7] In particular, the incentives for the rural poor to apply were undermined by high transport costs for travel to social security agencies.

2.1.5 Legal Environment

While in recent years Kazakhstan has introduced notable reforms to its legal environment, the country continues to face considerable challenges in entrenching the rule of law and related institutions, upon which its successful transition to a market-orientated economy will depend.

Kazakh commercial laws have improved significantly in recent years and are considered on par with many other CIS countries, but they still fall short of standards

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[3] The Gini index measures inequality over the entire distribution of income or consumption. A value of 0 represents perfect equality, and a value of 1 perfect inequality.

[4] The poverty ratio in Kazakhstan was 8.5 per cent in 2001, using the internationally comparable definition of the proportion of population living below purchasing power parity (PPP) USD 2.15 per day, compared to 23.8 per cent in Russia in 2000. Other Central Asian republics had a much higher percentage.

[5] *Sociological survey of rural rayons,* UNDP Kazakhstan, 2002. A summary of the survey can be found in UNDP, Poverty in Kazakhstan: Causes and Cures, 2004.

[6] In 2002, the poverty line amounted to 40 per cent of the subsistence minimum, which was KZT 4,761 (USD 31.1) in 2002.

[7] *Survey of poor households 'Low-Income Population: Causes and Conditions'*, Kazakhstan Statistics Agency. A summary of the survey can be found in UNDP, Poverty in Kazakhstan: Causes and Cures, 2004.

that are generally acceptable internationally. Due to its macroeconomic stability and potential abundance of natural resources, Kazakhstan has a relatively high possibility of attracting foreign investment. However, political uncertainty, lack of infrastructure, and an inadequate judiciary, together with widespread corruption, inhibit the development of a sound investment climate. To see an improvement in the investment climate there also needs to be corresponding improvement in the judicial system, and particularly in the conduct of fair trials.

An analysis of key commercial laws that contribute directly to creating a favourable investment climate in Kazakhstan, such as secured transactions, bankruptcy laws, and regulation of financial markets, shows that even relatively good laws often suffer from poor implementation.

This implementation gap both undermines the utility of the specific laws in issue and diminishes the confidence that both Kazakhstan and foreign investors and traders have in the legal system as a whole, in particular in its ability to uphold contractual rights. Kazakhstan's poor record of upholding political freedom and civil liberties is also of concern, given the continuing large and unchanging gap between the adoption of new laws and their effective implementation. The President constitutionally holds a vast amount of power not only over the legislative, but also over the executive branch. The judiciary, as well, remains under the control of the President and the executive branch, making it difficult to root out corruption, which is a challenge faced by the Government.

There is a concern that the level of the country’s economic progress is not matched by similar progress in legal reform and democratic transition in the country. Because of the inter-dependence of all three of these pillars of transition, and given that experience has shown that in transition countries these pillars are mutually reinforcing, Kazakhstan will only be able to achieve long-term improvements in its investment and political climate if its efforts to advance economically are at least matched by a commitment to legal reform. The Foreign Investors Council (FIC), set up in 1998 as a consultative body comprising of major foreign investors in the region, and chaired by the President, shapes further improvements to the legislative environment. As such the Legal Working Group of the FIC has successfully contributed to the strengthening of judicial independence (e.g. increase of judges’ salary, reforms aimed at independence of judiciary from local authorities, etc.), creation of Specialised Economic Courts, and drafting laws on maritime, investment, arbitration, etc. The challenge facing Kazakhstan in 2004 and beyond is to further upgrade its commercial laws to standards that are generally acceptable internationally and, at least as importantly, to make those laws fully effective through a strengthening of the court system and the rule of law.

2.1.6 Environmental Issues

The EBRD’s work in the natural resource sector (extractive industries) during the next two years will require focus on the environmental, worker safety, labour, and community issues associated with the sector. Environmental issues will be reflected in due diligence and monitoring, according to the 2003 EBRD Environmental Policy. Particular emphasis will need to be paid to worker safety issues in the extractive industries and power projects where mines are associated.

Where the enterprise sector involves companies in agribusiness or service and supply companies to the natural resource sector, particular care will need to be taken to ensure the associated issues are adequately identified and addressed.

In addition to environmental issues in the corporate sector, special attention will be paid to worker protection and safety. Where projects are identified in the petrochemical industry, the project focus will be on energy efficiency and environmental improvements. Water-use issues will remain a critical part of due diligence and monitoring for industrial, agribusiness, and natural resource projects.

For metallurgical projects, both worker safety and environmental issues will be the focus of due diligence. Any port or shipping project due diligence will need to reflect the agreements of the Caspian littoral states, as well as bilateral agreements on environmental and emergency response. Power projects, including distribution systems, will need to incorporate attention to not only worker safety, but also public safety, where appropriate.

The Bank will also undertake environmental technical cooperation projects to address institutional capacity issues, where relevant. In the financial sector, an environmental workshop for financial institutions is planned in the fourth quarter of 2004 in Kazakhstan, to assist local banks to strengthen their environmental due diligence capacities. A tailored environmental training programme is also being prepared for the Kazakh Development Bank.

New projects in Kazakhstan will continue to be subject to the Bank's Environmental Policy and Procedures and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence. The Bank will continue to cooperate with other institutions to generate synergies for environmental cooperation work in Kazakhstan.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions for Bank Operations

The general macroeconomic environment has been strong during the last two years, supported by prudent fiscal and monetary policies. The economy remains heavily resource-based and is vulnerable to fluctuations in commodity prices. International reserves of the National Bank of Kazakhstan (NBK) and reserves in the National Fund[8] provide some cushioning against a hard landing if oil prices should fall unexpectedly. However, rapid asset growth of the banking sector in recent years warrants some caution. In this respect, preserving macroeconomic stability through the continuation of prudent fiscal and monetary policies and close monitoring of the quality of banking assets are of the utmost importance during the strategy period.

The growth outlook in the medium to long-term hinges on continued improvement in the investment climate, which will promote investments and growth in the non-oil and gas sector.

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[8] The National Fund was established in 2001 to reduce the impact of volatile market prices of natural resources on the economy and to accumulate the wealth generated from the natural resource sector for future generations. The National Fund is managed by the NBK and all assets are exclusively invested abroad, primarily in liquid investment grade assets.

Ouput: The economy grew strongly – 9.8 per cent in 2002 and 9.2 per cent in 2003, driven by the buoyant gas and oil extraction industries and high commodity prices, which have resulted in positive spill-over effects across the economy. The proportion of oil and gas, and related service sectors in the economy, continued to expand over the past two years, but at a more modest pace as the non-oil and gas sectors have also grown strongly. Growth was fairly diversified in the industrial sector in 2003 with above average growth recorded in the chemical industry (16.3 per cent), machine-building (20.7 per cent), manufacture of wood and wood products (65.3 per cent), non-metallic mineral products (27.3 per cent) and food and beverages (9.4 per cent). The strength of the economy was maintained in 2004 with 9.1 per cent growth in the first half of the year. The impact of real exchange rate appreciation that began in the first half of 2004 on the non-oil sector is still uncertain but, given strong labour productivity growth in the last four years, the sector should be able to withstand increased competitive pressure.

Monetary policy and exchange rates: Prices have been generally stable although annual average consumer price inflation (CPI) increased from 5.8 per cent in 2002 to 6.4 per cent in 2003 due to gasoline supply shocks at the end of 2003. During the first half of 2004, inflationary pressures abated but high foreign currency inflows and the fiscal easing are putting an increasing strain on monetary policy.

The National Bank of Kazakhstan (NBK) changed its policy target from maintaining exchange rate stability to price stability at the beginning of 2004. Target inflation rates (based on average annual CPI) have been set at 5-7 per cent for 2004 and 4-6 per cent for the years 2005 and 2006. Reflecting the policy shift, the real effective exchange rate appreciated by 1.4 per cent during the first four months of 2004, compared to the same period of the previous year. Despite this policy shift, the NBK has continued to intervene repeatedly in the market to ease the strong upward pressure on the tenge, reflecting growing exports and capital inflows. The NBK has issued bills to absorb the impact on the domestic money supply. However, interventions were not fully sterilised and led to a continued increase in base money which rose by 48 per cent year-on-year to July, while broad money increased by 34 per cent. The growth in money supply has not created much inflationary pressure so far, as the demand for money has also risen, but some tightening of liquidity may become necessary, for example, through the further appreciation of the exchange rate. Close monitoring of asset prices is also critical as bank lending continues to rise rapidly and the level of non-performing loans remains high.

Fiscal policy: The consolidated fiscal surplus, including inflows into the National Fund (which channels foreign currency inflows into overseas investments at times of high oil prices), reached around 4.7 per cent of GDP in 2003, up from 2.2 per cent in 2002. Although the number of companies whose tax payments are earmarked for the National Fund (and hence for saving) has been reduced,[9] given the recent sharp increases in international oil prices, the consolidated fiscal surplus is likely to widen further in 2004.

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[9] Their tax payments will flow into the general budget, where they will support an increase in expenditure by 2 percentage points of GDP compared to 2003 and offset anticipated revenue reductions from tax cuts.

Excluding the National Fund, according to the revised 2004 budget, the fiscal deficit of the general Government is expected to widen from 1 per cent of GDP in 2003 to 2 per cent of GDP in 2004. The 2004 expenditures accommodate increased civil servants' salaries, higher capital expenditures and capitalisation of newly established and existing state-owned development institutions. On the revenues side, various tax cuts became effective in 2004: VAT was lowered from 16 per cent to 15 per cent; the maximum income tax rate was reduced from 30 to 20 per cent; and social security tax, a tax to support the pay-as-you-go component of the pension system changed from a uniform system of 21 per cent to a system of different rates, ranging from 7 per cent to 20 per cent, applied on a regressive scale depending on individual earnings. Notwithstanding these tax cuts, budget revenues in the first half of the year have met the projected target reflecting higher oil prices, broadening of the tax base accrued to the general budget and continued strength of the economy.

The 2005 central Government budget adopted by the Government in August 2004 (expected to be approved by Parliament in October/November) accommodates large increases in social expenditures and expects the central Government deficit to narrow to 1.5 per cent from 1.8 per cent in 2004.

External sector: The current account deficit narrowed from 3.5 per cent of GDP in 2002 to 0.2 per cent in 2003, owing to the continued surge in oil and commodity prices. Merchandise exports increased by 32 per cent as average oil prices increased by 14 per cent. For the entire year, a current account surplus of 1 per cent of GDP is forecast on the basis of continued terms of trade improvements (average oil prices have increased by 35 per cent during the first eight months) although import demand is also likely to increase, reflecting the strength of domestic consumption. Foreign direct investment (FDI), primarily in the natural resources sector, reached USD 2.2 billion in 2003 (on a net basis), a similar level to 2002. Gross international reserves excluding gold reached USD 4.2 billion or, 3.9 months of imports of goods and services at the end of 2003. Including the assets of the National Fund, reserves reached the more comfortable level of 7.1 months of imports of goods and services.

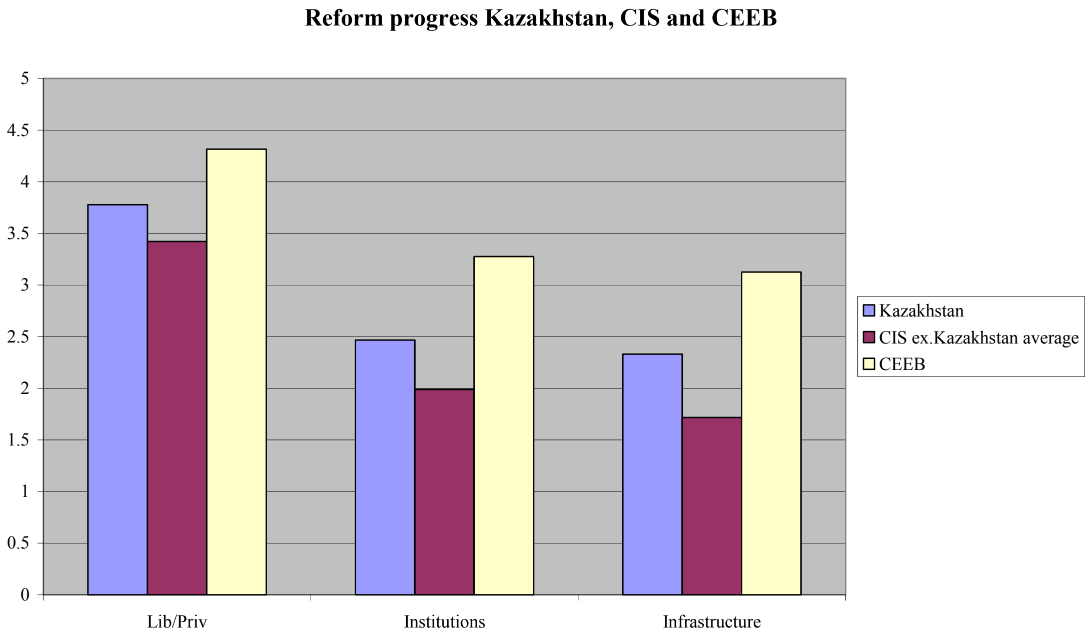
The level of external debt remains high and is increasing further. The external debt stock reached USD 23 billion, or 77 per cent of GDP at the end of 2003. However, most of the debt is still inter-company loans associated with FDI, and repayments are linked to the oil price, which mitigates the impact of a sharp decline in oil prices. Public debt, including sovereign guaranteed debt, was 12 per cent of GDP at the end of 2003 and this level is likely to decline further as the Government adopts a policy of repaying maturing sovereign external debt. The share of inter-company loans in private sector external debt was 63 per cent at the end of 2003. Debt service as a percentage of exports of goods and services remained high at 34.5 per cent in 2003, although the ratio declined from 35 per cent in 2002.

2.2.2 Transition Success and Transition Challenges

The overarching challenge for Kazakhstan in the medium to long term is to ensure that the economy remains diversified and that wealth derived from natural resources is managed appropriately. Kazakhstan has already undertaken wide-ranging reforms including the establishment of the National Fund which has a savings function – to accumulate assets for future generations, - in addition to the stabilisation function.

Diversified growth performance of recent years indicates that reform efforts have paid some dividends.

Table 2:



Source: EBRD Transition Report 2003.

Nevertheless, the economic reform environment in Kazakhstan continues to provide a mixed picture (Table 2). Kazakhstan remains one of the most advanced reformers in the CIS but still falls significantly behind the advanced transition economies of Central Eastern Europe and the Baltic States (CEEB). In the past two years, there has been some strengthening of market institutions building on earlier reform efforts. Progress is most noticeable in the financial sector, where it has one of the strongest regulatory and supervisory frameworks among the CIS countries, although it can be enhanced further to withstand potential future volatility. Infrastructure reform, including the strengthening of the regulatory regime, is advanced in some sub-sectors. On the other hand, the enterprise sector including "national companies" has been slow to advance corporate governance and transparency, limiting the prospects for companies to attract external sources of financing particularly FDI, especially outside the oil and gas industry. Although Kazakhstan has a relatively liberal trade regime in terms of tariffs, it is yet to become a member of the World Trade Organisation (WTO) and thus does not fully enjoy the benefits of having non-discriminatory access to world markets.

The Government adopted a comprehensive industrial strategy for economic diversification in May 2003. The priority areas are sectors that have links with the oil extraction sector, high value-added sectors (such as space, nuclear and information technology) and agriculture. To support diversification and investment in the non-oil sector, a number of new state-owned institutions were established, in addition to the existing Kazakhstan Development Bank: a Kazakhstan Investment Fund, a Science Foundation, an Innovation Fund and an Export Insurance Corporation. However, for all the Government's activism, a difficult business climate, including widespread corruption and limited competition on the domestic market, continue to be the biggest obstacles to additional investment and innovation outside oil and gas.

In view of the achievements to date and long-term challenges for economic diversification outlined above, there are four main challenges for Kazakhstan during this Strategy period.

- The authorities need to maintain their commitment to an open market economy including the advancement of WTO accession in order to strengthen competition and improve the competitiveness of enterprises.
- Further improve the investment climate *inter alia*, strengthen efforts to fight corruption and increase administrative transparency in order to foster private sector development.
- The levels of financial transparency and corporate governance standards of local companies, both private and state-owned, should be enhanced in order to attract financing from FDI and domestic institutional investors.
- Private sector participation in infrastructure services should be further advanced in order to benefit from efficiency gains while strengthening the capacity of the regulatory agency.

More specific achievements and challenges are outlined in the subsequent paragraphs.

Investment Climate

The investment climate in Kazakhstan has been improving. According to the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) where 250 business enterprises were surveyed, firms perceived the overall business environment to have improved in the period 1999-2002.[10] However, corruption and administrative transparency issues need to be addressed further to enhance the investment climate.

The Corruption Perceptions Index score of Kazakhstan published by Transparency International (on a scale ranging from 10 to 0, 0 being highly corrupt) fell from 3.0 in 2000 to 2.2 in 2004, indicating a perception of increased prevalence of corruption. In 2004, Kazakhstan's ranking fell behind some of the CIS countries – Belarus, Armenia, Russia and Uzbekistan.

Following the enactment of the Civil Service Law in July 1999, which introduced a competitive and transparent recruitment process of civil servants, a Code of Ethics was adopted in January 2000. The code in general prohibits civil servants from accepting any gift or payments from the public. The anti-corruption law originally adopted in 1998 was amended in September 2003. The amended law widened the definition of corruption and coverage of state officials that would be subject to the law. In December 2003, a new Agency for the Fight Against Economic and Corruption Crimes was established with the mandate to investigate this type of crime. In the first half of 2004, the Agency investigated over 350 cases of corruption, imposing fines totalling KZT 40 million (USD 300,000). Nevertheless, it is too early to assess its effectiveness.

[10] BEEPS data are available on http://www.ebrd.com/beeps/

While these are important steps in addressing corruption, as a natural resource-based economy, there is an issue of transparency of revenues that accrue from oil and gas sectors. The Extractive Industries Transparency Initiative (EITI) advocated by the UK government and endorsed internationally by extracting industries and governments, calls for a process whereby an independent party ensures that contractual payments reported by companies match revenues received by the Government. The objective is to increase transparency and accountability of revenues derived from natural resources by ensuring that funds will not be diverted into personal or other accounts held outside the Government. In transition countries, Azerbaijan and the Kyrgyz Republic have so far endorsed this initiative. Kazakhstan is yet to adopt this initiative despite publicly expressed concerns on the "secrecy" of product sharing agreements (PSA) signed with Western oil majors in the early years of independence. As a first step toward improved transparency, the National Fund transactions should be made more transparent through the publication of its audits.

There are also issues on the transparency of financial interests of high-level Government officials. Currently, Government officials are required to declare their incomes and wealth annually to the tax authorities but these declarations are not published. Enhanced public disclosure would improve policy accountability. As a number of companies are owned or controlled by former and present Government officials, it could also reduce the level of unfair advantage enjoyed by companies that could influence Government policies, thereby reducing the barriers to competition.

For foreign investors, the general investment climate has also improved, but in recent years Government has restricted foreign investments in key areas. Examples include restrictions on future oil and gas explorations in the offshore Caspian field to 50 per cent (the state-owned integrated oil and gas company, KazMunaiGas will automatically receive a 50 per cent stake in the venture) and limitation of foreign investor participation in international and inter-city fixed line services to a minority stake. The "national solutions" to development needs may address some of the strategic concerns, including national security issues, but international experience points to the advantage of foreign investment in knowledge and skills transfer which will lead to the build-up of human capital. New tax incentives provided to FDI inflows into non-oil sectors are only likely help attract FDI in those sectors at the margin. It is more important to strengthen the commitment to an open market economy. Kazakhstan began WTO accession negotiations in early 1996 but there is still no clear target date for its accession.[11] Early accession to WTO is important, not least because it will demonstrate the country's willingness to commit to international rules and obligations.

[11] Topics under discussion in the WTO Working Party include: agriculture, the customs system (and customs union arrangements), price controls, import licensing, industrial subsidies, sanitary and phytosanitary issues, technical barriers to trade, transparency of the legal system and legislative reform, services and trade related aspects of intellectual property rights.

Enterprise Reform & SME Development

Progress in enterprise reform has slowed in recent years, although the financial performance of enterprises has improved, due to a favourable general macroeconomic environment. Except for the agricultural sector, productivity has generally improved across the economy. In industry, labour productivity grew, on average, by 12 per cent per annum between 1999 and 2003. This is largely owing to increased production in the oil and gas sector but non-oil sectors have also experienced productivity improvements. Nevertheless, increased productivity in the non-oil industrial sector is largely based on improved capacity utilisation rather than capital investment. In 2003, investments were mainly concentrated in mining, the predominant sub-sector of which is oil and gas (36.5 per cent of total capital investment), followed by real estate (14.5 per cent), public sector (13.9 per cent) and transport and communication (13.4 per cent). The manufacturing sector as a whole only accounted for 9.4 per cent of total capital investment. This implies that although access to financing has increased in recent years, enterprises are yet to undertake capital investments due to following factors: i) limited availability of long-term financing; ii) lack of market opportunities to justify capacity expansion; iii) absence of competitive pressures that will force enterprises to invest in product upgrades and diversification; and iv) lack of know-how to undertake expansion plans.

Enterprises can improve access to long-term financing by enhancing transparency and governance practices. The new law on joint-stock companies (JSCs), which became effective in May 2003, established higher thresholds for capital (minimum capital requirement increased by tenfold to around USD 300,000) and stricter reporting and notification requirements. The new law also requires shareholder registrars of JSCs to be maintained by authorised independent registrars (see Annex 6 Legal Transition). Those companies that did not meet the new requirement by August 2003 had no other choice than to reregister as limited liability companies and were de-listed from the stock exchange. From 1 January 2005, all "national companies" and commercial banks are required to present their financial records and accounts in line with International Financial Reporting Standards (IFRS) format. The remaining JSCs will also be required to adopt such standards as of 1 January 2006. Nevertheless, further efforts are needed to improve corporate governance practices, especially if enterprises are to have improved access to equity finance. In Russia, the adoption of the Corporate Governance Code has helped ease access to finance for those enterprises that abide by the code. The development of a similar code of standards and practices could also be considered in Kazakhstan.

Market opportunities and competitiveness across the economy could be significantly enhanced by increased openness to trade and investments facilitated by a modern competition policy framework, reflective of commonly accepted international standards. To date, in this respect, development and implementation efforts of the authorities still leave room for improvement and appear somewhat conflicting. Notably, until recently, the Agency for Regulation of Natural Monopolies and Protection of Competition (AMA) was responsible for competition enforcement functions in addition to its "natural monopolies" regulation function. In Kazakhstan a number of enterprises are considered as natural monopolies, including those operating in areas which could, applying international experience, be considered competitive. Such natural monopolies require approval from AMA for tariff changes.

Responsibility for two such distinct, and at times conflicting, functions may have undermined AMA's development of a clear and focused modern competition policy framework for Kazakhstan. Going forward, it is important that the concept of natural monopoly only be applied to those areas where new market entry is limited and that an appropriately empowered competition authority be charged with the implementation and enforcement of modern competition policy in competitive areas of the marketplace. In this regard, a recently announced transfer of competition enforcement functions away from AMA could contribute to a positive step towards the development of modern, international standard, competition policy framework in Kazakhstan.

Recent privatisations consisted of the sale of residual but significant state stakes in Kazakhmys, Aluminium of Kazakshtan and the CNPC-Aktobemunaigas joint venture. In oil and gas and related sectors, KMG a holding company 100 per cent owned by the state, is of increasing importance. It was established in 2002 through the consolidation of the state's oil and gas production and distribution businesses. Recently, it began an asset restructuring programme. The programme calls for the splitting of KMG's 55 subsidiaries into core and non-core assets, a reduction in the number of subsidiaries through mergers, and the privatisation of non-core assets. The restructuring should improve the management of the KMG group, but potential conflicts of interests remain. They relate to KMG's role as the state representative in joint ventures with foreign operators on the one hand and its role as a fully commercial entity on the other. The issue of fair and open access to the transportation infrastructure controlled by KMG – through its subsidiaries – may also require more effective regulation (see Infrastructure section).

SMEs account for over 98 per cent of total registered enterprises in Kazakhstan.[12] Small enterprises alone account for 93 per cent of total registered enterprises and together with peasant farms, represent around 25-30 per cent of total employment. Small non-agricultural enterprises mainly operate in the service sector (81 per cent). Those that are in industry mostly operate in the food and light industrial sectors. Access to financing for small enterprises has improved as bank lending in general has grown rapidly. Loans outstanding to small businesses increased by 70 per cent between the end of 2002 and June 2004 and accounted for over 20 per cent of total loans outstanding. Over 60 per cent of loans to small businesses were long term loans (those with maturity of over 1 year). Average (nominal) interest rates charged to small businesses declined from 16.6 per cent in 2002 to 15.5 per cent by June 2004. These are encouraging signs for the further development of small enterprises and hence, further diversification of the economy.

Infrastructure Reform

As a vast, thinly populated and landlocked country, Kazakhstan faces substantial investment needs in infrastructure, so that bottlenecks for further expansion of economic activities in the country can be removed. Kazakhstan was one of the first countries in the CIS to undertake infrastructure reforms, including the introduction of the private sector in the provision of infrastructure services. This is particularly true

[12] In Kazakhstan, small enterprises are defined as enterprises with up to 50 employees. Medium enterprises are defined as those with 51-250 employees.

in the power sector. On the other hand, in the area of transport infrastructure, which is closely associated with investment needs for natural resources, the public sector remains dominant and reform progress has been relatively slow. The telecommunications sector reforms also lag behind other CIS countries such as Russia (See Table 3). For Kazakhstan to meet huge investment requirements, private sector participation is essential because it will enhance efficiency and generate transfer of skills and technologies. The key challenge for the Government is to establish and enforce credible "rules of the game" through effective laws and strong, clear regulations in order to attract private investment.

Table 3: EBRD index of infrastructure reforms 2003 and key infrastructure indicators in selected CIS

	Armenia	Azerbaijan	Georgia	***Kazakhstan***	Kyrgyz Republic	Moldova	Russia	Tajikistan	Turkmenistan	Uzbekistan
POWER & ENERGY										
Electric power (EBRD index) 2/	3.3	2.3	3.0	**3.0**	2.3	3.0	3.0	1.0	1.0	2.0
Electricity tariffs 3/	4.5 (98)	2.3 (45)	6.5 (90)	**2.7 (92)**	1.32 (41)	5.6 (91)	2.4 (102)	1.7 (65)	0.5 (63)	1.4 (72)
GDP per unit of energy use 4/	3.3	1.7	4.2	**1.7**	3.2	1.7	1.6	1.7	1.3	0.7
RAILWAYS										
Railways (EBRD index) 2/	2.0	2.3	3.0	**2.7**	1.0	2.0	2.3	1.0	1.0	3.0
Railway labour productivity 5/	20.6	29.4	71.9	**51.0**	16.2	27.5	90.1	50.3	32.7	51.1
ROADS										
Roads (EBRD index) 2/	2.3	2.3	2.0	**2.0**	1.0	2.0	2.3	1.0	1.0	1.0
Paved roads 6/	96.2	92.3	93.4	**89.7**	91.1	87.0	67.4	.n.a.	81.2	87.3
TELECOMMUNICATIONS										
Telecommunications (EBRD index) 2/	2.3	1.0	2.3	**2.3**	2.7	2.3	3.0	2.3	1.0	2.0
Fixed-line (mobile) penetration rate 7/	14.0 (1.2)	12.1 (10.7)	13.1 (10.2)	**12.1 (3.6)**	7.8 (1.0)	14.6 (5.1)	24.2 (12.1)	3.7 (0.2)	8.0 (0.2)	6.7 (0.7)
Internet penetration rate 8/	9.4	1.4	5.7	**11.5**	12.3	4.9	28.4	0.5	3.5	0.1
WATER & WASTE WATER										
Water and waste water (EBRD index) 2/	2.0	2.0	2.0	**1.7**	1.0	2.0	2.3	1.7	1.0	1.7
Access to safe water by urban population 9/	n.a.	93 (58)	90 (61)	**98 (82)**	98 (66)	97 (88)	100 (96)	93 (47)	n.a.	94 (79)

Source: EBRD Transition Report 2003 and World Bank, *World Development Indicators.*
1/ All indices are assessment as of mid-2003 and all indicators refer to 2002 unless otherwise stated
2/ EBRD index ranges from 1 (little or no progress in commercialisation) to 4+ (full commercialisation and implementation of an effective regulation)
3/ US cents per kilowatt hour; collection rate in per cent in bracket
4/ PPP in US dollars per kgoe; 2001 estimate
5/ 1996=100
6/ As per cent of total roads; 1999
7/ Per 100 inhabitants
8/ Per 10,000 inhabitants
9/ Per cent of population; access to safe water by rural population in brackets; 2000

Transport

The development of a further transport network, including pipelines, is critical for Kazakhstan to gain access to international markets. Reforms of the railway sector that would open it to third-party operators are finally being implemented. Earlier efforts to reform Kazakhstan State Railways (Kazakhstan Temir Zholy or KTZ), which is estimated to carry in excess of 70 per cent of the country's freight ton-kilometres and approximately half of the total passenger-kilometres, including urban services, have been derailed by management changes and the Government only agreed on a restructuring programme in February 2004. Based on this programme, KTZ was split into several joint-stock companies. KTZ itself was turned into an infrastructure company with responsibility for tracks, track maintenance and train movement. Separate companies were created for the operation and maintenance of locomotives (JSC Locomotive) and freight wagons (JSC KazZhelDorTrans). The operation of passenger services had already been unbundled in 2003 with the creation of six regional companies. The ownership of these will be transferred from KTZ to the Ministry of Transport on 1 January 2005. The current subsidy system of discounted infrastructure access charges for passenger transports will be replaced by explicit payments from the state budget to operators for the operation of loss-making, but socially important inter-city routes in 2005. Non-core companies will be sold through open tenders between 2004 and 2006. Track access charges will be regulated by the AMA which needs to further develop and implement an appropriate tariff methodology. Most importantly, as state-owned freight operators will compete with private operators, non-discriminatory access policy should be implemented.

Regulatory framework for other transport infrastructure, such as oil and gas pipelines which are important for the growing oil and gas sectors, requires further strengthening. While the Government has received assistance from USAID for the development of tariff methodology for the use of oil and gas pipelines, further work is needed in order to implement this methodology. Furthermore, there is regulatory uncertainty over the access regime to oil and gas pipelines that are controlled by subsidiaries of KMG. With the opening of CPC pipeline in 2001, there are currently no export bottlenecks.[13] However, as output is set to rise, especially when Kashagan field comes on stream after around 2007, the access issue will become more pertinent. The third party access regime to the oil berths at Aktau port also requires further clarification.

Road and aviation sectors are primarily developed by public financing. In recent years, road sector development has received a large allocation from the central budget. Key challenges in the road sector are to prioritise investment and to separate regulatory functions from project planning and execution functions.

Power sector

Kazakhstan embarked on the liberalisation and privatisation of the power sector in earlier years. The sector consists of a state-owned national transmission and dispatch company – KEGOC, a number of mainly privately-owned power generation companies (around 70 per cent of power generation capacity is private) and a highly segmented distribution market served by regional electricity companies (RECs)[14]. Most of the electricity is sold through direct purchase contract between generators and large consumers and RECs, although around 10 per cent of daily consumption is handled through Kazakhstan Market Operator for Electric Energy and Capacity (KOREM), the spot market operator set up in 2000. Market liberalisation has resulted in some tangible benefits, especially to the wholesale market with prices declining roughly by 50 per cent between 1998 and 1999. However, inadequate regulatory framework for retail tariffs has undermined the performance of RECs.[15]

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[13] CPC pipeline is developed and operated by a consortium of governments (Russia, Kazakhstan and Oman) and a number of oil majors with oil properties in the Caspian region.

[14] At least 25 per cent of consumers are served by private distribution companies.

[15] Until the new tariff methodology was adopted in 2002, tariff methodology was based on cost-plus. However, local regulators were able to manipulate the methodology and in many regions retail tariffs remained at below cost-recovery levels.

Acknowledging the inadequacies of tariff regulation, in June 2002 the Government adopted a new price cap tariff methodology for public utilities in the water, electricity and municipal services sectors. The price cap methodology sets forward-looking tariffs over a three-to-five year period to equate revenues with total (operating and investment) costs. Once set, the tariffs are adjusted for inflation, the real exchange rate and demand but not increases in operating costs, thus providing an incentive for efficient performance. The methodology also allows reasonable returns to investors. In February 2003, AMA began to implement this methodology and by early 2004, over 60 utilities (not only RECs but also water and waste water utilities) had adopted the new methodology. The full implementation of new tariff methodology could elicit further private sector interests in electricity distribution and promote privatisation of the sector.

In July 2004, a new Law on Electrical Energy (the "Electricity Law" or "Law") was adopted which will provide for the creation of a fully competitive electricity market in Kazakhstan. The law requires the separation of electricity supply functions of RECs and local network operating functions by 1 October 2004. The electricity supply companies spun off from RECs will have the status of "guaranteed suppliers of electricity" for their respective regions. As such, they must supply electricity to every solvent customer in the region. RECs are also required to consolidate with only one REC for each administrative region (oblast) by 1 January 2006. The electricity supply business will begin competing with independent electricity traders, while RECs as network operators will be regulated as natural monopolies and will have to provide access to third-party users of their network on a non-discriminatory basis. The law also provides for the strengthening of the role of KOREM in electricity trade. From 1 October 2004, all electricity generators and guaranteed suppliers are required to sell/purchase a certain portion of their output/demand at KOREM. The authorities expect by 1 January 2005, at least 50 per cent of electricity generated in Kazakhstan will be sold/purchased at KOREM.

Municipal and environmental infrastructure

Although expenditure responsibilities and specific shares of state tax revenue have been delegated to local Governments and they have been given the right to raise local taxes and fees, the intergovernmental fiscal framework is still evolving in Kazakhstan. There are imbalances between expenditure responsibilities and revenue raising powers. In particular, the current practice of budget withdrawals, which are not controlled by local Governments or based on a set of predetermined criteria, prevents local Governments from preparing predictable financial plans and seriously impairs their creditworthiness, limiting their access to the financial markets. Moreover, the key challenges ahead include strengthening the implementation capacity of local Governments to undertake investment programmes.

The extent of private sector participation in water and waste water and district heating has been limited to date, because of the uncertain regulatory environment, although local private sector operators do exist. With the improved tariff methodology adopted in recent years, this should not only spur more investment into rehabilitation and modernisation of facilities by municipal utility companies, but also facilitate more significant private sector participation (see power section above).

Telecommunications
The telecommunications sector in Kazakhstan consists of a majority state-owned fixed line operator, Kazakh Telecommunications Company (KTC), four private mobile phone operators and a number of private internet and other service providers. The extent of sector reforms has lagged behind many other CIS countries (see Table 3). However, with the adoption of a new law on telecommunications in July 2004, sector liberalisation is likely to advance further. The law provides for the opening of international and inter-city fixed-line services, currently exclusively provided by KTC to other operators, although foreign ownership of providers of these services will be restricted to minority stakes. Secondary legislation on tariff rebalancing and universal access needs to be prepared and enforced. Although the authorities have been developing universal service and tariff rebalancing models of KTC with assistance from the Bank, full implementation of these models is also required ahead of further market liberalisation.

Financial Sector Reform

Kazakhstan has one of the most developed banking sectors in the CIS, with domestic credit to the private sector reaching 23 per cent of GDP at the end of 2003. Credit to the private sector continues to grow strongly – 64.3 per cent in July 2004 from a year earlier, but at a more modest pace compared to the rapid growth in 2000-2002. The majority of outstanding loans are long-term and banks provide more diversified products such as consumer credit, mortgage loans and lease finance. A key challenge ahead for both banks and the regulatory authority is to further improve the risk management functions, as the share of classified loans remains relatively high and has been increasing in spite of high real growth.[16]

The banking sector has consolidated rapidly in the aftermath of the 1998 crisis, through the enforcement of effective regulation. At present there are 35 commercial banks (33 of them are members of the deposit insurance system), down from 71 at end-1998 and almost 200 at the peak in 1993. Of the commercial banks, 16 banks were foreign-owned. Of the three state-owned banks EximBank was sold in February 2004 to a group of local investors. The Kazakhstan Development Bank (KDB) and Zhilstroibank (a mortgage bank set up in April 2004 to provide housing loans) remain state owned with defined roles and do not compete directly with the commercial banks. Although these specialist state-owned banks may help serve market segments that are currently not sufficiently addressed by commercial banks, their eventual privatisation should be considered when commercial banks are able to service these market segments adequately. Eventual privatisation should also prevent potential misallocation of resources.

The regulatory quality of the financial sector has also improved in recent years with the introduction of group level consolidated supervision, international accounting standards, deposit insurance system (compulsory for all the deposit taking banks from

[16] Classified loans increased from 29 per cent of total loans at the end of 2002 to 39 per cent at the end of 2003, partly because of the introduction of stricter classification during 2003. This created a total of five categories for “doubtful” loans in addition to the “loss” loans category. While the share of classified loans declined slightly to 38 per cent by end-June 2004, the level is still high and warrants some caution.

1 January 2004) and adoption of the Law on Credit Bureau in July 2004. In recent years, the enforcement capacity of the regulator on prudent lending limits has improved, as it has been able to build information on connected party lending and large single party exposures. In order to separate financial sector supervision from the monetary and regulatory functions of the NBK, the FSA was created in January 2004. It plans to focus on implementation and enforcement of the EU Directives on the regulation and supervision of financial markets in Kazakhstan by 2007.

According to the Financial System Stability Assessment Update conducted as part of the joint World Bank-IMF Financial Sector Assessment Programme (FSAP) in February 2004, potential weaknesses of the banking system are its vulnerability to increased classified loans and the reliance of some banks on unreliable wholesale funding.[17] The assessment also found large banks to be vulnerable to increased provisions for loans to agriculture, oil and construction. Therefore continued vigilance is required, should external shocks affect loan performance. The report also cautions against the use of administrative measures to address specific concerns, such as the introduction of ceilings on "excessive deposit rates" by the Deposit Insurance Fund. Although interest rates charged on loans have been declining there are increasing administrative pressures to force interest rates down further. Administrative measures would not necessarily address underlying issues, such as lack of competition, and may effectively conceal problems faced by some banks that need to be addressed through preventive action.[18]

The key challenge for the financial sector is the development of the non-bank financial sector, including the development of capital markets. Since the launch of the mandatory, privately-managed pension pillar in 1998, pension fund assets have grown to 9 per cent of GDP (end-June 2004). Assets are heavily concentrated and not sufficiently diversified from a portfolio management perspective. National Bank bills and corporate bonds account for 34 per cent and 26 per cent of total assets, respectively. Government bonds, including municipal bonds, account for another 19 per cent. However, their share is declining as the Government seeks to reduce its domestic debt burden. Investments into domestic equity are less than 5 per cent of total assets. Domestic companies still fear the loss of control that would result from having institutional minority shareholders, while the institutional investors are concerned about the insufficient protection of their minority interests.

The development of primary securities markets mirrors the portfolio of pension funds with growing issuance of corporate bonds (75 issues worth USD 1.5 billion) and mortgage bonds (5 issues worth USD 100 million). Market capitalisation of securities listed on the Kazakh Stock Exchange (KASE) increased from 41 per cent of GDP in 2001 to 52 per cent in 2003.[19] However, trading on KASE is concentrated in foreign exchange, repurchase agreements and government securities. The enactment of the new Securities Market Act in 2003 has strengthened regulation in terms of clarity of rules, enforcement powers including the authority to institute sanctions, transparency

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[17] IMF, 2004, "Republic of Kazakhstan, Financial System Stability Assessment Update".

[18] Banks offering high deposit rates may be facing liquidity problems which should be further investigated by the regulator.

[19] IMF, 2004, "Republic of Kazakhstan, Financial System Stability Assessment Update". The ratio includes both equities and bonds. Equities alone accounted for 38.4 per cent of GDP but most of the listed equities are not actively traded.

and fairness, and powers and authority for self-regulatory organisations. The regulatory framework should be further complemented by an industry-led assessment of corporate governance standards and practices of enterprises that aim to tap capital markets.

The insurance market is growing, but from a low base. There are currently 34 insurance companies, 6 of which are with foreign participation. There are only 2 life assurance providers. Total gross premiums collected amounted to 0.6 per cent of GDP in 2003, up from 0.4 per cent in 2001. The regulatory regime of the sector has strengthened in recent years but the regulator needs to further develop its capacity to determine the levels of reserve requirements.

2.3 Access to Capital

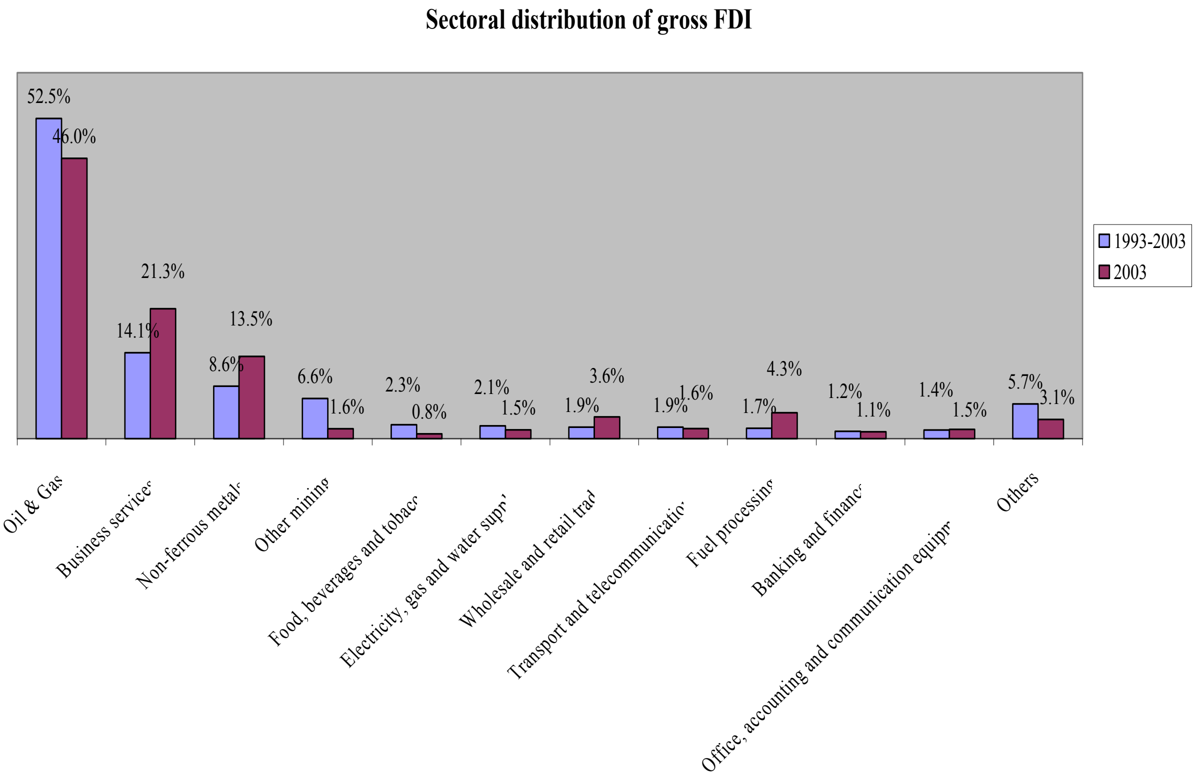
Kazakhstan's access to private capital flows continued to improve. Reflecting the prudent macroeconomic policies of recent years, Kazakhstan's sovereign foreign currency rating was first upgraded to an investment grade by Moody's ("Baa3") in September 2002, followed by Standard & Poor's ("BBB-") in May 2004. The rating by Fitch is one notch lower at "BB+" but it is on positive outlook. The Government has refrained from refinancing from international capital markets in recent years, in spite of improved credit ratings, as it has adopted a policy of repaying maturing debt. Spreads on the outstanding sovereign Eurobonds continued to tighten, with bonds maturing in 2007 trading at 140 basis points over benchmark US government bonds in mid-September 2004.

Domestic banks and corporates have taken advantage of improved sovereign credit risk ratings and have successfully obtained financing from international capital markets. The landmark issuance of a USD 500 million 10-year Eurobond by Kazkommertsbank in April 2003 at 487.5 basis points over US government bonds was followed by BankTuranAlem with the issuance of USD 225 million 7-year Eurobond, also at 487.5 basis points over US government bonds.

Access to international loan markets by large, mainly state-owned companies and medium-sized banks has also improved. In July 2003, KazTransGas received a USD 150 million one-year syndicated loan at 225 basis points over London interbank rate (Libor). Kazakhmys signed a USD 125 million three-year pre-export syndicated loan at 275 basis points over Libor in September 2003. In 2004, KazMunaiGas received a USD 300 million 5-year syndicated loan at 175 basis points over Libor. Medium sized banks such as ATF Bank, Caspian, Bank Center Credit, Nurbank and Temir Bank were also able to raise financing from the international loan market, albeit the tenor was only up to 1-1.5 years.

Access to official sources of financing remains good, but lack of appetite for increased sovereign external debt obligations by the Government has limited new inflows particularly from IFIs. Kazakhstan has attracted one of the highest levels of FDI per capita in the CIS countries, but it has so far been predominantly directed towards the oil and gas industries (see Table 4). If non-oil sectors are to attract more FDI, the investment climate needs to improve further.

Table 4:



Source: National Bank of Kazakhstan

3. Strategic Orientations

3.1 Bank's Priorities for the Strategy Period

The Bank is ready to play a crucial role in supporting Kazakhstan through the challenges ahead. The objective remains to proactively expand its activities in the private sector, while public sector involvement will be focused on projects where significant transition impact will be achieved, or which have a regional dimension.

3.1.1 Enterprise Sector

In support of economic diversification and in order to advance transition and address increasing regional inequality, the Bank will focus on the following areas. The Kazakhstan Small Business Programme (KSBP) will remain the centrepiece of the Bank's SME operations, with new funding under the planned third extension, to strengthen the local financial sector and emphasis the development of rural and agricultural sectors. The Trade Facilitation Programme will further expand Kazakh enterprises' access to international markets. Support for the domestic agribusiness sector will be provided primarily through the Grain Warehouse Receipts Programme, which will continue to support the domestic agribusiness sector through the expansion of additional commodities used as collaterals. New structures, such as agricultural equipment financing facilities, will also be considered. The Bank is working with fledgling local agribusiness companies to develop financing proposals in food processing and consumer goods. To attract higher FDI inflows and to promote new capital investments the Bank, through its ongoing business development efforts, will co-finance projects sponsored by strategic foreign and local investors in the non-natural resources sector. The Bank will selectively support companies in the natural resource sector, including service and supply operations and in the oil and gas and mining sectors. Efforts will continue in the development of local businesses contracted to infrastructure and natural resource projects. The Bank will continue to link the provision of funding for investment activities to enhancements in transparency, integrity, corporate governance and effective regulation.

3.1.2 Infrastructure

Promoting commercial principles and open, non-discriminatory access to infrastructure and supporting regional cooperation will remain key priorities for the Bank. Through existing operations in the transport, power and communications sectors, the Bank has established an important role in the provision of finance and technical cooperation (TC) advisory services to enhance the Government's approach of investing into and managing public infrastructure, including private sector participation. The Bank will continue to support the strengthening of the regulatory framework through the ongoing TC to the Agency for Regulation of Natural Monopolies and Promotion of Competition. Lending operations under development in transport, power and communications sectors will be undertaken in conjunction with appropriate regulatory and institutional reform, mainly on a non-sovereign basis, and will stress regional cooperation where appropriate. The Bank will continue to work with municipalities to improve their creditworthiness and to develop primarily non-sovereign, but also sovereign, operations in the modernisation of municipal infrastructure. The Bank will continue to finance sovereign operations in the road sector, where upgrades are required. In all cases, co-financing from other

International Financial Institutions (IFIs) and commercial sources will be actively sought.

3.1.3 Financial Sector

The financial sector has continued to develop quickly, providing a foundation for the enterprise sector, although scope remains for further development in support of economic diversification and macroeconomic stability. Involvement in the financial sector will focus on diversifying financial services, including provision of longer tenor and more sophisticated products. The Bank will develop suitable funding structures to enable us to provide local currency lending especially for rural SMEs. Efforts to facilitate transition in the sector will focus on training for partner banks, further promotion of higher corporate governance standards through an increase of the existing equity investments and new participations in second-tier medium size banks, extending the list of borrowing banks to increase competition; and supporting the expansion strategy of selected Kazakh banks in CIS countries where feasible, to increase synergies for existing and planned Bank projects. The Bank will also extend activities to non-bank financial institutions, in particular assisting in the privatisation of the State Accumulation Pension Fund and will support development of the mortgage sector, as well as leasing. In undertaking such operations, the Bank will pay close regard to the prospects for systemic vulnerabilities that may result from rapid portfolio growth and sudden macroeconomic developments. The Bank will also continue to work on integrity, transparency and anti-money laundering issues to encourage and support gradual improvements.

3.1.4 Policy Dialogue

The Bank will continue to conduct policy dialogue on the investment climate through the Foreign Investment Council (FIC), and bilateral discussions. Coordination in terms of policy dialogue and complementarity of operations will be reinforced, in particular with the IMF, the World Bank, the Asian Development Bank, key bilateral donors, especially on regional cooperation initiatives.

The Bank will continue to ensure that all EBRD operations in Kazakhstan are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans. The proposed strategy responds to Kazakhstan's current transition challenges and is consistent with EBRD institutional objectives. It reflects the Bank's objective to continue expanding its activities in the country and to maintain an emphasis on non-sovereign operations.

3.2 Sectoral Challenges and Bank Objectives

Given the macroeconomic environment, the country’s progress on key structural reforms, and in line with the main transition challenges facing Kazakhstan, the Bank's activities will be based on the following operational priorities and objectives in the coming years:

3.2.1 Corporate Sector

The Bank will focus on assisting the Kazakh corporate sector in its modernisation and restructuring process through financing efficiency improvement programmes of medium and large Kazakh companies. In this context the Bank will continue to encourage the establishment and improvement of good corporate governance practices as one of the conditionalities of any facility provided. The Bank will continue to support the entrance and business expansion of reputable foreign strategic investors and facilitate their role in transferring technology and skills, enhancing competition, setting quality, productivity, environmental and other standards for entire industries. Priority will be placed upon projects which promote economic diversification away from the natural resource extraction sector.

The emphasis in the different sub-sectors working with corporates will depend upon the specific transition challenges, constraints and circumstances in the given industry.

Agribusiness sector

Strategic orientation will be the development of operations with strong linkages to primary agriculture, which can positively impact the acceleration of agricultural reforms. The financing of private agro-processing enterprises and extending the maturity of financing available will remain a principal focus, which facilitates market access for farmers' produce. The Bank is considering selective consumer goods market projects which will standardise quality and ultimately improve availability and prices of foodstuffs. New ways to assist agribusiness-related SMEs will continue to be explored and KSBP's activities will be expanded to rural and agriculture SMEs. After the successful introduction and financing of the Grain Warehouse Receipt Programme, the structuring of direct risk financing for private traders is being developed. Risk participations are being structured with the aim of providing term loans for the purchase of agricultural equipment a key factor in sustaining the production growth witnessed in the last couple of years.

Telecommunications sector

The Bank is committed to supporting the sector as it faces the challenges of market liberalisation, which will foster increased competition and enhance the nature and extent of services available to the population. This includes continuing work, and participation in, the further privatisation of Kazakhtelecom. The Bank will support viable projects to improve service and promote increased competition with fixed line and mobile operators. Projects which promote the development of data transmission and the internet, media and selected informatics projects, e.g. software development and IT, will be considered. Regulatory development, including the adoption of the new Communications Law, is needed to provide a legal basis for the implementation of the Government Programme for the Telecoms Market Development in Kazakhstan for 2003-2005, adopted in February 2003. Among the critical areas to be addressed in the regulatory sphere is that of tariffs. In this respect, as part of a cross-sectoral institution building and regulatory framework assistance programme, the Bank will provide expert technical and legal assistance to the Anti-Monopoly Agency in the implementation of tariff reforms in the telecoms sector.

Property Development and Retail sectors

Selective support will be offered to projects that promote better office space, logistics/warehouse, hotels and retail infrastructure (and in tourism where possible), in response to demand, via a variety of financing instruments, appropriate for small and medium size projects.

General Industry sectors
Investment which can drive improvements in market functioning, competition, corporate governance and transparency standards of the sector and provide benchmarks for global best practice in operations and customer orientation will be supported.

Heavy Machinery: the Bank will cooperate with companies which are in the process of upgrading their technology, efficiency and business and governance standards. The Bank will utilise leasing schemes to finance the production of investment equipments including agricultural machines and tractors.

Petrochemical Industry: focus will centre on taking advantage of the enormous scope for environmental and energy efficiency improvements in this capital intensive industry, and support the companies to move up the value-added chain.

Metallurgy: the Bank will continue to seek opportunities to assist Kazakh companies to further exploit their strong resource endowment, to make environmental and energy efficiency improvements, to make progress in corporate governance, and to meet the rising quality requirements of domestic and international markets.

Where possible, the Bank will seek opportunities in other sectors, including the construction materials sector.

3.2.2 Small and Medium-Size Enterprises

Based on the capacity built in all participating banks for large scale SME lending it is now planned to extend lending operations systematically to the rural regions of Kazakhstan, including the agriculture sector. The planned KSBP III – Rural and Agriculture Facility, will match the funding provided by the participating banks and is planned to be in the amount of USD 120 million with up to USD 60 million on EBRD's own account. The remainder will be co-financed via the IFC Central Asia SME Cooperation Fund and/or syndicated. At present approximately 5,000 SMEs are financed monthly by KSBP, with half of the loans granted to businesses in smaller towns and rural areas. Future efforts will be directed at enabling the banks to further expand into rural communities and at developing loan products and respective lending specialists to cater to the agriculture sector. So far 110,000 loans have been disbursed to approximately 70,000 SMEs, which employ a total of 500,000 people.

3.2.3 Financial Sector

The strengthening of the financial sector’s resistance against macroeconomic shocks and further enhancement of its stability will remain the Bank’s key aims in the Kazakh financial sector. EBRD’s support will be designed to strengthen the existing partner banks through equity and longer tenor and more sophisticated debt financing, and to enhance competition through a selection of new clients among smaller financial institutions. The Bank will also seek to play an active role in the development of non-banking financial institutions, such as pension funds, mortgage activities and the domestic insurance and leasing markets. The Bank will continue to actively explore opportunities to support development of the capital markets through the issuance of long-term Kazakhstan tenge denominated bonds.

Banking
The Bank will continue to expand its successful Trade Facilitation Programme with selected Kazakh banks, providing additional coverage (including risk participations of Confirming Banks and third parties) and extending the maximum tenor for guarantee transactions up to 5 years, in order to support Kazakh exports and intra-regional trade in machinery and equipment, as well as construction services. The programme will be rolled out to additional banks subject to EBRD's requirements being met. The same form of roll out is expected for the Warehouse Grain Receipts Programme, including through increased syndication of exposure. KSBP IIII will provide further co-financing to expand the partner banks' SME lending, including rural and agricultural lending. The Bank will provide additional equity to selected Kazakh banks through an increase of the existing equity investments as well as new participations in second tier medium sized banks. Additional equity investments will support expansion of the Bank's operations in the fast growing Kazakh banking market and in its neighbouring countries, where feasible, to increase synergies for existing and planned EBRD projects; and allow further enhancement of banks' corporate governance through Supervisory Board participations and technical assistance.

The Bank will further support the development of the local mortgage market through direct mortgage loan facilities to Kazakh banks. The mortgage facilities will enable banks to grow their mortgage portfolio, offer longer mortgage tenors to their borrowers, reduce funding costs and provide more favourable terms to the customers. Strengthening of banks' mortgage portfolio will help foster competition in the Kazakh mortgage market. Securitisation of mortgage receivables under the conditions of mortgage loans will contribute to the development of a secondary market for mortgages in Kazakhstan. The Bank will further extend the list of borrowing banks by selecting credible clients among smaller financial institutions to increase competition.

Non-Banking Financial Institutions
The Bank continues a dialogue with the Government regarding a possible EBRD role in the privatisation of the State Accumulation Pension Fund and further supports the development of the mortgage, leasing and insurance markets through equity participations and loan facilities.

The Bank has had positive discussions with the Government, including NBK, on its potential involvement in the local currency debt market. Local currency financing will allow the Bank to provide much needed medium-term and long-term tenge financing to borrowers with predominantly tenge earnings (SMEs, municipals, mortgages, etc.); and to promote the development of the Kazakh capital markets, providing additional investment opportunities for local institutional investors, such as pension funds, that currently suffer from a lack of reliable instruments in the market (especially given the Government's plans to reduce its domestic debt).

3.2.4 Infrastructure and Energy
The key aim of the Bank will be to establish commercial principles in the operation of infrastructure and achieve the necessary investments on the basis of sound financing, incentive-based regulation and cost-reflective user tariffs. Lending operations currently under development in the port, aviation, rail, shipping, oil and gas, and energy sectors will be undertaken in conjunction with appropriate regulatory and

institutional reform, mainly on a non-sovereign basis. The Bank will continue its policy dialogue at the federal and regional Government level to explore the scope for more effective lending to local Government for investments in municipal and environmental infrastructure. The Bank will continue to finance sovereign operations in the road sector. In the Municipal and Environmental Infrastructure sector significant work remains to be done to ensure a stable and predictable environment supportive of a significant increase in non-sovereign borrowing by Kazakh municipalities. In all cases, IFI and commercial co-financing will be sought actively.

Transport Sector

The Bank will support the various sub-sectors with the objective of creating an efficient economy within the country and enhancing international and regional economic integration, predominately on a commercial basis.

Railways: support for KTZ's ongoing restructuring and rolling stock improvements through syndicated debt, enhancing their access to commercial financing sources. Support for sector restructuring continues through work on a framework facility for lease financing of rolling stock, which provides for a degree of unbundling and increased private sector involvement in freight activities.

Roads: active engagement with the Government to restructure its road sector financing approach with particular emphasis on planning, separation of maintenance and investment functions and development of road sector revenue based on cost recovery from users.

Ports and Shipping: the Bank's involvement in key port and shipping projects for the development of substantial oil reserves in the north-east Caspian, will be linked to regulatory elements including the structure of port ownership and management, regulation of port access, tariff regimes and implementing of appropriate shipping legislation, and maritime regulatory bodies. KazTransMorFlot (KTMF) has been established as the national shipping company to facilitate this development (50:50 KMG:Government) with plans to invest in the ports of Aktau (upgrade of oil related infrastructure), and Bautino (key service support for Kashagan oilfield); and a Caspian tanker fleet to access existing oil export pipeline routes through Azerbaijan and from the Russian Caspian port of Mahachkala.

In the ***Municipal Sector,*** the Bank will maintain its active engagement with the Government, including through the provision of technical assistance to promote transition elements for regional independence. With clear support from key senior Government officials, the Bank will pursue selected projects which create opportunities for the achievement of strong transition impact. One such project might be the Astana Transit project, the objective of which would be to provide a modern and reliable public transport system in the new Kazakh capital of Astana, while creating an efficient public transport management system, separate from the provision of actual services.

In the ***Power and Energy Sector***, the Bank will actively focus on financing priority investments in systems operation, transmission, generation and distribution transactions on a non-sovereign or private basis.

Power: recently adopted approaches to tariff reform, if implemented in a timely manner will contribute to enhance investment climate for the sector. Subject to implementation of appropriate tariff regulation, the Bank may become re-engaged in the privatisation and financing of regional power distribution companies. The Bank will support an open and transparent privatisation of the RECs to strategic investors by means of lending to privatised companies. The Bank will consider further lending for the construction of second and third phases of the KEGOC North-South power transmission line on a non-sovereign basis. Lending operations currently under consideration are to private power utilities in the North and East of the country. Depending on the success in the implementation of tariff reforms and of the concept for further market deregulation the Bank will consider lending to generators, trading companies and RECs.

Energy Efficiency: significant potential exists for energy efficiency improvements in the industrial sector. The Bank will continue to review projects for potential energy efficiency improvements and will work with clients to identify and implement investment opportunities. TC resources remain available for energy audits and for training technical and senior management on the benefits of energy efficiency and energy management practice. The Bank will investigate the potential for implementing energy saving programmes with public authorities and private sector partners under PPP arrangements. TC funding will be sought to facilitate project development and assist with implementation. The private sector Energy Service Company (ESCO) market in Kazakhstan is limited. However the Bank will encourage development in this sector. Given the size and growth of the SME sector, high energy intensity of the country, and relative strength of the banking sector, the Bank will explore the potential to replicate in Kazakhstan a dedicated Energy Efficiency credit line framework, modelled on the Bulgarian one.

In the ***Natural Resources Sector***, priority will be directed to those projects where transition impact can be achieved in the oil, gas and mining sectors via the financing of projects and through capacity building exercises which can be supported with TC funds.

In order to increase transparency and develop a more level playing field, the Bank will continue building capacity along the model of the multi-sector long-term "Network Infrastructure Regulatory Development" TC programme for capacity building of the AMA. The Bank's involvement in the financing of infrastructure (e.g. modernisation of the Central Asia gas pipeline network, export pipelines to China, oil and gas terminals) upgrades is critical for ensuring a more transparent tariff system, as well as increased transparency and competition in the allocation of export access to all market participants on a non-discriminatory basis, and increased transparency of licenses and other agreements that generate substantial payments to state entities. In this respect, the Bank's Kenkiyak-Atyrau financing could be a template for achieving such transition objectives. In this sector transparency is an important element to determine the Bank's level of involvement. The Bank will seek to support projects that demonstrate a high level of transparency and those that will commit to higher standards.

The Bank will support greater corportisation for state-owned companies regarding the separation of their non-commercial activities (such as social obligations, etc.) through policy dialogue, and will encourage improved corporate governance and business practices through conditionalities in its facilities (including the adoption of benchmarking practices). The Bank will pay special attention to increased transparency and skill transfer when supporting projects involving large and medium sized sponsors, both state-owned and private. The Bank will seek to enhance competition in the sector taking into consideration various models of approach, including: i) competition of two or three separate state-owned oil companies (i.e. China); ii) competition between state-owned and privately owned national oil companies (i.e. Russia, Italy, France and UK); and iii) competition at the "subsidiary level", whereby different state-owned subsidiaries compete against each other (i.e. Mexico and some Latin American countries).

The Bank will support projects that meet high standards in industrial Health & Safety policies and procedures, rehabilitation of environmental conditions around major industrial zones; and the introduction of modern technology and skills. The Bank will strive to maximise forward and backward linkages with local SMEs, in relation to large-scale projects.

4. *Other IFIs and Multilateral Donors*

The Bank undertakes policy dialogue on a regular basis with other IFIs and members of the donor community, including in country. Cooperation on projects, in particular those with a regional focus, has taken and will continue to take place.

4.1 International Monetary Fund (IMF)

Kazakhstan joined the IMF in July 1992 and the Government has worked closely with the Fund on its stabilisation policies. In December 1999, the IMF approved a 3-year credit for Kazakhstan in an amount equal to USD 453 million under the Extended Fund Facility (EFF) in support of the Government's economic programme for 2000-2002. Subsequently, in May 2000, the NBK made an early repurchase of all outstanding balances owed to the IMF, approximately USD 385 million. Cooperation with the IMF continues, in particular through policy dialogue on macroeconomic issues, and technical assistance in areas including monetary policy and financial sector development. The Fund continues to conduct surveillance of the Kazakh economy in the context of its annual Article IV consultations

4.2 World Bank (WB)

The WB commenced operations in Kazakhstan in July 1992 and has since provided 23 loans worth a total of USD 2 billion (USD 1.4 billion disbursed). Since 1997 activities have focussed on public resource management, sharpening the focus of welfare and social protection policies, and increasing the potential savings mobilisation of the country. Adjustment lending accounted for more than 50 per cent of the total portfolio. The current portfolio is focused mainly on environment projects and public sector infrastructure. Overall portfolio performance is satisfactory, with strong disbursements and timely procurement.

Given Kazakhstan's recent economic growth and reduced need for external financing, the Government of Kazakhstan has refocused the partnership strategy with the World Bank towards: 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.

4.3 International Finance Corporation (IFC)

IFC, the private sector arm of the World Bank Group started operations in Kazakhstan in September 1993. IFC seeks targeted opportunities to work with foreign investors, including in the oil and gas sector; it continues to expand activities in the SME sector, through creation of a loan fund for SME suppliers/contractors working for Ispat Karmet and funding contributions to EBRD's Small Business Programme. Funding has been approved for more than 17 projects, presenting a total value in excess of USD 120 million. The IFC, with the support of USAID, helped the Ministry of Agriculture and the Agrarian Committee of Parliament develop amendments to the Law on Financial Leasing, the Civil Code, and the Economic Litigations Code, which were adopted by Parliament in January 2004. This regulatory framework for leasing now meets international standards.

4.4 Asian Development Bank (ADB)

Kazakhstan has been a member of the ADB since 1994. Since joining ADB, Kazakhstan has received 12 loans (for 8 projects) totalling USD 502 million and 50 technical assistance projects amounting to USD 23 million. In 2003, ADB approved 6 technical assistance grants for a total of USD 1.5 million, out of which 4 grants are advisory and 2 grants are project preparatory.

In October 2003, the ADB's mid-term Country Strategy and Programme (2004-2006) for Kazakhstan (CSP) was approved. 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. The CSP aims to support Kazakhstan's development goals through i) private sector development, ii) human development, and iii) sustainable environment management. These efforts will also be guided by Kazakhstan's regional cooperation activities. The CSP includes 13 technical assistance programmes for USD 6 million and USD 190 million in public lending for the 2004-2006 period. These programmes encompass the areas of natural resources management, rural water supply, regional and rural development, education, transport, central and local government support, and private sector support.

4.5 Islamic Development Bank (IDB)

As of 1 May 2004 IDB has approved a total of 25 projects for USD 119 million. In 2003, 2 projects in the health sector (for a Surgery Centre), and 2 transport sector projects (Almaty – Gulshad and Karaganda – Astana roads) were completed. The IDB's first direct investment in the private sector is a USD 5 million equity investment in the Central Asian Investment Company (January 2004). Several credit lines to local banks have been provided, as well as to the Central Asian Enterprise Fund, for use in trade finance, leasing, and SME loans. In May 2003 a USD 5.2 million investment in the agribusiness sector was approved for the purchase of equipment and agricultural machinery for the Joint-Stock Company "Agrofirma". In September 2003 the first project in the education sector was approved – construction of the Kazakh Humanities and Legal Training and Research Centre in Astana for a total amount of USD 13.6 million, guaranteed by a local bank.

As part of the assistance to Kazakhstan in joining the WTO, IDB is conducting seminars and consultations on the WTO agreements, as well as courses in international trade policy.

4.6 United Nations (UN)

The United Nations assistance programme was initiated in 1993, and currently 12 UN agencies operate in Kazakhstan. Their work is guided by the United Nations Development Assistance Framework (UNDAF) which, for 2000-2004, focuses on four priority areas in Kazakhstan: Social Security and Human Development; Economic Management and Effective Governance; Democracy and Participation; and

Environment and Sustainable Development. The UN is active in many regions, and maintains working relationships with Parliament, the Presidential Administration, the Government and the oblasts, as well as with donors, NGOs, the private sector, and other stakeholders. Annually, the UN system disburses technical assistance grants of around USD 6 million on programmes in Kazakhstan.

The United Nations Development Programme (UNDP) coordinates the UN agencies' activities. UNDP support is closely linked to the longer term Vision of Kazakhstan 2030 (prepared through a UNDP project), and its Development Strategy 2010. UNDP's interventions have the overriding goal of helping Kazakhstan to achieve human security and equitable growth and are focused on three areas: i) social development and poverty reduction; ii) governance and democratic reform; and iii) environmental management for sustainable development. In view of new challenges stemming from potential security threats, UNDP is giving increased attention to developing a strategy for preventive development. In the area of poverty reduction, UNDP is working closely with the ADB and WB to assist the Government in developing its Mid-Term Poverty Reduction Strategy. With USD 1 million from the private sector, UNDP is supporting SME development, particularly through creation of business advisory services. Working with bilateral donors, UNDP is assisting Parliament to strengthen its legislative functions and institutional capacity. UNDP mobilised another USD 1.1 million from the Japanese Government to initiate a social and economic programme in the economically depressed and radiation-affected area of Semipalatinsk. UNDP is accessing the Global Environmental Fund for biodiversity protection and to address threats of global warming and ozone depleting substances in Kazakhstan. Its current GEF pipeline portfolio is approximately USD 15 million.

4.7 European Union (EU)

A Partnership and Cooperation Agreement was signed on 23 January 1995. 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.

The EU's main support for Kazakhstan is provided through the Tacis programme where some EUR 153.6 million has been allocated since 1991. The programme for Kazakhstan is based on the Strategy Paper 2002-2006 and the Indicative Programme 2002-2004 for Central Asia, which consists of i) a regional programme, ii) nationally identified regional priorities and iii) poverty alleviation. Over 50 per cent of Tacis funds are aimed at supporting the emergence of a market economy; this has included developing macroeconomic forecasting and planning models within the Ministry of Economy. Tacis has supported the Government in the transformation and privatisation process, and has focused on key issues in the food chain from the farm to the consumer. Human Resources Development has been at the heart of several Tacis projects in Kazakhstan. About 25 per cent of Tacis funding is allocated to the Small Project Programmes (SPPs), which are smaller in size, offer greater flexibility and can cross-cut various sectors of cooperation.

The port of Aktau has received considerable support under the TRACECA framework (where the EU is supporting the development of new routes over land, sea and air).

III. Annexes

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Annex 1 Political Assessment

Over the two years since the adoption of the last country strategy in 2002, Kazakhstan has continued to make progress towards implementation of the principles of multi-party democracy, pluralism and market economy as envisaged in Article 1 of the Agreement Establishing the Bank.

Kazakhstan has made the greatest strides forward in terms of market reforms. As in previous years, economic progress made by the country was significant while political reforms were slower and did not match the economic achievements. There are many challenges remaining in the political field. Strong presidential power is not adequately balanced by the country's legislature or judiciary. A weak judiciary does not contribute to maintaining the rule of law and to eliminating pervasive corruption. The Government's human rights record needs improvement in a number of areas including the freedom of the media.

The recent registration of opposition parties and the abandonment of a controversial media law were positive steps in the country's democratic transition. The parliamentary elections of 19 September 2004 were widely seen as a test of the authorities' commitment to democratic reform in the light of Kazakhstan's bid to become the OSCE Chairman-in-Office in 2009. These polls failed to meet international standards in many respects, although they were an improvement over previous elections.

Political Environment

According to the Constitution of 1995, Kazakhstan is a presidential republic. The President is elected by popular vote for a seven-year term in office. The last presidential elections took place in 1999 and they did not comply with the international standards for free and fair elections, according to the OSCE/ODIHR, which monitored the electoral process.

The incumbent President Nursultan Nazarbayev, the leader of the ruling *Otan* party, has announced his intention to run for another seven-year term in 2006 and it is widely believed that he will win another term in office until 2013.

The Parliament has two chambers. The lower chamber, *Majlis*, consists of 77 representatives elected by popular vote for a five-year term with 67 representatives from single seat constituencies and 10 from the party lists. The upper chamber, *Senate*, is comprised of 39 representatives, of which seven are appointed by the President.

The last parliamentary elections took place in 1999 and although they were an improvement in comparison to the earlier presidential poll, they fell short of international standards. The parliamentary polls on 19 September 2004 were conducted on the basis of the amended election law of 16 March 2004. The law was the result of a long dialogue between the authorities and the OSCE. According to the latter, a number of amendments to the election law represented considerable progress but further improvements were desirable.

There are 12 political parties in Kazakhstan, an increase of five since the 2003 local elections. The registration of the opposition *Democratic Choice of Kazakhstan (DVK)* party in May 2004 was a welcome development providing improved opportunities for political pluralism in Kazakhstan. The DVK claims more than 70,000 members, well in excess of 50,000 members required for a party to be registered. The DVK was founded in 2001 as a political movement. In a decision believed to be politically motivated, the leader of the DVK Galymzhan Zhakiyanov was imprisoned for seven years for misappropriation of state resources. In August 2004 Zhakiyanov was transferred to a settlement colony (an area where a person is able to move around freely yet cannot leave) and was allowed to meet with journalists.

Three of the twelve registered political parties describe themselves as opposition – the *Ak Zhol Party*, the *DVK* and the *Communist Party of Kazakhstan*. The opposition parties criticised the introduction of electronic voting and warned against its use on a large scale as paving the way for potential fraud during the electoral process. They also protested against the exclusion of opposition figures from local election commissions and unfair media coverage during the election campaign.

The pro-presidential *Civic Party* and *Agrarian Party* formed an electoral bloc to jointly contest the 19 September parliamentary elections. A new pro-presidential party, the *Asar*, which is led by the Kazakh President's daughter Dariga Nazarbayeva, claims some 170,000 members and emerged as a front-runner at the September parliamentary elections.

In June 2004 the Kazakh President announced wide-ranging plans for democratic reforms in the country. They included strengthening the role and authority of Parliament by allowing Parliament a greater role in determining the composition of the Government, including the appointment of the Prime Minister; an increase in the number of representatives in both chambers of the legislature to reflect the country's regional and ethnic diversity; reforming the method of appointment of the Central Election Commission to allow for party representation; further decentralisation of state administration; introduction of the jury system; expanding the remit of the Ombudsman; extension of trade union rights and full abolition of the death penalty in the long term.

All these plans are yet to materialise and the first serious political test on the path of democratic reforms was the conduct of the September parliamentary elections. According to preliminary conclusions of the international observers (the observation mission was a joint effort of the OSCE/ODIHR (Office for Democratic Institutions and Human Rights), the OSCE PA (Parliamentary Assembly) and the Parliamentary Assembly of the Council of Europe, the 19 September parliamentary elections fell short of international standards for democratic elections in many respects. The shortcomings included the exclusion of two prominent opposition leaders from the electoral process, non-transparent manner of functioning of the Central Election Commission, lack of political balance in the composition of election commissions, strong media bias in favour of pro-presidential parties, cases of pressure on voters from Government officials and the manner in which the electronic voting was introduced.

At the same time the observers noted several positive elements that represent an improvement over previous parliamentary polls. The voters had a real choice between 12 political parties, including genuine opposition parties; television debates, although restrictive in format, gave the parties more opportunity to inform the public of their views; domestic observers were given more rights than before and transparent ballot boxes were used in all polling stations as a confidence-building measure. In response to criticism, the Central Election Commission decided at the last moment to give voters a choice of voting on paper or electronically.

According to official results, the pro-presidential parties won the overwhelming majority of votes both on the party list and in single mandate constituencies. President Nursultan Nazarbayev's party Otan won 42 out of 77 seats in the lower house of Parliament with the pro-Government bloc of the Civic and Agrarian parties (AIST) coming second with 11 seats. The Asar party led by Dariga Nazarbayeva came in third with 4 seats and the pro-Government Democratic Party of Kazakhstan and the opposition Ak Zhol each claimed 1 seat. Independent candidates accounted for the remaining 18 seats. The DVK, which has formed an electoral bloc with the Communists, stayed below the 7 per cent threshold required to gain a seat in Parliament. A co-chairman of Ak Zhol, Altynbek Sarsenbayev, resigned as information minister in protest at the conduct of the elections.

Human Rights Conditions

According to reports from human rights organisations, the Government's record in this area remains poor, notwithstanding important strides forward in the past year towards improvement of the situation with human rights and election reform. There were reports on cases of police abuse, arbitrary detentions, harassment of opposition leaders, independent journalists and human rights defenders.

A particular area of concern is the freedom of the media, involving cases of harassment of independent journalists and independent media outlets. In July 2004, for example, an independent weekly *Assandi-Times*, which is considered to be a major opposition media outlet, was fined for libel. An Almaty district court sentenced the publisher to pay a large fine of 50 million tenge (approximately 370,000 USD) in moral damages to the state treasury. The OSCE Representative on Freedom of the Media raised concerns regarding this case as it effectively annihilated an independent media outlet, thus narrowing down pluralistic voices in the media prior to the crucial parliamentary elections. The new Information Minister pledged to introduce a new media law next year that is fully compliant with international standards.

The Kazakh authorities argue that the artificial acceleration of democratic reforms could undermine the stability which contributed to the atmosphere of religious and inter-ethnic tolerance prevailing in the country today. Irrespective of the actual pace of the reforms, it is essential to continue political reforms so that they match economic achievements and thus facilitate further progress. Transparent public finances, predictable decision-making, good governance, corruption-free environment, based on strict adherence to the rule of law, are essential for future progress.

There are no serious problems in the area of labour rights. The Constitution and the laws provide for basic workers' rights, including the right to organise and bargain collectively. The Constitution provides for the right to strike and this right was exercised primarily to protest the non-payment of wages. Forced and child labour is prohibited by legislation, however child labour was routinely used in agricultural areas, especially during the harvest season, but abuse of child labour was not a problem.

Trafficking in persons remains a problem, although the Government has undertaken significant actions, including the adoption of anti-trafficking legislation and the establishment of law enforcement guidelines. The country's Criminal Code covers most forms of human trafficking, but prosecutions under these articles are rare.

Kazakhstan's interest in chairing the OSCE in 2009 and the statements made by the leadership reflect the country's commitment to the OSCE and the principles upon which it is based. It is essential that Kazakhstan demonstrates its ability to implement these commitments before December 2006, when the chairmanship decision is to be taken.

The registration of the DVK and the recent transfer of the opposition DVK leader to a low-security facility, the parole of human rights advocate and journalist Sergey Duvanov, the withdrawal of the restrictive law on NGOs last year and the veto of the controversial law on media this spring are positive steps demonstrating the authorities' willingness to make progress on the path of full democratisation. A key test on this path, however, is to ensure free, fair and transparent elections.

Kazakhstan has signed most of the UN human rights treaties although some of the important agreements signed by the country, such as the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights, have yet to be ratified.

External Relations

A vast Eurasian country, Kazakhstan has pursued a multi-dimensional foreign policy geared towards maintaining balanced relations with the external world. The country strives to maintain good relations with Europe and Asia as well as with the United States. Kazakhstan has extended its full support to the US-led anti-terrorist campaign.

An active proponent of regional cooperation, Kazakhstan continues its membership of a number of regional economic and security organisations, ranging from the Central Asian Cooperation Organisation (CACO) and Eurasian Economic Community to Economic Cooperation Organisation (ECO) and Shanghai Cooperation Organisation.

In the last two years, relations with immediate neighbours have further improved. The country maintains traditionally good relations with Russia as a main trade partner and a major transit route. Cooperation with Russia is also important for Kazakhstan within the framework of the evolving 'Single Economic Space' among four countries (also including Ukraine and Belarus), as well as other regional groupings. This year Russia also joined the Central Asian Cooperation Organisation, which previously had only four Central Asian countries as members (all, with the exception of Turkmenistan).

The past year saw an improvement in relations with China as the two countries agreed to expand trade and railway links; also to build pipelines linking Kazakhstan's natural wealth with the Chinese market.

Annex 2 Signed Projects

(as at 31 August 2004)

Investment	Signing Date	Total project cost EUR million	EBRD finance € million	Stage
National Bank of Kazakhstan	22/12/93	39.5	37.0	Completed
Aktau Port Reconstruction Project (Phase I)	16/04/96	58.9	42.4	Repaying
PPF - Eagle Kazakhstan Fund - Rustam	25/06/97	3.9	0.4	Completed
AIG Silk Road Fund	25/09/97	23.5	5.4	Repaying
PPF - Eagle Kazakhstan Fund - UKPF	23/11/97	3.6	3.2	Disbursing
Ispat-Karmet Steel Works	05/12/97	322.1	44.5	Repaying
Kazakhstan Small Business Programme	05/01/98	71.5	71.5	Repaying
PPF - Eagle Kazakhstan Fund - Bauta	13/01/98	1.9	1.7	Repaying
PPF - Eagle Kazakhstan Fund - Spectrum	09/03/98	2.6	2.2	Repaying
Kazkommertsbank ("KKB")	07/07/98	32.9	32.9	Completed
Karaganda Power Project	13/10/98	36.6	12.3	Repaying
PPF - Eagle Kazakhstan Fund - Rainbow Paint	16/12/98	3.3	3.0	Repaying
PPF - Eagle Kazakhstan Fund - Foodmaster	09/07/99	2.6	2.4	Disbursing
Turan Alem Towers (Samal Properties)	13/07/99	22.6	7.6	Repaying
TPG Co-Investment	21/07/99	13.7	3.4	Disbursing
Regional TFP: Bank Turan Alem (Guarantee & Pre-export)	12/08/99	22.8	23.8	Disbursing
Regional TFP: ATFBank (Guarantee & Pre-export)	02/11/99	3.9	3.9	Disbursing
KEGOC Power Transmission and Rehabilitation Project	03/12/99	210.4	37.0	Repaying
KTZ Track Maintenance and Commercialisation Project	03/12/99	74.9	53.5	Repaying
Kazaktelecom Debt (KTC)	18/12/99	20.6	20.6	Completed
Regional TFP: Halyk Savings Bank (Guarantee & Pre-export)	27/03/00	2.3	2.3	Disbursing
Citibank Kazakhstan Subordinated Credit Facility	25/09/00	16.5	16.5	Disbursing
PPF - Eagle Kazakhstan Fund - Kazintel	24/10/00	0.7	0.5	Completed
PPF - Eagle Kazakhstan Fund - NDT/Arna	24/10/00	6.0	4.1	Disbursing
Kazakhstan Road Sector Development Project	08/12/00	101.1	23.4	Repaying
Baring Vostok Private Equity Fund	13/12/00	4.3	1.9	Repaying
Regional TFP: Kazkommertsbank (Guarantee & Pre-export)	01/01/01	13.6	13.6	Repaying
PPF - Eagle Kazakhstan Fund - Romat	01/07/01	3.4	3.0	Repaying
Bank Turan Alem Cumulative Preferred Redeemable Shares	24/10/01	17.9	5.6	Disbursing
PPF - Eagle Kazakhstan Fund - Ak-Nar	04/11/01	4.4	4.0	Disbursing
BTA Leasing (debt)	15/11/01	4.1	4.1	Repaying
EFES - Kazakhstan	05/12/01	7.8	7.8	Repaying

Investment cont.	Signing Date	Total project cost EUR million	EBRD finance € million	Stage
Kazakhstan Atyrau Airport Project	15/12/01	24.5	20.6	Disbursing
EFES - EBI	15/04/02	3.3	1.3	Disbursing
Kazakhstan Halyk 2002 Warehouse Receipt Programme	27/06/02	4.1	4.1	Completed
Kazakhstan AMB 2002 Warehouse Receipt Programme	28/06/02	2.1	2.1	Completed
Kazakhstan KKB 2002 Warehouse Receipt Programme	03/07/02	33.2	20.8	Completed
Kazakhstan Turan Alem Bank 2002 Warehouse Receipt Programme	03/07/02	32.9	20.6	Completed
Kazkommertsbank Syndicated Loan	20/09/02	20.6	12.3	Disbursing
Kazakhstan Temirbank 2002 Warehouse Receipt Programme	24/10/02	2.5	2.5	Completed
KSBP II - HSBK	20/01/03	8.2	8.2	Disbursing
Kazkommerts Policy (portage equity)	21/01/03	1.0	1.2	Disbursing
KSBP II--Kazkommertsbank	18/02/03	8.2	8.2	Disbursing
Bank Turan Alem Senior Syndicated Loan	27/02/03	24.7	8.2	Disbursing
KSBP II--Bank Turan Alem	27/02/03	8.2	8.2	Disbursing
Regional TFP: Bank Center Credit (Guarantee&Pre-Export)	08/05/03	5.3	5.3	Disbursing
Mortgage Loan: BTA Ipoteka	27/05/03	4.1	4.1	Repaying
Kazkommertsbank Equity Investment	06/06/03	29.1	29.1	Disbursing
Kazakhstan Bank Turan Alem 2003 Warehouse Receipt Programme	18/07/03	34.1	20.6	Completed
Warehouse Receipt Programme 2003	08/08/03	2.5	2.5	Completed
Kazakhtelecom Corporate Loan	30/09/03	90.5	49.4	Disbursing
KSBP II - Bank Center Credit USD 10 Million Investment	06/12/03	8.2	8.2	Disbursing
Kazakhstan: Road Sector Restructuring - Atyrau-Aktau	06/12/03	206.8	98.1	Signed
KSBP II - Bank Turan Alem USD 10 Million Investment	06/12/03	8.2	8.2	Disbursing
Kazakhstan KKB 2003 Warehouse Receipt Programme	07/12/03	46.7	32.9	Disbursing
Kazakhstan Kazkommertsbank 2003 Warehouse Receipt Programme	18/12/03	69.9	6.2	Completed
KEGOC	16/03/04	66.6	28.8	Signed
Kazakhstan Bank Turan Alem 2004 Warehouse Receipt Programme	26/05/04	53.5	32.9	Disbursing
Soufflet ACL 2004 Altyn Bidai	18/06/04	5.0	5.0	Disbursing
Regional TFP: Bank Caspian	22/07/04	1.3	1.3	Signed
Kenkiyak-Atyrau oil pipeline	29/07/04	188.1	67.1	Signed
Kazakhstan Bank Center Credit 2004 Warehouse Receipt Programme	10/08/04	4.9	4.9	Signed
Country Total		**2,152.5**	**1,018.5**	

Annex 3 Current Portfolio Stock

(at 31 August 2004)

Sector	**Portfolio € million**	**Undrawn Commitment € million**	**Operating Assets € million**
Energy	140.9	109.1	31.8
Financial Institutions	309.7	45.8	263.9
General Industry	14.8	0.0	14.8
Infrastructure	206.4	129.9	76.4
Specialised Industries	66.9	11.2	55.7
Agribusiness	13.6	4.5	9.1
Bank Equity	34.7	1.9	32.7
Bank Lending	154.9	36.7	118.2
Equity Funds	18.5	3.1	15.5
Natural Resources	67.1	67.1	0.0
Non-Bank Financial Institutions	7.9	0.0	7.9
Power & Energy	73.8	41.9	31.8
Property & Tourism	3.9	0.0	3.9
Small Business Finance	93.7	4.1	89.6
Telecoms, Informatics & Media	49.4	6.7	42.6
Transport	206.4	129.9	76.4
Country Total	**1462.6**	**591.9**	**870.3**

Annex 4 TC Projects

(as at 31 August 2004)

Commitment Name	€ Committed	€ Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
Kazakh PPF: Sema Group – Investment Advisory Services	106,481	106,481	25/10/02	Closed	Finance, Business	ECT
Eagle Kazakhstan PPF – Pre and Post Inv Advisory Svcs	49,900	49,900	31/10/03	Closed	Finance, Business	ECT
Kazakhstan Telecommunications Regulatory Development Programme Phase III	355,921	355,921	25/10/02	Closed	Telecom	ECT
Japan KSBP Training Facility	848,591	848,591	22/08/02	Closed	Finance, Business	JAP
BAS Programme – Framework – SME Support Facility for small and medium enterprises created by the restructuring of Kazakhstan Temir Zholy (KTZ) Railway Company	225,000	35,341	11/09/03	Disbursing	Transport, Storage	JAP
Kazakhstan Small Business Programme II	822,707	0	24/09/03	Committed	Finance, Business	JAP
Kazakhstan Railways TC Studies – OPER	18,883	0	16/04/04	Committed	Transport, Storage	SWI
Ispat-Karmet Steelworks IHSA	49,550	31,150	04/12/03	Disbursing	Community, Social Services	UKD
Warehouse Receipt Credit Adviser	20,856	0	11/11/02	Committed	Agriculture, Forestry, Fishing	USA
Textiline Legal Due Diligence	24,624	16,454	04/07/03	Disbursing	Finance, Business	USA
KSBP II MSE Credit Advisers	1,031,493	1,031,493	16/08/02	Closed	Finance, Business	USSP
KSBP II MSE Credit Advisers	1,203,209	1,009,940	19/08/03	Disbursing	Finance, Business	USSP
KSBP II MSE Credit Advisers	962,567	0	25/08/04	Committed	Finance, Business	USSP
Country Total	**5,719,781**	**3,485,270**				

Annex 5 Legal Transition

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 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.

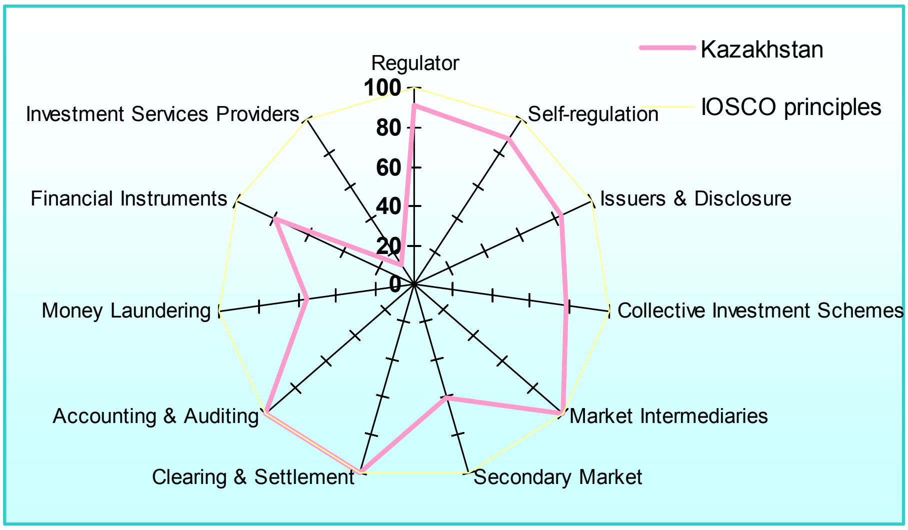
Capital Markets

The primary legislation governing the securities market includes the Civil Code and the Law on Securities Market (the "SML"). The Civil Code was promulgated in March 1995 and amended in October 2003. The SML came into force in August 2003, replacing a similar law adopted in 1997. The securities market of Kazakhstan is supervised by the Agency for Regulation and Supervision of Financial Market and Financial Organisations (the "Agency"), which was established in January 2004 pursuant to the Law "On State Regulation and Supervision over Financial Market and Financial Organisations" adopted in July 2003. While the Kazakhstan Stock Exchange was established in 1993, there remains much scope for development of Kazakh capital markets, especially after the "Russia crisis" of 1998/9 which brought the market for government securities close to standstill.

According to the findings of the EBRD's 2004 Securities Market Legislation Assessment, Kazakhstan is a country whose existing securities market legislation (i.e., "law on the books", not how the relevant legislation is being implemented), when assessed against relevant international standards, was rated among "medium compliance" countries. According to the assessment, Kazakhstan has extensive legislation in place covering accounting/auditing, clearing and settlement, and market intermediaries. However, as can be seen from the spider graph attached below, there is still much progress to be made in regulating investment service providers and secondary market, as well as countering money laundering.

For example, while there is the general provision in the SML that the Agency has a right to inspect the activity of securities market participants, the relevant monitoring mechanism in place does not include review for insider trading, fraudulent/deceptive conduct or market/price manipulation. This is an area where improvement is needed. In addition, the regulator should require that market intermediaries have in place policies and procedures designed to minimise the risk of using an intermediary's business as a vehicle for money laundering. Further, currently there is no special entity which provides various investment services because the existing legal framework only allows the possibility for certain combinations of activities in the securities market. This has had a negative impact on the development of investment services providers, which in turn has restricted the securities market from realising its potential as previously mentioned.

Quality of securities market legislation –Kazakhstan (2004)



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 2004

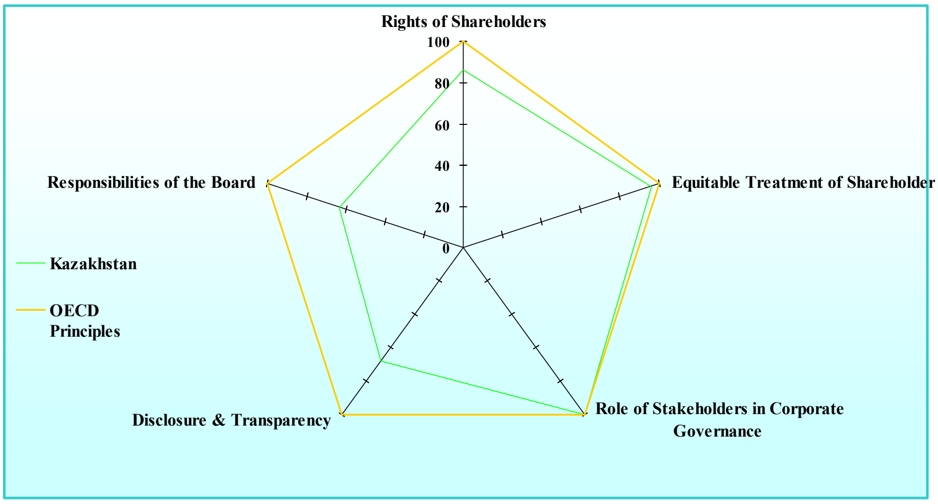
Company Law and Corporate Governance

A new Law on Joint Stock Companies (the "New JSC Law") was adopted in May 2003, which replaces a similar law adopted in 1998. It has brought about some important changes. Firstly, the differentiation of joint stock companies into open and closed types is eliminated. Only two types of joint stock company are now possible: "regular" and "public" JSCs. Secondly, new capitalisation requirements are now imposed. Thirdly, the New JSC Law prohibits all types of joint stock company from maintaining internal registrars. Shareholder registrars may now be maintained by duly authorised independent registrars only. Fourthly, the New JSC Law introduces some stricter reporting and notification requirements for joint stock companies. Lastly, the New JSC Law attempts to address the issue of "national companies", i.e., closed joint stock companies 100% owned by the State, by setting a very broad and general statutory basis for exercising stricter governmental control and supervision over national companies' activities.

According to local practitioners, the New JSC Law was intended to reduce the number of joint stock companies in Kazakhstan and to improve their quality in order to facilitate the development of local securities market. However, there have been some criticisms. For example, the new law requires closed-types of joint stock companies to re-organise and re-register as other forms of enterprises. Concerns have been raised as to the expenses involved and potential problems regarding violation or distortion of shareholder rights that could occur in the re-organisation and re-registration process.

According to the results of the 2003 EBRD's Corporate Governance Sector Assessment, Kazakhstan is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented), when compared to the OECD *Principles of Corporate Governance,* were rated among "high compliance" countries. "High compliance" means that the existing corporate governance related laws are relatively sound in the majority of the areas highlighted by the OECD *Principles of Corporate Governance,* with some weaker performance however in the case of Kazakhstan in the areas of the board's responsibilities and disclosure and transparency (see chart below).

Quality of corporate governance legislation –Kazakhstan (2003)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2003 assessment

General reform priorities for a "high compliance" country are to improve effective implementation and enforcement of existing legislation. In terms of corporate governance practices in Kazakhstan, the most frequent shareholder rights violations include infringement of shareholders' rights by the management of the company in connection with the alienation of company assets, providing access to information and financial reporting. Abuses also occur in providing accurate information on major transactions or related party transactions. To deal with these problems, the regulator should be given sufficient independence and adequate resources to carry out its mandate; the competence of judiciary system in adjudicating corporate governance related disputes should also be enhanced.

Concessions

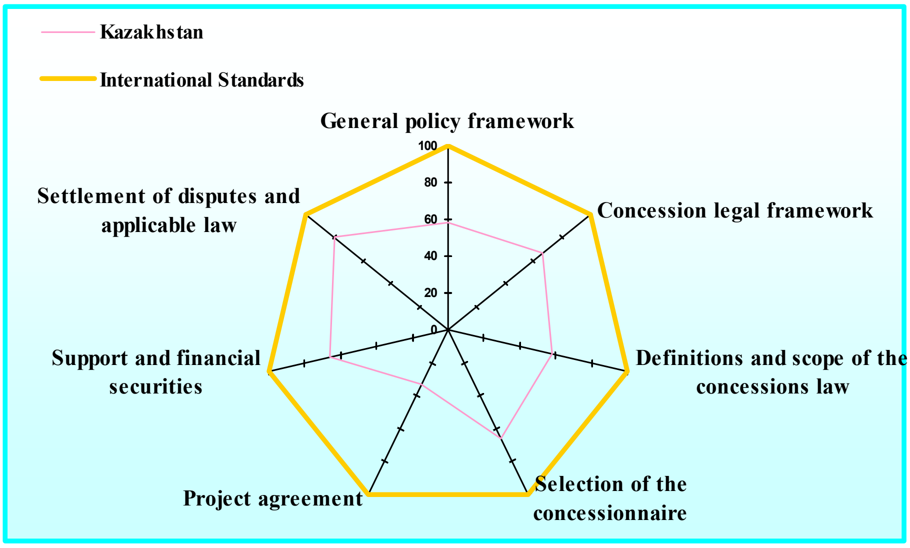
Both policy and legal framework for promoting Private Sector Participation (PSP) in infrastructure, utilities and public services are contained in various documents, including numerous sector-specific and municipal policy framework documents. Kazakhstan does not have a general framework Concessions Act. Instead, the country takes a sector-by-sector approach in regulating concession policy. The rights and obligations of concessionaires, as well as the nature of government regulation, vary sector by sector.

Sector legislation applicable to concession arrangements includes the Mining Law of 27 January 1996, as amended, the Law on Energy of 16 July 1998, the Law on Oil of 11 December 1993, as amended, and various presidential edicts. In addition, in 2003

Kazakhstan introduced a new Law on Investments that supersedes and consolidates previous legislation governing foreign investment and is applicable to domestic investment as well.

The recent 2004 EBRD Concession Laws Assessment project assessing the legal framework governing concessions and PSP (laws on the books rather than how they work in practice), rated Kazakh concession related laws as providing a *moderate environment*. In particular, as can be seen from the chart below, the weakest framework exists in the area of the project agreement. This means that rules regulating rights and obligations of parties are insufficiently clear and somewhat rigid and need to be developed. Other areas of the legal framework that need to be improved include government support, financial securities provisions and concessionaire selection procedures.
The possibility of international arbitration and application of a foreign law is generally provided for. Overall, despite certain positive features, the general legal framework for PSP needs to be improved.

Quality of concession legislation –Kazakhstan (2004)



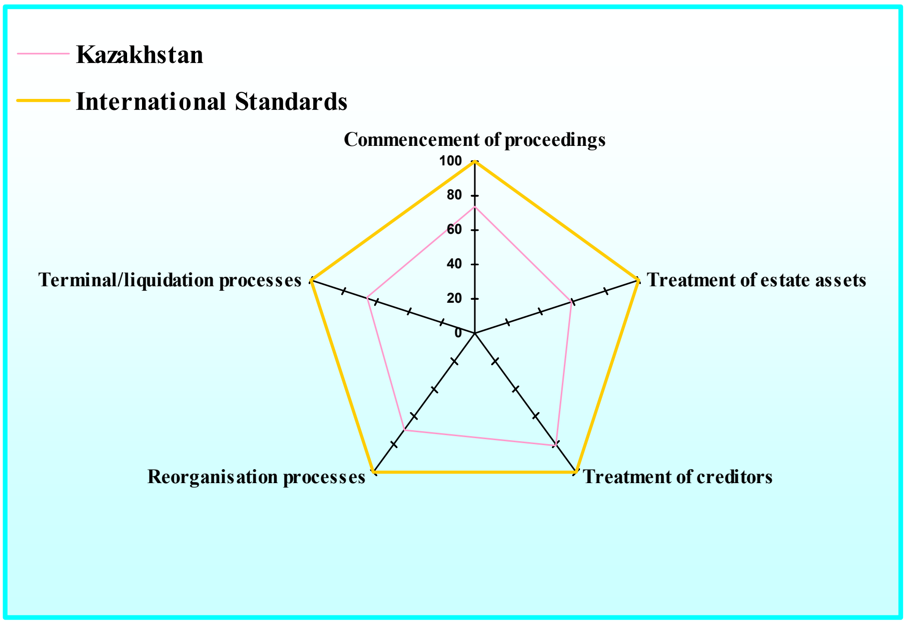
Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2004

Insolvency

Bankruptcy and insolvency are governed by the Law Concerning Bankruptcy, as amended in 2004 (the "Insolvency Law"). This law scored "medium compliance" when compared with international standards in the EBRD's 2003 Insolvency Sector Assessment but is amongst the strongest of the insolvency laws in central Asia. The chart below shows the level of compliance of the Insolvency Law with international standards in five core areas and demonstrates that there is room for improvement in Kazakhstan's insolvency law in each of the five areas. In addition, the chart shows the relative weakness of the Insolvency Law in addressing reorganisation processes, terminal/liquidation processes and the treatment of estate assets.

Quality of insolvency legislation –Kazakhstan (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank's Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on "Legislative Guidelines for Insolvency Law", and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2004

Some of the specific limitations of the law that were revealed in the Insolvency Sector Assessment include the following: Principally, the law requires that three months must elapse after a debt has become due before a creditor may use that debt as evidence of the debtor's insolvency. This is considered, by most standards, too long. In addition, the Insolvency Law is not as clear as it could be with respect to the evidence that must be adduced by creditors to demonstrate the debtor's insolvency. Finally, the legislative base could be improved by providing a clearer statement on the effect of an insolvency proceeding on the rights of secured creditors and by not subjecting secured creditors to administration expenses (this could be avoided by permitting secured creditors, in a liquidation, to exercise their ordinary contractual rights under their security so that all costs of realisation are controlled by the secured creditor).

It is worthwhile to point out some of the positive features of the Insolvency Law. This law provides for both good interim protective relief of the debtor and the reversal of fraudulent transactions which should have the effect of enlarging the pool of assets available for distribution from the estate. Although the reorganisation provisions of the Insolvency Law do not generally comply with international standards, they are surprisingly strong in relation to others in the region in that they provide for the appointment of a rehabilitation manager over the debtor's assets while allowing the debtor to seek court approval to re-assert control over the business during the restructuring. In addition, to help avoid fraudulent or unnecessary proceedings, the Insolvency Law requires the report of an auditor to independently analyse and confirm whether a restructuring is truly viable.

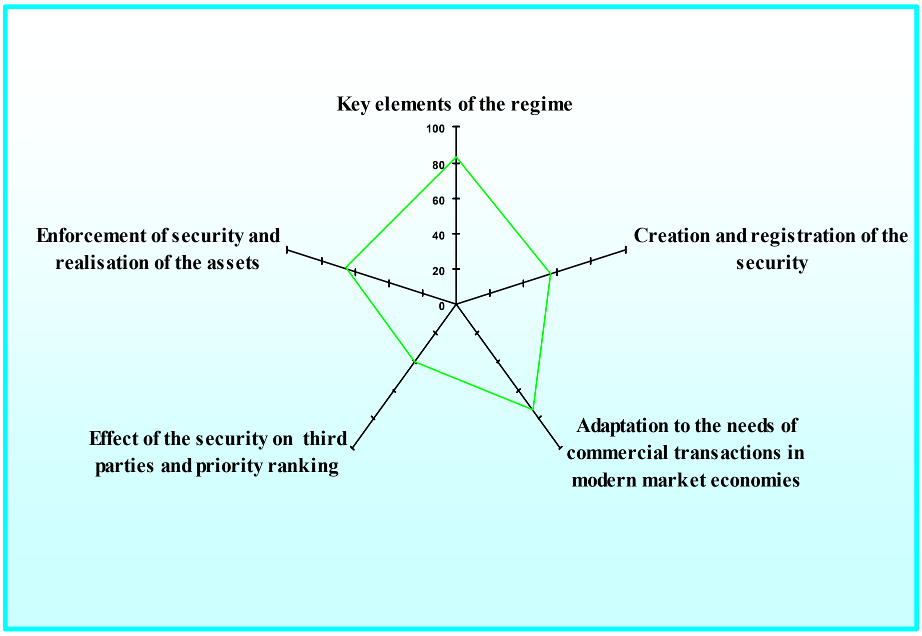
Several problems with the application of insolvency law in Kazakhstan were revealed in EBRD's 2004 Legal Indicator Survey, a case study that the Bank conducted to measure the effectiveness of insolvency legislation in the region. In particular, the insolvency regime appears to be an ineffective weapon, or insufficiently credible threat, for creditors to induce a recalcitrant debtor to pay their debts. Access to the insolvency system is overly formal and complex, the process is generally regarded as being expensive and inefficient and the reliability and competence of judges are seen as relatively weak. Kazakhstan was found to have one of the largest "implementation gaps" (the difference between the overall quality of its insolvency law and the effective implementation of that law) amongst the EBRD's countries of operations.

Secured Transactions

Security rights over movable assets (also referred to as pledges) are regulated by the Civil Code of the Republic of Kazakhstan, adopted in December 1994, and other laws. Non-possessory and possessory security can be registered if the parties so choose, though in certain cases, registration of a pledge is mandatory. Security over immovable assets (mortgage) is covered primarily by a 1995 Presidential Decree (having the force of law) on Mortgage of Immovable Property. An enterprise can be charged by way of a mortgage, where the security will cover all the following: 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.

Based on the 2002 EBRD Regional Survey of Secured Transactions, the secured transactions legal regime is "adequate", although not particularly enabling for sophisticated transactions. As shown in the chart below, the key elements of a regime for secured transactions are satisfactorily covered, and the regime is relatively adapted to the demands of a market economy.

Legal and Practical Regime for Taking Security over Movable and Intangible Property – Kazakhstan (2002)



Note: Scoring on a scale from 1 to 100, where 100 represents the most advanced legal and practical regime. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

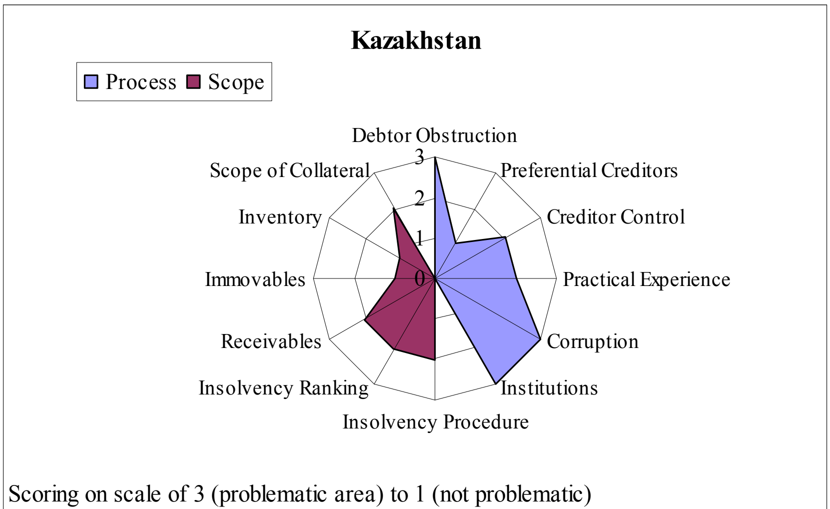
Source: EBRD Regional Survey of Secured Transactions, 2002

However, as the chart also shows, some transactions remain difficult to achieve. For example, a pledge over assets described generally would mostly not be a viable option to secure a transaction due to restrictions in either description of the assets or in the maintaining of their value.

The rules on perfection of the pledge are more advanced than in the rest of the region: Kazakhstan is one of the rare countries in the region to have established a system for the registration of pledges over movable property. However, the registration procedure is not always clear and practitioners have expressed some concerns on the efficiency of the whole process. In principle, pledges over movable assets are registered at the Centre for Immovables of the Ministry of Justice (or in one of their branches) unless the assets are subject to registration in an asset registry (e.g. certain intellectual property rights, securities, means of transport, etc.). Not all pledges will be registered - it depends on the parties' agreement. Mandatory registration is subject to a host of different rules, which render the procedure uncertain and complex. There is also the risk of denial of registration as valuation of registered assets is required and the rules with regard to valid valuation are not clear. Finally, registration of mortgages can be time-consuming and expensive due to the documents which are required for registration. In this respect, the EBRD has experienced unacceptably long delays in perfecting its security rights over a borrower's assets.

The means of enforcement provided by the law seem adequate on the books, yet in practice enforcement is reported as problematic because of deficiencies in the court system, uncertainty regarding enforcement mechanisms, instances 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. Additionally, serious delays could occur due to the right of the court to postpone the sale of the pledged property by up to one year upon the debtor's request. These problems were confirmed by a survey that the EBRD conducted in 2003, focusing on the enforcement of pledges (charges) in the region. While Kazakhstan provided very encouraging overall results in terms of the return that a lender could expect from enforcing its security over the charged assets and the time and simplicity involved in such process (certainly the best in the region), the survey also highlighted serious problems, in particular the high risk of court corruption and the lack of training of key enforcement officers, such as the bailiffs (see chart below).

Obstacles to charge enforcement process –Kazakhstan (2003)



Note: The fuller the "web" of the graph, the more serious the problems are in each of the respective categories "Process" factors measure the impact of specific incidences on the enforcement proceedings. "Scope" factors relate to the ability of the system to deal with specific situations or items.

Source: EBRD Legal Indicator Survey 2003

There is thus a good deal of efforts remaining for the Kazakh government in order to achieve the advanced legal regime for secured transactions that the country and its economy certainly need.

Telecommunications

The telecommunications sector in Kazakhstan is currently governed by the Law on Communications of 2004 (the "Communications Law") and regulated by the Agency for Information Technology and Communications (AITC). Unusually, AITC is responsible for both formulating and implementing government telecommunications policy (policy formulation is normally the responsibility of government through the relevant ministry). Among the areas AITC is specifically responsible for is licensing operations, interconnection procedures and determination of accounting principles for regulated operators. The Communications Law represents a significant improvement in the environment for telecommunications in Kazakhstan and covers all major areas in the sector, providing a legal basis for liberalisation, equal network access for market participants, universal service provisions, etc. Surprisingly, the passage of the Communications Law was accompanied by additional legislation limiting foreign ownership in Kazakh companies providing international or long-distance fixed-line calls to 49%.

While there is limited competition in the fixed-line, satellite, mobile and value-added/data markets, the incumbent majority state-owned operator, KazakhTelecom (KTC), possesses a monopoly on domestic and international long distance services and is dominant in virtually all market segments through its control of the majority of local and backbone communications infrastructure. The government announced a plan for paced liberalisation in August 2003 that aims to increase competition in 2004, with full liberalisation following by end-2005. While the government has announced an intention to further privatise KTC a number of times (most recently earlier in 2004), no meaningful steps appear to have been taken to make this intention a reality.

The mobile sector in Kazakhstan is competitive with approximately 10% market penetration at the end of 2003. The leading players within the mobile market are Altel (50% KTC shareholding), K-cell (KTC, Sonera and Turkcell joint venture - KTC holding 49%) and K-mobile (currently wholly owned by VimpelCom, a major Russian mobile company). Both K-cell and K-mobile operate GSM networks while Altel recently replaced an older AMPS network with a CDMA network. An attempt to licence a third GSM in 2004 failed, apparently due to absence of sufficient interest and possible concerns about limitation of foreign investment in the sector.

As telecommunications is still currently considered a natural monopoly in Kazakhstan, critical elements of sector tariff setting remain the responsibility of the Anti-Monopoly Agency and are governed by natural monopolies legislation. Nonetheless, a programme of tariff rebalancing is currently underway with KTC seeking to implement significant tariff adjustments ahead of sector liberalisation.

Whilst significant reform work has been undertaken, the success of these reforms will hinge upon their proper implementation over the short to medium term. Timely adoption of the necessary secondary legislation and regulatory instruments will be the key to such implementation. The authorities should ensure that such legislation and instruments are adopted and enforced without delay – in particular, the authorities should ensure that all necessary legislation and mechanisms are in place before the onset of full liberalisation. Along with implementation, a number of critical matters remain at issue. In particular, the government's recent imposition of a limitation on foreign ownership in certain operators (see above) will most likely diminish the pool of capital available for investment in the development of the Kazakh telecommunications sector and potentially send undesirable signals with respect to foreign investment in Kazakhstan in general. Equally, uncertainty as to the reality of the independence enjoyed by the AITC could impact upon investor confidence in the sector. Accordingly, moves by the government to clarify the powers and responsibilities of AITC in a manner reflective of international standards in this area would be most welcome. Similarly, the current dual regulatory authority with respect to tariffing should be revised, with all relevant tariffing powers being devolved to AITC as soon as it has sufficient capacity in this area.

Legal Reform Projects

The EBRD has been active in providing technical cooperation in the telecommunications sector in Kazakhstan since 1998. Many of the reforms mentioned above have been facilitated by technical co-operation assistance from the EBRD's telecommunications regulatory development programme. Among the areas the EBRD has provided assistance with are: revision of sector legislation, interconnection, licensing, tariffing and universal service. The Bank's is currently developing a technical cooperation project with the Anti-Monopoly Agency which will provide assistance to the Agency with the reform of relevant regulation across a number of network infrastructure sectors, including telecommunications.

Annex 6 Environmental Assessment

A number of key environmental challenges for Kazakhstan are associated with its industrial base, which is dominated by extractive industries (oil, gas, coal, and a wide range of minerals). These industries are generally resource-intensive and inefficient. Greenhouse gas emissions are high – 8 tonnes of CO_2 per capita, per year – which is comparable to the highly automated and motorised countries in North America and Western Europe. Capacity building in the area of occupational health and safety is a significant need, particularly in high risk sectors, such as extractive industry and heavy industry. Other critical environmental issues are desertification and water resource management, such as the diversion of water for irrigation and its contribution to the catastrophic decline of the Aral Sea. Kazakhstan's vast land area and small population density impose a unique challenge to establish effective environmental management. Although the Ministry of Environmental Protection is in charge of overall environmental management of the country, the Ministry of Agriculture and the Ministry of Energy and Mineral Resources also address forestry and mineral resource-related environmental issues. Furthermore, a number of other institutions have environment-related responsibilities. The current environmental management situation is complex and needs further streamlining.

Kazakhstan also inherited critically adverse environmental conditions from the previous regime. Some areas of Kazakhstan had been exposed to intense radiation-related short-term and long-term effects due to uranium mining and processing, the manufacturing of nuclear fuel and the testing of nuclear warfare. Uranium has been mined in 8 of 14 oblasts at about 100 sites and nuclear explosions were carried out at a dozen military and industrial areas. The best known military testing ground is the Semipalatinsk Nuclear testing site in Eastern Kazakhstan. Political change lifted the veil on uranium mining and nuclear testing and placed radioactive environmental contamination in the spotlight (UNECE Kazakhstan Environmental Review 2000). Kazakhstan's National Environmental Action Plan 1998 (NEAP) addresses these issues: pilot projects for radioactive waste treatment in the East Kazakhstan and Karagenda oblasts, a plan to reduce air pollution caused by radioactive dust from the "Koshkar-Ata" tailing in Aktan and the establishment of the International Centre for Investigation of the Impact of Semipalatinsk Testing Site on Heath and the Natural Environment. The Government continues to face complex institutional and technical tasks as well as financial requirements to address the issues.

In the environmental policy sphere, Kazakhstan has made a number of improvements towards international standards in environmental policy reform. Sustainable development principles, for example, have been integrated into the recently approved Innovative Industrial Development Policy (2003-2015) for industries outside the oil sector. In December 2003, a presidential decree defined a new environmental strategy for the country for 2004-2015 'Concept of Environmental, Health and Safety Policy 2004-2015'. In the area of environmental legislation, new laws were adopted: a Land Use Code (June 2003), Forest Code and Water Code (July 2003), and the Law on Environmental Information (April 2004) which sets up public information disclosure requirements. A new Solid Waste Code is currently under review by Parliament. These new laws are based on EU legislation, and the Law on Environmental Information reflects the requirements of the UN Economic Commission for Europe (UNECE) Convention on Public Participation.

Kazakhstan also ratified the five environmental conventions under the UNECE that deal with transboundary issues. Like many countries in the region, the assistance of the international community is needed to help Kazakhstan with capacity-building programmes to strengthen implementation of these policies, laws, and international conventions. EBRD (along with UNECE and United Nations Environment Programme) assisted Kazakhstan and the other littoral states of the Caspian Sea from 2001 to 2003 in developing regional guidelines for environmental impact assessment for projects where impact can be felt beyond the national borders (i.e., transboundary by design, such as international pipelines, or transboundary impact from accidents, such as offshore oil spills). The regional guidelines were agreed in November 2003, when the Caspian littoral states ratified the Framework Convention for the Protection of the Marine Environment of the Caspian Sea. Kazakhstan is very active in regional programmes, such as the Caspian Environmental Programme (CEP). Two of the CEP's regional thematic centres (CRTCs) are hosted by Kazakhstan, the Biodiversity CRTC in Atyrau and the CRTC in Almaty which focuses on the fluctuating water levels of the Caspian Sea.

Other international institutions are active in Kazakhstan. For example, the ADB has recently completed work on Kazakhstan Country Environmental Analysis Improved Environment and Natural Resource Management in Kazakhstan and Second Water Resource Management as well as prepared concept papers on Participatory Water Management in Central Asia. The World Bank's primary focus in the country is on water resources, including irrigation management, pollution clean-up projects, and the Aral Sea basin. The World Bank assists with the Caspian Environmental Programme and other regional initiatives. They have also helped Kazakhstan in the development of the forestry code. The Japanese International Cooperation Agency (JICA) provided support for environmental monitoring of the Balkhash Lake and watershed, as well as has been providing assistance addressing public health issues in Semipalatinsk.

Annex 7 Selected Economic Indicators

Kazakhstan

	1998	1999	2000	2001	2002	2003	2004
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	-1.9	2.7	9.8	13.5	9.8	9.2	9.0
Private consumption	-0.5	0.1	0.9	7.7	7.2	na	na
Public consumption	-15.2	7.6	15.0	19.2	-4.5	na	na
Gross fixed capital formation	-7.2	0.5	16.1	25.3	3.5	10.3	na
Exports of goods and services	-11.9	3.0	28.7	-1.1	20.5	na	na
Imports of goods and services	-7.2	0.6	26.1	2.5	2.0	na	na
Industrial gross output	-2.4	2.7	15.5	13.8	10.5	8.8	9.0
Agricultural gross output	-18.9	28.0	-4.2	17.3	3.4	1.4	1.0
Employment[1]			*(Percentage change)*				
Labour force (end-year)	na	0.0	0.7	5.2	-1.1	3.2	na
Employment (end-year)	na	-0.4	1.6	8.0	0.2	3.9	na
			(In per cent of labour force)				
Unemployment (end-year)	13.1	13.5	12.8	10.4	9.3	8.8	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	7.1	8.3	13.2	8.4	5.8	6.4	6.7
Consumer prices (end-year)	1.9	17.8	9.8	6.4	6.6	6.8	4.8
Producer prices (annual average)	0.8	18.8	38.0	0.3	0.4	9.3	na
Producer prices (end-year)	-5.5	57.2	19.4	-14.1	11.9	5.9	na
Gross average monthly earnings in economy (annual average)	13.4	13.4	30.9	20.8	17.0	14.3	15.4
Government sector[2]			*(In per cent of GDP)*				
General government balance[3]	-8.0	-5.2	-1.0	-0.9	-0.3	-1.0	-2.1
General government expenditure[4]	26.1	23.2	23.2	23.4	22.1	24.0	26.1
General government debt	22.4	31.5	25.5	20.4	17.7	15.5	12.5
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	-14.1	84.4	45.0	40.2	30.1	29.3	35.0
Domestic credit (end-year)[5]	38.6	35.4	57.3	17.1	30.2	24.1	30.0
			(In per cent of GDP)				
Broad money (M2, end-year)[6]	8.6	13.6	15.3	17.1	19.2	21.0	24.4
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	25.0	18.0	14.0	9.0	7.5	7.0	na
Treasury bill rate (3-month maturity)[7]	23.6	15.6	6.6	5.3	5.2	5.9	na
Deposit rate[8]	14.5	13.5	15.6	12.8	11.0	10.9	na
Lending rate[9]	17.0	20.8	18.8	15.3	14.1	14.9	na
			(Tenges per US dollar)				
Exchange rate (end-year)	83.8	138.2	144.5	150.2	154.6	144.2	132.3
Exchange rate (annual average)	78.3	119.5	142.1	146.7	153.3	149.6	137.2
External sector			*(In millions of US dollars)*				
Current account	-1,225	-236	563	-1,203	-866	-69	376
Trade balance[10]	-801	340	2,440	1,320	2,301	4,088	6,181
Merchandise exports	5,871	5,989	9,288	8,928	10,027	13,233	18,526
Merchandise imports	6,672	5,648	6,848	7,607	7,726	9,144	12,345
Foreign direct investment, net	1,143	1,468	1,278	2,861	2,163	2,188	2,500
Gross reserves, excluding gold (end-year)	1,461	1,479	1,594	1,997	2,551	4,236	6,862
External debt stock[11]	9,932	12,081	12,685	15,158	18,201	22,859	27,409
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)[12]	2.2	2.6	2.2	2.3	2.7	3.9	4.7
			(In per cent of exports of goods and services)				
Debt service	22.4	27.3	50.8	37.5	35.2	34.5	36.6
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	15.2	14.9	14.9	14.8	14.9	14.4	14.4
GDP (in millions of tenges)	1,733,264	2,016,456	2,599,902	3,250,593	3,776,277	4,449,700	5,173,230
GDP per capita (in US dollar)	1,457	1,132	1,231	1,492	1,658	2,069	2,623
Share of industry in GDP (in per cent)	23.9	23.9	25.2	25.2	25.3	na	na
Share of agriculture in GDP (in per cent)	9.4	11.1	9.8	10.1	9.5	na	na
Current account/GDP (in per cent)	-5.5	-1.4	3.1	-5.4	-3.5	-0.2	1.0
External debt - reserves (in US$ million)	8,471	10,602	11,091	13,160	15,650	18,623	20,547
External debt/GDP (in per cent)	44.9	71.6	69.3	68.4	73.9	76.8	72.7
External debt/exports of goods and services (in per cent)	146.6	174.7	121.7	148.2	156.8	152.3	133.9

[1] Employment data are based on labour force surveys from 1998, leading to a break in the series.

[2] General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.

[3] Government balance includes quasi-fiscal operations (zero after 1995). Balance excludes privatisation revenues and transfers to the National Fund.

[4] Expenditures include extra-budgetary funds after 1998, leading to a break in the series.

[5] Domestic credit from International Financial Statistics. Break in series in 1997 and 2001.

[6] From International Financial Statistics

[7] Three-month T-bill rate until December 1998, average effective yield of short-term NBK notes thereafter.

[8] Deposit rate refers to the weighted average of interest rates on time deposits of individuals in tenge by maturity.

[9] Lending rate refers to weighted average of interest rates on credits extended to legal entities excluding banks in tenge by maturity.

[10] Exports are at declared customs prices and are not corrected for under-invoicing of oil and gas exports.

[11] Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.

[12] Excluding National Fund.

Annex 8 Bilateral Assistance

Canada

Canada's official development assistance to Kazakhstan is delivered through three main Canadian International Development Agency (CIDA) channels, the bilateral program including regional projects, local initiatives supported by a decentralised fund operating from the Canadian Embassy in Almaty, and industrial cooperation.

A. Two bilateral regional projects, focusing on agricultural vocational training and water resource management training, have had some activities in Kazakhstan and will draw to a close in 2005. (Previous assistance to vocational training in the oil and gas sector and to locust control through remote sensing ended in 2003-04.) The regional greenhouse gas emission reduction program and a climate change fund have also been of some benefit to Kazakhstan and may generate investment opportunities in the future as pilot projects progress toward commercial viability. The regional program run by Canadian Executive Services Overseas (CESO) has funded almost 40 technical support missions by Canadian experts since 1998, mainly in the service and manufacturing sectors. Though the Partnerships for Tomorrow Programme, eleven exchanges in several domains (e.g. higher education, business training, trade and development, environment, marine safety and public health management) have fostered the establishment of long term relations between universities, municipalities, and other private sector and civil society organisations in Canada and Kazakhstan.

B. From the Embassy in Almaty, a Canada Fund for local initiatives (CAD 75,000 in 2004-05) is focused on poverty reduction through the social sectors and delivered by local non-governmental organisations. Civil society in Kazakhstan also benefits from the Central Asia Governance Support Program, which will end in 2004/05, with approximately CAD 150,000 spent this fiscal year in Kazakhstan.

C. Since 1991, the industrial cooperation mechanism has provided CAD 380,000 in support to investment projects aimed at the establishment of joint ventures. A further CAD 420,000 has supported investment viability studies. Agriculture, and extractive industries in the natural resource sector predominate.

Kazakhstan is not a country of focus for CIDA's bilateral assistance. Overall, since 1991, Canada's bilateral support to Kazakhstan, though all channels, mechanisms and funds amounts to CAD 14 million. CIDA is proposing Tajikistan as a country of focus for Central Asia, and through this program, Kazakhstan may continue to benefit indirectly. Canada's final decision on the future of its bilateral assistance in Central Asia will not be made until the ongoing International Policy Review has reached its conclusion, sometime in late 2004 or early 2005.

France

In 2002, France provided EUR 2.4 million of bilateral assistance in total, of which EUR 1.1 million was for technical cooperation and EUR 0.7 million for project support. The total assistance for 2003 was EUR 4.7 million, of which EUR 1.5 million was for technical cooperation and EUR 2.5 million was for emergency aid.

Italy
In 1995, Italy and Kazakhstan signed the Treaty for Friendship and Cooperation which established the 'Bilateral Working Group for Economic Matters, Trade and Economic and Industrial Cooperation'. The group aims at strengthening the economic cooperation between the two countries and expand the areas of activities beyond the energy sector. Italy is in fact one of the largest European investors in the Kazakhi energy sector. ENI-AGIP is the sole exploiter of the Kosogan oil field, in the north western area of the Caspian Sea, which is thought to have the largest oil reserve in the world. In March 2004, the international consortium AGIP-KCO has reached an agreement with the Kazakh government for the exploitation of the Kosogan oilfield. Production is expected to begin by 2008, will reach 21 million tons per annum by 2010, and may reach up to 56 millions tons per annum thereafter.

Servizi Assicurativi del Commercio Estero (SACE), the Italian Export Credit Agency, has recently decided to upgrade its risk rating for Kazakhstan from 6 to 5 out of 7 based on Organisation for Economic Cooperation and Development (OECD) ratings. As a result, SACE is now prepared to accept Kazakh sovereign guarantees and to consider private investors with adequate credit record. As of end of 2003, overall SACE's exposure in Kazakhstan amounted to EUR 10.8 million.

Japan
Japan commenced bilateral assistance in 1991 and is the top donor to Kazakhstan. In recent years around 15 per cent of total international assistance to Kazakhstan has been extended by Japan.

At the end of 2003, total commitments of loan aid stood at JPY 88.8 billion, and that of grant aid had reached JPY 5.66 billion. Disbursements of technical assistance amounted to JPY 8.72 billion.

Currently the three priority areas consist of: i) human resources development to meet the needs of a market economy; ii) development of economic and social infrastructure; and iii) mitigation of hardships caused by transition (assistance in the social sector, redressing regional disparities and preservation/improvement of the natural environment). A loan aid project for water supply improvement and sewage system rehabilitation in Astana is being implemented under the second priority. Technical assistance for the health care system in the Semipalatinsk region is ongoing under the third priority, as are grant aid projects for upgrading medical equipment in the hospital complex in Kyzlorda and for improving water supplies in rural communities.

The preparation of a new country assistance strategy for Kazakhstan is due to commence during 2004.

Switzerland
The Secrétariat d'Etat à l'économie (seco) has very limited bilateral activities in Kazakhstan, most of them being regional, i.e. for the whole of Central Asia.

United Kingdom
The UK's current bilateral programme in Kazakhstan focuses on: i) support for land-use planning in the former nuclear testing area (Semi-Palitinsk); ii) support for work

on establishment of a national integrated water management system; iii) support for work on Extractive Industries and Transparency Initiative (EITI). With the exception of work on EITI, all other existing Department for International Development (DFID) programmes in Kazakhstan will be completed in 2005. After the second half of 2005 the UK envisages providing targeted support to EITI and HIV AIDS prevention through our Central Asia regional programme. The bilateral programme in the country will cease.

DFID Projects

Nura-Ishim river Basin Management project – The north-east of Kazakhstan is identified as a priority zone in the National Environmental Action Plan (NEAP) reflecting the high levels of industrial pollution and high discharges of mercury into the Nura River which have made this unsafe as a course of water. Through DFID support the state Academy of Construction and Architecture has mapped the extent of the river's contamination. DFID is working with the National Committee for Water Resources under the Ministry of Agriculture and the World Bank.

The purpose of this project is to improve water management in the Nura-Ishim Basin using methods that can be replicated elsewhere in Kazakhstan. It is designed in 2 phases: a) institutional reform and revised regulation, b) development of an integrated river basis planning procedure. DFID support is GBP 1 million since 1999 (including financial support from Department for the Environment, Food & Rural Affairs - DEFRA).

Semipalitinsk Nuclear Testing Ground - During the forty years' lifetime, from 1949 to 1989, of the Semipalatinsk Nuclear Test Site (the Polygon) its operation was supported locally by the employment of up to 400,000 people. The Polygon itself covers an area of 18,500 km^2 of open grass steppe to the south and west of Semipalatinsk city, within parts of the Oblasts of East Kazakhstan (9990 km^2), Pavlodar (7215 km^2) and Karaganda (1295 km^2). Following the closure of the Polygon as a nuclear test site by the President of Kazakhstan on 29 August 1991, a massive deterioration in the state of the surrounding economy of these Oblasts and large-scale unemployment in the former Semipalatinsk Oblast have occurred.

The purpose of the project is to put in place a participatory land use planning process, providing accurate and accessible information to communities, industry and decision makers to allow consensual planning that ensures radiologically acceptable and sustainable land use in the Semipalatinsk Test Site (the Polygon). The goal is for the Polygon and environs to be managed in a radiologically acceptable and sustainable manner. DFID support is GBP 600,000 since 2000 (including financial support from DEFRA).

<u>United States</u>

For the past ten years, USAID has assisted Kazakhstan in its transition to a market-based economy. Successful past economic programmes include banking reform and supervision, fiscal reform, and pension reform. USAID economic assistance over the period 1991 to 2004 totalled approximately USD 222 million (including private sector initiatives, economic restructuring and enterprise funds). USAID's current programme at roughly USD 10 million per year aims to strengthen the competitiveness and growth of small and medium size enterprises (SMEs) through four main components: i) further deepening of financial markets through strengthening of financial institutions (establishment of a credit bureau, development of the mortgage industry, strengthening of the pension system and insurance industry), support for micro and small business lending, development of leasing, and promotion of direct investments; ii) improving the quality of economics and business education, transferring modern business skills, and making business information more available; iii) company-level technical advice and training to improve enterprise operations, financial management, marketing, product quality, and access to markets and finance; and iv) promoting more transparent, systematic implementation of laws and regulations, including customs modernisation, reduction of investment constraints, support for World Trade Organisation accession, improvement of the tax environment, enforcement of commercial law, and improvement of public accountability by strengthening the Government budget process and auditing capacities.