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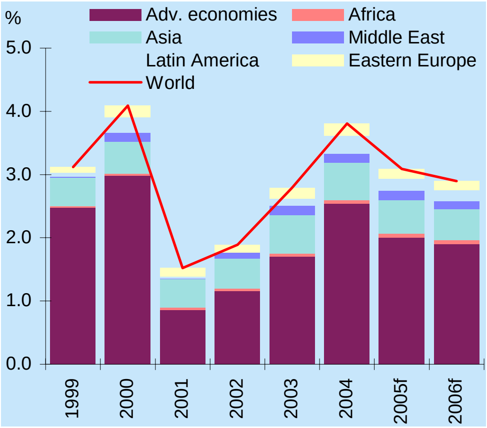
This *D&B Country Report* was prepared in Jun 2005.

Global Economic Outlook

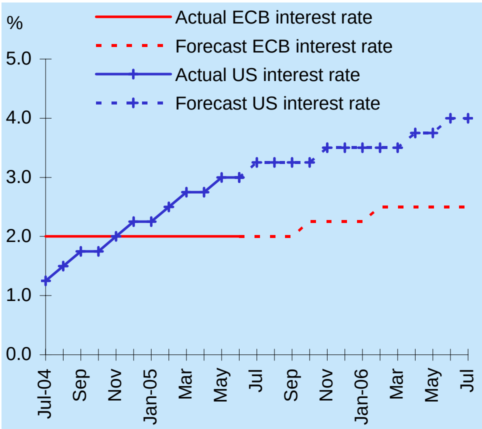
Real GDP growth forecast	2005	Interest rates and oil price	Jun. 2005
World, %	3.1	US interest rate, %	3.00
US, %	3.4	ECB interest rate, %	2.00
Euroland, %	1.6	Japan interest rate, %	0.10
Japan, %	3.2	Oil price (Brent crude), USD p/b	57.4



Sources: International Monetary Fund; D&B

World Growth

In 2004 the world economy grew by 3.8% (based on a market exchange rate based weighting method), making it the strongest year since 2000. We expect the rate of expansion to slow moderately to 3.1% in 2005 and 2.9% in 2006, reflecting weakening output growth in key economies. As the US, Japan and Western rates of expansion are slowing, the differential in performance between them will not narrow significantly; instead, the relative strength of the US economy is set to persist over our forecast horizon. This has also helped the US dollar gain value against other major currencies recently, despite the continuing huge deficits on the US current account and government balance.

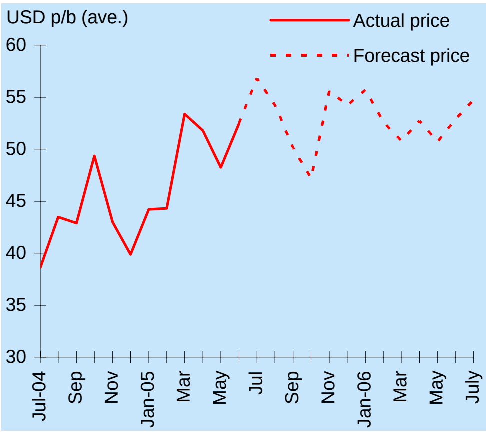


Sources: US Federal Reserve; European Central Bank; D&B

US and Euroland Interest Rates

US: We believe that short-term interest rates will continue to increase by 25 basis point increments, reaching 4% by mid-2006. Energy-related weakness during the first half of 2005 appears to be subsiding, with stronger demand growth resuming. Further increases in oil prices or a weakening in labour market conditions could prompt retrenchment in the household sector, lowering growth and requiring a pause in monetary tightening.

Euroland: The ECB left interest rates unchanged at 2% on 2 June, acknowledging that inflationary pressures inside the currency area remained largely contained. The probability of a cut to 1.75% has increased given weaker demand conditions in a number of euro-zone countries.



Source: D&B

Oil Price (Brent Crude)

Our oil price forecast for 2005 is USD50.1 per barrel (p/b). After falling below USD50.0p/b in May, the price of Brent crude rose above this level in June. Crude prices have been drive up by low global inventory levels of heating oil and strong demand for diesel. In addition, there has been strong demand from Asia for Middle Eastern crude and an increase in US refinery inputs. OPEC agreed to increase quota levels to 28 million barrels per day from 1 June; however, there are still concerns that supply cannot keep up with demand with most countries producing at maximum capacity. The tightness of the market means that any disruption to supply will drive up prices.

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Country Risk Indicator DB5b

For Country Risk Indicator Definition see page 49

Regional Risk Indicators

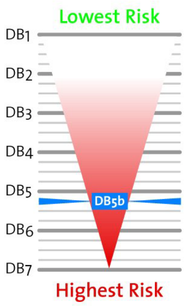
Slovenia	DB2c
Hungary	DB2d
Estonia	DB3b
Slovak Rep.	DB3b
Latvia	DB3c
Lithuania	DB3c
Poland	DB3c
Czech Rep.	DB3d
Bulgaria	DB4c
Romania	DB4c
Croatia	DB4d
Kazakhstan	**DB5b**
Azerbaijan	DB6a
Russian Fed.	DB6b
Serbia & Mont.	DB6b
Ukraine	DB6b
Georgia	DB6c
Kyrgyz Rep.	DB6c
Macedonia	DB6c
Albania	DB6d
Belarus	DB6d
Bosnia & Herz.	DB6d
Tajikistan	DB6d
Turkmenistan	DB6d
Uzbekistan	DB6d

Kazakhstan's Risk Indicator History

End-2002	DB5b
End-2003	DB5b
End-2004	DB5b

Comparative Risk Indicators

Dominican Rep.	DB5b
Indonesia	DB5b
Zambia	DB5b



High Risk

Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.

The DB indicator is a comparative assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years.

Overall Outlook

- The short-term economic outlook for Kazakhstan remains decidedly positive.
- The ongoing exploitation of the country's abundant natural energy resources will ensure robust economic growth continues in 2005 and 2006.

Positive Factors

+ In view of President Nursultan Nazarbayev's tight grip on power, Kazakhstan's short-term political risk outlook is broadly stable.
+ Although, recent 'democratic revolutions' in other former Soviet states may increase calls for greater democracy, Kazakhstan's buoyant economy means the risk of any serious political upheaval is much lower in its case.
+ As in the recent past, robust private consumption and increasing investment in Kazakhstan's energy sector are expected to underpin strong economic growth over the two-year forecast period. We expect real GDP to grow by 8.5% and 7.3% in 2005 and 2006 respectively.
+ The country's external economic situation should remain strong during the forecast period, bolstered by high oil prices, increasing oil production and the continuing strength of inflows of (energy-related) foreign direct investment (FDI).
+ Strong oil-related revenues will have the twin benefits of ensuring the continued growth of the National Fund and containing the government budget deficit; we forecast relatively low deficits of 1.1% and 2.0% in 2005 and 2006 respectively.
+ Inflation is expected to remain broadly under control; we forecast annual average (consumer price) inflation of 7.0% in 2005 and 6.1% in 2006.

Negative Factors

– Given Kazakhstan's dependence on oil revenues and the narrowness of the export base, the economy remains highly sensitive to changes in global commodity prices, although the National Fund should minimise this vulnerability.

– Kazakhstan's commercial sector is hampered by excessive bureaucracy, significant inter-enterprise arrears and an opaque legal system.

– Corruption remains a serious concern. The ongoing 'Kazakhgate' scandal, over the alleged payment of bribes by US firms to senior Kazakh officials to secure commercial contracts, could embarrass the government.

– The government has generally been committed to fostering an investment environment attractive to foreign investors. However, in recent years, there have been rising complaints from foreign investors about unhelpful government intervention.

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Key Information

Economic and Development Information

	2002	*2003*	*2004e*	*2005f*	*2006f*
GDP (nominal)					
KZT billion	3,776	4,450	5,543	6,415	7,195
USD billion	24.6	29.7	40.8	47.9	54.1
Breakdown of GDP					
Agriculture (%)	8.0	7.3	7.0	6.7	6.5
Industry (%)	35.8	35.6	38.6	38.5	38.8
Services (%)	56.2	57.1	54.4	54.8	54.7
Economic indicators					
Real GDP growth (% change)	9.8	9.2	9.4	8.5	7.3
Inflation, year end (%)	6.0	5.9	6.9	7.0	6.1
Government balance (% GDP)	-0.3	-0.9	-1.3	-1.1	-2.0
Total external debt (% of GDP)	73.9	76.8	68.9	68.3	67.2
Current account balance (% GDP)	-3.4	-0.2	0.1	0.7	0.2

Long-term real GDP growth potential, annual average, 2005-14: 6-7%

Development indicators	***Kazakhstan***	***Russia***	***Turk'istan***	***Ukraine***	***Uzbekistan***
Population, 2000 (m)	**14.9**	145.5	4.8	49.5	24.8
Population, 2015 (m)	**15.5**	134.5	5.7	44.7	30.1
Population, 2050 (m)	**16.9**	114.1	7.8	37.0	41.4
Urbanisation (%)	**56**	73	45	68	37
GNI per capita (USD)	**1,260**	1,670	750	700	360
GNI per capita (USD PPP)	**5,490**	8,010	3,800	3,700	2,360
Life expectancy (years)	**65**	65	66	68	70
Dependency ratio, 2000	**0.52**	0.44	0.68	0.46	0.72
Dependency ratio, 2015	**0.41**	0.39	0.45	0.43	0.53
Dependency ratio, 2050	**0.57**	0.70	0.52	0.70	0.53

Political Information

Head of state	President Nursultan Nazarbayev
Head of government	Prime Minister Daniyal Akhmetov
Political system	Presidential democracy
Date of independence	*December 1991*
Last elections	Parliamentary: September/ October 2004
Next elections	Presidential: 2006

Miscellaneous Information

Religions	Sunni Muslim, Orthodox Christian
Capital (pop.)	Astana (303,000)
Timezone	GMT +5 hours

Sources: International Monetary Fund, *International Financial Statistics*; Asian Development Bank, *Key Economic Indicator*; World Bank, *World Development Indicators*; European Bank for Reconstruction & Development, *Transition Report*; D&B

Executive Summary

Political Risk

In view of Nursultan Nazarbayev's tight grip on government, Kazakhstan's short-term political risk outlook is broadly stable. Nazarbayev has cemented his hegemony through constitutional manipulation and the effective and early neutralisation of emerging political threats. As economic development advances, the public's attention could gradually turn to less tangible or immediate needs, such as greater political freedoms. However, as he has shown in the past, Nazarbayev is well equipped to deal with any such issues. We expect Nazarbayev to easily win the 2006 presidential election, which will extend his tenure to 2013. Some kind of dynastic succession seems the most likely event after this period.

The recent spate of regime changes in other former Soviet states, such as Georgia, Ukraine and the Kyrgyz Republic has increased speculation about the likelihood of similar events taking place in Kazakhstan. However, in D&B's view, significant local differences make the likelihood of a 'democratic revolution' quite low in Kazakhstan's case. A key difference between the Kyrgyz Republic, Ukraine and Georgia, and Kazakhstan is the latter's vastly superior economic prospects (due largely to the country's abundant natural resources). Rising real incomes owing to the fast economic growth of recent years should have reduced the capacity for civil unrest. In addition, opposition leaders would need to be confident of gaining a broad level of international (especially US) support before instigating a popular uprising. However, countries with large investments in Kazakhstan would be probably more concerned about preserving stability.

Macroeconomic Risk

Kazakhstan's economy has grown rapidly since 2000, driven by a combination of higher oil exports (owing both to generally rising prices and increasing output), rapid growth in investment and robust private consumption. In 2004, private consumption was supported by falling unemployment and rising real income levels, while investment retained its upward trend, supported by strong industrial activity and continuing expenditures aimed at upgrading Kazakhstan's oil producing and transportation capabilities. Despite strong economic growth, inflation remained broadly under control, with the year-end rate staying below 7.0% in 2004 (as it has done since 2001). The fiscal situation also remains basically sound: strong economic growth, high world prices for oil and metals (Kazakhstan's top two export items) and tight expenditure control resulted in a moderate deficit (excluding savings of oil revenues to the National Fund of Kazakhstan) equivalent to 1.3% of GDP in 2004.

Going forward, the authorities are expected to continue following prudent macroeconomic policies, enhancing management of public accounts and maintaining a monetary policy supportive of low inflation and a competitive exchange rate. We expect all components of GDP to make positive contributions to growth over the short term, with overall growth driven in particular by strong private consumption and (energy-related) fixed investment. However, these components of growth will not expand as fast as in recent years; consequently, we forecast real GDP growth of 8.5% in 2005 and 7.3% in 2005, slower than the average 10.5% growth posted between 2001 and 2004. Despite more moderate economic growth, inflation is forecast to edge up to 7.0% in 2005, before declining to 6.1% in 2006. On the fiscal front, we forecast deficits of 1.1% and 2.0% of GDP in 2005 and 2006 respectively (excluding transfers to the National Fund of Kazakhstan); this assessment is predicated on D&B's oil price forecast of USD51.1 in 2005 and USD52.7p/b in 2006.

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External Economic Risk

D&B's broadly positive short-term external economic outlook for Kazakhstan is predicated on the following key assumptions:

- relatively strong global oil prices of USD51.1 p/b and USD52.7 p/b in 2005 and 2006 respectively;
- the continued expansion of Kazakhstan's oil production and transportation capabilities, and the ongoing inflows of foreign direct investment (FDI) entailed by this;
- the absence of external shocks that would prevent Kazakhstan from continuing its positive economic trend.

As a result of rising oil output and high market prices for Kazakhstan's major commodity exports (oil, metals and gas), in 2005 the current account surplus is forecast to rise to 0.7% of GDP from 0.1% of GDP in 2004. In 2006, oil output will continue to rise and oil prices will remain strong. However, due to strong domestic demand and weaker global demand, we still forecast a small reduction in the current account surplus to 0.2% of GDP. The stock of external debt will continue to rise in the forecast period, although this will be due mainly to the accumulation of private debt (i.e. commercial debt not guaranteed by the state). On the currency front, upward pressures on the tenge will persist in the forecast period owing to a combination of strong export earnings and higher foreign exchange flows stemming from increased private borrowings and FDI.

Commercial Risk

The commercial risk situation in Kazakhstan is somewhat mixed. On the positive side, Kazakhstan probably boasts the strongest banking sector out of all the members of the Commonwealth of Independent States, and fast economic growth and the extension of efficiency enhancing reforms are expected to aid the development of the sector over the next few years. The scope for further short-term growth in the sector is illustrated by the fact that the ratio of banking assets to GDP in Kazakhstan is still far below typical levels in developed economies. Meanwhile, given the still high number of domestic banks relative to Kazakhstan's population of around 15 million, further consolidation can be expected.

The principal negative consideration with respect to banking is the possibility that in the context of fast growth and high liquidity (brought about by the rapid expansion in private deposits) banks may be overextending themselves by making imprudent loans to high-risk enterprises. Similarly, the credit risk environment in general, while benefiting from recent rapid economic growth, continues to be constrained by the high incidence of past arrears and inadequate means of recourse. In particular, despite efforts to improve bankruptcy regulation, debtors retain considerable scope to slow or obstruct the enforcement of proceedings aimed at securing the retrieval of debts.

Meanwhile, corruption remains a serous concern, affecting all levels of Kazakh society. The most recent Transparency International report places Kazakhstan in the lowest (worst) quartile of countries surveyed. The suggestion that recently acquired oil wealth has increased Kazakhstan's susceptibility to corruption is supported by the ongoing 'Kazakhgate' scandal, which has exposed corruption among the country's political elite and could complicate relations with the US.

Political Risk

Key Point: In view of President Nursultan Nazarbayev's tight grip on government, Kazakhstan's short-term political risk outlook is broadly stable. Although calls for greater democracy may increase in the future, Nazarbayev seems well equipped to deal with most threats.

Recent Developments

Since the dissolution of the Soviet Union in December 1991, Kazakhstan has made little progress towards democracy; indeed, guided by the belief that 'enlightened authoritarianism' offers the best path away from totalitarianism, President Nursultan Nazarbayev has often adopted methods that echo the country's dictatorial past. In the immediate aftermath of communist government, between the end of the Soviet-era parliament's operations in December 1993 and a rigged parliamentary election in March 1994, the country was effectively ruled by presidential decree.

Following the election, Nazarbayev, who was First Secretary of the Kazakh Communist party and a member of the Soviet Politburo, dissolved parliament and the country's independent-minded Constitutional Court; he introduced a new constitution that increased his executive powers and held a dubious referendum, which extended the president's term of office by four years. In 1995, Nazarbayev consolidated his grip on power: he ruled by decree, further extended the presidential term of office to seven years, and diminished parliament's powers; he also rigorously vetted all the candidates before elections to a new bicameral parliament in 1995.

However, Nazarbayev has brought Kazakhstan a considerable degree of political stability, while his free-market economic policies have laid the foundations for long-term economic growth. The people tend to be politically passive and prefer strong, rather than democratic, leadership. Although over 60% of the population live in poverty, they are accustomed to Nazarbayev and most believe they could do no better under anyone else.

Many Kazakhs credit their leader with securing the country's independence and keeping the peace in their vast, multi-ethnic state. Consequently, Nazarbayev's popularity is high; in the presidential election of January 1999, he received almost 80% of votes cast (turnout was 88.3%). However, international observers raised doubts as to whether the elections were free and fair. In addition, opposition to Nazarbayev has been rising in recent years; specific causes of tension include his tendency to rule by decree and the absence of local elections.

Table 1

Results of the Presidential Election, January 1999

Candidate	*% of vote*
Nursultan Nazarbayev	79.8
Serikbolsyn Abdilin	11.7
Gsni Kasymov	4.6
Engels Gabbasov	0.8

Source: http://www.electionworld.org

Over the years, Nazarbayev has cemented his hegemony through constitutional manipulation and the effective and early neutralisation of potential threats. For example, in July 2002, the president signed a controversial new law requiring, among other things, political parties to have a minimum of 50,000 members (up from 3,000 previously), a minimum of at least 700 members in each of Kazakhstan's 14 provincial regions and the automatic dissolution of any party receiving less than 3% of the national vote in parliamentary elections. The effect of this law was even greater concentration of power in the three main pro-Nazarbayev parties and the exclusion of the vast majority of all other opposition parties from future elections.

Table 2
Party Standings after the Assembly Election, September/October 2004

Party	*Seats*
OTAN	42
Non-partisans and others	18
Agrarian and Industrial	11
Asar	4
Ak Zhol	1
Democratic Party	1
Total	**77**

Source: http://www.electionworld.org

Nazarbayev's hold on power was further consolidated by the parliamentary election that took place on 19 September 2004 and 3 October 2004. Following the conclusion of run-off polling (in some states) on 3 October 2004, the results indicated that Nazarbayev's Otan (Motherland) Party had won 42 seats in the 77 member Mazhilis (lower house). With loyal parties controlling all but one of the remaining seats, Nazarbayev was placed in a very strong position to push through any constitutional amendments in the new legislature. However, as in the past, international observer groups were highly critical of the election, judging it to be neither free nor fair. Although the Organisation for Security and Co-operation in Europe (OSCE) stopped short of accusing the government of organised fraud, its other findings included: government pressure on state employees; overwhelming media bias against the opposition parties; and intimidation of members of the opposition. However, despite opposition calls for protests, there was little indication of social unrest stemming from the election.

Political Environment

Prospects for long-term government stability depend chiefly on how long Nazarbayev remains in power. Although he is due to face re-election in 2006, in June 2000 parliament passed a law granting Nazarbayev special powers for life, such as a permanent seat in Kazakhstan's Security Council and immunity from future prosecutions. A number of commentators subsequently suggested that Nazarbayev might be preparing the ground for officially declaring himself president for life; this eventuality cannot be ruled out completely. A precedent for this already exists in neighbouring Turkmenistan, where President Saparmurat Niyazov has proclaimed himself president for life, and there are few independent voices in Kazakhstan to debate how much power the president should be granted, given that members of Nazarbayev's family also occupy a dominant position in the Kazakh media, owning several newspapers, and television and radio stations.

The Issue of Succession

Unless Nazarbayev falls ill or is assassinated, he will continue to play a key role in the workings of the country. Given his tight grip on power, Nazarbayev should secure another convincing victory in the 2006 presidential election. This would extend his tenure for another seven years until 2013. Beyond this point, it seems likely that Nazarbayev would prefer to see power move to a chosen successor, ideally a member of his own family. With this in mind, Nazarbayev's eldest daughter, Dariga Nazarbayeva, has started to raise her political profile: in mid-2003 she set up a new political party, Asar (All Together). Despite benefiting from her dual role as head of Kazakhstan's largest media empire Khabar, Nazarbayeva's Asar party performed worse than expected in the September/October 2004 parliamentary election, securing only four lower house seats. However, despite this minor setback,

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over the longer term we believe Nazarabayeva will continue to be groomed for an eventual dynastic succession, possibly with a view to taking over from her father in the 2013 presidential election. Nonetheless, Nazarbayeva's role as eventual family successor is not yet assured as other contenders (such her brother-in-law and rival, Timur Kulibayev) could gain greater prominence over time.

The most perilous political succession scenario (although admittedly low risk) would arise if Nazarbayev were to leave office unexpectedly, for example if he died or became ill. In this event, there could be a higher risk of increased popular opposition to any less-established leadership, both from within and outside of Nazarbayev's own political groupings. Indeed, in such an eventuality, we believe a possible scenario could be a period of uncertainty in which a three-dimensional struggle for power would be played out between the old guard (consisting of the extended Nazarbayev family, focusing especially around his daughters and sons-in-law) and established pro-Nazarbayev personages (such as Prime Minister Daniyal Akhmetov) on the one hand, and more popular pro-reformist parties currently forced to operate outside of the mainstream on the other.

The Spread of Democracy?

The recent spread of regime change in other former Soviet states, such as Georgia, Ukraine and the Kyrgyz Republic has increased speculation about the likelihood of similar events taking place in Kazakhstan. Recent efforts by the Kazakh government to clamp down on opposition activity could be indicative of such concerns: in April 2005, the Kazakh parliament approved a number of amendments to the electoral law including a controversial change limiting protest activity after election campaigns. This followed the passage in February 2005 of a vague law banning 'extremism'.

However, in D&B's view, significant local differences make the likelihood of a 'democratic revolution' quite low in Kazakhstan's case. A key difference between the Kyrgyz Republic, Ukraine and Georgia, and Kazakhstan is the latter's superior economic prospects (due to the good fortune of the country's abundant natural resources). Rising real incomes from the fast economic growth of recent years should have reduced the capacity for civil unrest. Despite his autocratic tendencies, Nazarbayev probably deserves some credit for welcoming foreign investment and creating a reasonably liberal market environment which have helped to improve the country's economic prospects. In addition, opposition leaders would need to be confident of gaining a broad level of international (especially US) support before instigating a popular uprising. However, countries with large investments in Kazakhstan would be probably more concerned about preserving stability.

Political System

Executive: The president is both head of state and commander-in-chief of the armed forces. Under the terms of the August 1995 constitution, the president may veto any legislation that has been passed by parliament, and even dissolve the legislature in extreme circumstances. If the president does not accept a law, the president may issue a decree having the force of law. In 1999, the presidential term was extended from five years to seven years. The president has the power to appoint and dismiss the prime minister, provincial governors and the judiciary. The prime minister appoints and chairs the Council of Ministers, serves as Kazakhstan's head of government and largely dictates the government's policy agenda.

Legislature: Kazakhstan has a bicameral parliament consisting of a lower house, *Mazhilis*, and an upper house (the Senate). The 77-seat Mazhilis is popularly elected for a four-year term: 67 members are elected in single-seat constituencies and ten by proportional representation. The Senate has 47 members, with 40 members elected for a six-year term in double-seat constituencies by the local assemblies (half of these are renewed every two-years), and seven members appointed by the president. In addition, ex-presidents are automatically appointed ex-officio life senators. Deputies in both the Senate and Mazhilis have the right to initiate legislation.

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Meanwhile, the Assembly of the Peoples of Kazakhstan, an unelected body, represents the country's ethnic groups.

Parliament represents a negligible threat to Nazarbayev's authority. Since 1995, he has effectively turned it into a rubber-stamp body. Nazarbayev's tight grip on the electoral system and his success in sidelining opponents have also ensured a compliant parliament dominated by his supporters. Although Nazarbayev is sensitive to Western opinion and has stressed his achievements in introducing democracy and stability in Kazakhstan, there is little need for him to concede greater powers to parliament or allow greater representation of opposition political forces in order to satisfy the country's external donors.

Local Government: Kazakhstan is divided into 15 regions (*oblasts*) and the territory of Almaty, each headed by a provincial governor (*akim*). Local governments also exist at city and village level. However, there is presently no system of local elections.

Judiciary: Government interference continues to compromise the legal system's independence. Indeed, the constitution codifies the procedure by which the president and the executive branch may exert pressure on the judiciary. According to the constitution, the president proposes Supreme Court nominees to the Senate, and also appoints provincial judges (nominated by the Supreme Judicial Council) and local level judges (from a list presented by the Ministry of Justice). The president also appoints three members of the seven-strong Constitutional Council, which replaced the Constitutional Court abolished in 1995.

In most cases, defendants' rights (including the right to be present at a trial, the right to counsel and the right to be heard in court and call witnesses for the defence) are respected. However, cases involving government opponents are frequently held in secret. In addition, corruption is evident at every stage and level of the judicial process. Judges are poorly paid and have been known to solicit bribes from participants in trials; in addition, judicial positions can be purchased. Justice for foreign investors under the current legal system cannot be guaranteed in cases where a contract is broken, intellectual property rights are violated, ownership is disputed or payment is not made.

Policy Agenda

Kazakhstan has proven to be one of the most committed of the Central Asian republics to market-oriented economic transition. Since 1992, Kazakhstan has implemented a number of large- and small-scale privatisations, liberalised prices and exchange rate regulations, and established a rudimentary legal and regulatory framework for trading in securities. However, the implementation of reforms has been uneven and the pace of institutional and (individual) enterprise reform, in particular, has been slower than hoped for. This has hindered the government's attempts to diversify the economy to reduce its current heavy reliance on oil revenues.

With respect to the short term, in accordance with International Monetary Fund (IMF) guidance, recent government policy statements have frequently made reference to the following key objectives:

- adopting prudent fiscal policies that consolidate public finances, increase tax revenues, reform the tax code, strengthen tax and customs administration, and improve public expenditure management;
- accelerating structural reforms, including those aimed at restructuring the financial and corporate sectors, speeding up the privatisation of medium-sized and large state-owned enterprises, improving governance, strengthening transparency and developing the legal and regulatory frameworks necessary for a market-based economy; and

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- pursuing a tight monetary policy in order to control inflation, while maintaining a free-floating exchange rate.

On the political front, the government is (nominally) committed to the long-term development of democratic institutions and human rights in Kazakhstan, although official policy often stresses the need to develop an economic middle class before allowing Western-style political freedoms and civil liberties. In the international arena, the government is seeking to deepen its membership of the Commonwealth of Independent States (CIS) by means of the nascent Eurasian Economic Community, an EU-inspired trading bloc comprising Russia, Belarus, Kazakhstan, the Kyrgyz Republic and Tajikistan. However, it is also seeking to forge closer political and strategic relations with China and the US, the latter having been nurtured by Kazakhstan's anti-terrorist overtures in the wake of September 2001.

Socio-Political Risk

Internal Stability

Kazakhstan has maintained a high degree of social stability since independence, a remarkable achievement given the country's diverse ethnic mix and its struggle to construct a viable national economy. However, although the authorities do not publish official crime figures, D&B believes that organised crime has risen markedly since the mid 1990s. The country has become a transit route for narcotics smuggled from Afghanistan to Europe and as such, has become a focus of attention for Russian and other Eastern European mafia gangs. In addition, Kazakhstan has witnessed a marked decline in police efficiency (exacerbated by the high level of corruption inside the force) and has failed to establish an effective judicial system that might deter criminal activity.

Interest Groups

For democracy to be genuinely representative it is essential for a country to develop an active civil society; Kazakhstan has made only minimal progress in this regard. A number of foreign organisations in the country, such as the Soros Foundation, and international monitoring organisations, such as the OSCE, have raised the profile of issues such as democratisation and human rights. However, the country still lacks an effective network of non-governmental organisations, societies, charities or protest groups. As a result, many groups, including most of Kazakhstan's hundred or so different ethnic minorities and special interest groups, are partially excluded from the political process, thereby increasing the potential for destabilisation.

The Nazarbayev Clan

Following independence from the Soviet Union, Nazarbayev and his kin have established themselves as the most powerful and probably the richest family in Kazakhstan. The family dominates the political sphere but also has substantial interests in the oil industry and the media. The family's grip on both government policy and the management of the country's key export industry is an obstacle to reform and a corrupting influence on Kazakhstan's political and economic life, making business deals more costly and dependent on personal relationships.

Allegations emerged in 2002 that Nazarbayev had secretly deposited around USD1 billion of state money in a Swiss bank account in 1996. Although the money, which was obtained by the government following the sale of a 20% equity stake in the TengizChevroil Consortium, was later transferred to Kazakhstan's National Fund, concerns about serious impropriety remain. In particular, the US Justice Department is currently investigating separate claims that large sums of money were transferred illegally between US consulting firms and high-ranking Kazakh government officials in order secure deals for US oil companies (see **Corruption**).

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Ethnic Groups

Slavs: Around two million ethnic Slavs arrived in Central Asia as internal migrants within the Russian Empire between the 1850s and 1917, many settling in Kazakhstan. More migrated to the country during the 1960s, including around 1 million Russians, Belarussians and Ukrainians. After the break-up of the Soviet Union, some ethnic Kazakhs vented their anger against the ethnic Russian newcomers and their descendants, making many Russians feel unwelcome. Together with the additional pressures of unemployment and economic hardship, this caused a great number of Russians to depart: between 1989 and 1998, when the proportion of ethnic Russians in Kazakhstan fell from 37% to 31% of the population.

Nazarbayev moved the state capital from Almaty, near the Chinese border, to Astana, 1,000 kilometres northwards, partly to assert his control over the majority Russian population living there. However, he has been careful not to overly antagonise the country's still substantial ethnic-Russian minority since it provides an important economic bridge to Russia and because Moscow pays close attention to the minority's welfare.

Uighurs: The Uighurs are a Muslim, nomadic people with a strong sense of history and national identity, whose 'homeland' of Uighurstan is the vast plateau and desert region that stretches from the borders of Kazakhstan, the Kyrgyz Republic and Tajikistan to Mongolia and Central China. The main socio-political risk posed by the Uighurs in Kazakhstan (where they number several hundred thousand) derives from their support for greater political freedom for the 5 million of their kinsmen who reside in China's Xinjiang province, where they are subject to Beijing's fierce assimilation policy. This support is a serious embarrassment for the Kazakh government, which is keen to develop ties with China. In 1995, Nazarbayev signed an agreement with the then Chinese President Jiang Zemin promising not to support Uighur separatism. The Kazakh authorities, under pressure from Beijing, have subsequently imposed strict controls over their Uighur minority and cracked down on the Uighurs' political activities. However, some Uighurs foresee armed conflict in Xinjiang in the next 10-20 years and warn that kinsmen in Kazakhstan will inevitably become involved.

Labour Relations

Both the constitution and the Labour Code contain provisions to safeguard the rights of workers, such as the right to organise and to strike; they also set out rules on pay, collective labour contracts, labour disputes, working hours, official holidays, work discipline, redundancy, maternity leave, pensions and vacations. However, the ability to exercise these rights has been curtailed by government restrictions on the influence of independent trade unions, both directly and through its support for state-sponsored unions. Members of independent unions have been harassed and dismissed from their jobs and permission to protest has been denied. In addition, the constitution prohibits the financing of trade unions by foreign sources, and on occasion the state has endeavoured to prosecute the leaders of independent unions for allegedly violating this provision. Partly as result of these factors, strikes and industrial action are rare despite the frustrations felt by workers in an environment of increased competitive pressures and steadily rising unemployment.

External Political Risk

Relations with Russia

Relations with Russia dominate Kazakhstan's foreign policy. Kazakhstan was the last of the former Soviet republics to leave the Soviet Union in 1991 and Nazarbayev has been anxious to maintain good relations with Moscow. Nazarbayev's motivation is threefold:

- Russia remains Kazakhstan's major trading partner, accounting for around one-quarter of the country's exports and almost one-third of imports. As the 1998 Russian financial crisis demonstrated, the fortunes of Kazakhstan's economy are inextricably linked to developments in Russia (see **Short-Term Economic Performance**).
- While Kazakhstan retains a significant ethnic Russian minority, the Kazakh government has been keen to avoid any act that might provoke either this Russian minority or Russian nationalists inside Russia. Indeed, the Kazakh government is aware that the concentration of Russians in Kazakhstan's northern regions provides Russia with a ready excuse to intervene in Kazakhstan's internal affairs should relations with Moscow turn sour.
- Russia's secret services and armed forces protect Kazakhstan from the lingering threat of Islamic insurgency; as such, Kazakhstan will continue to seek the protective shelter that Moscow can provide.

For its part, Russia has no wish to endanger either the Russian minority in Kazakhstan or the important trading links between the two countries. In addition, it largely shares the Central Asian states' concerns about radical Islam, given its own problems with Islamic militants in Chechnya and the growing international consciousness following the terrorist attacks on the US in September 2001.

Relations with China

Since independence, the Kazakh government has sought to improve relations with China, a country it fears might one day harbour territorial designs on its resource-rich, under-populated neighbour. As a result, the Kazakh parliament acted decisively in March 1999 to ratify an agreement finalising border demarcation in two areas. Disputes over this border, which stretches 1,700 kilometres, brought the Soviet Union and China to the brink of war in the 1960s.

The two countries also share a number of common vested interests in maintaining good relations. Since Kazakh independence, China has become one of Kazakhstan's most important trading partners and the possibility exists that both countries may seek to increase their economic inter-dependency by building an oil pipeline from Kazakhstan deep into Chinese territory (see **Oil and Gas Pipelines**). China and Kazakhstan are also united in their concern about the terrorist threats in the region. In a gesture of solidarity with Beijing, the Kazakh authorities have cracked down on the activities of Uighur nationalists in Kazakhstan (see **Ethnic Groups**).

Relations with the US

The US is keen to extend its influence into Central Asia because of the region's immense hydrocarbon wealth, its geo-strategic position as a buffer against Russian expansionism and the potential growth of Islamic fundamentalism. The US' role has largely been welcomed by Kazakhstan, which has been able to play off a US presence in the region against any potential threat from Russia or China; Washington has already conducted joint military exercises in the country.

The US has expressed some concern over the lack of democracy in Kazakhstan and voiced criticism about the conduct of past elections. However, these concerns are outweighed by the need for stability in a region which is rich in natural resources (with sizeable investments by US firms) and exposed to the risk of terrorism. In both these areas, Nazarbayev can be relied on to be generally co-operative. For these reasons it would be surprising if the US government decided to give strong support to the Kazakh opposition as part of its policy of spreading global democracy.

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Political Risk Outlook

In view of Nazarbayev’s tight grip on government, Kazakhstan’s short-term political risk outlook is broadly stable. Nazarbayev has continued to cement his hegemony through constitutional manipulation and the effective and early neutralisation of emerging political threats. As economic development advances, the public’s attention could gradually turn to less tangible or immediate needs, such as greater political freedoms. However, as he has shown in the past, Nazarbayev is well equipped to deal with any such issues. We expect Nazarbayev to easily win the 2006 presidential election, which will extend his tenure to 2013. Some kind of dynastic succession seems the most likely event after this period.

The recent spate of regime changes in other former Soviet states, such as Georgia, Ukraine and the Kyrgyz Republic has increased speculation about the likelihood of similar events taking place in Kazakhstan. However, in D&B’s view, significant local differences make the likelihood of a ‘democratic revolution’ quite low in Kazakhstan’s case. A key difference between the Kyrgyz Republic, Ukraine and Georgia, and Kazakhstan is the latter’s vastly superior economic prospects (due largely to the country’s abundant natural resources). Rising real incomes, owing to the fast economic growth of recent years should have reduced the capacity for civil unrest. In addition, opposition leaders would need to be confident of gaining a broad level of international (especially US) support before instigating a popular uprising. However, countries with large investments in Kazakhstan would be probably more concerned about preserving stability.

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Macroeconomic Risk

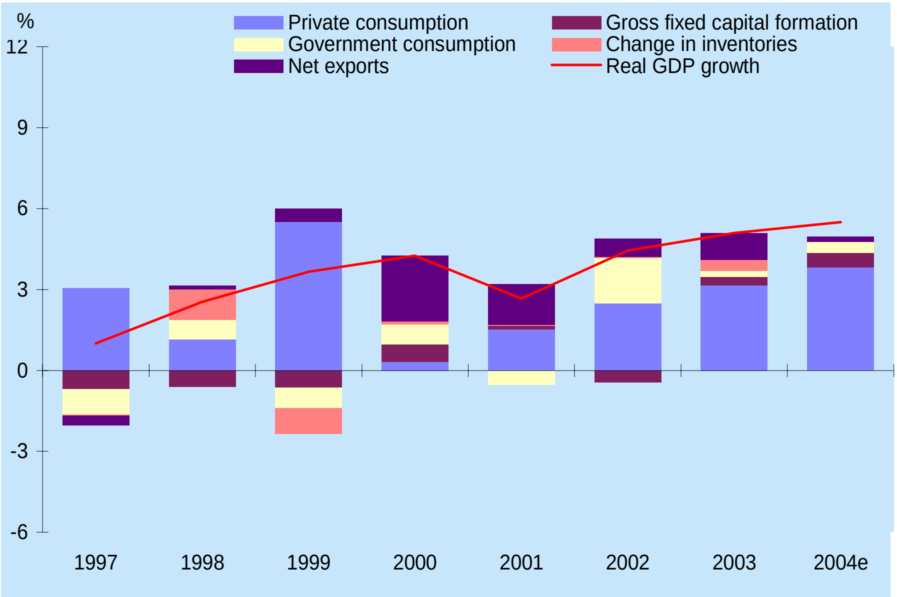
Key Point: As in the recent past, robust private consumption and increasing investment in Kazakhstan's energy sector are expected to underpin strong economic growth over the two-year forecast period. We forecast real GDP growth of 8.5% and 7.3% in 2005 and 2006 respectively.

Short-Term Economic Performance

After four successive years of economic decline following independence, Kazakhstan returned to growth in 1996, driven by a rise in export value and a steady increase in private domestic consumption as Kazakhs started to buy the consumer goods that had been absent in the final years of Soviet rule. However, in the second half of 1998, the fragile recovery was hit by the fallout from the collapse of the Russian rouble, causing real GDP to contract as exports to Russia and other members of the Commonwealth of Independent States (CIS) plummeted. The government's decision to float the tenge in April 1999 saw an immediate depreciation in its value, which improved export competitiveness and, as a result of import compression, helped to regenerate domestic industry. The recovery continued into the next decade with strong private consumption and an energy sector-led investment boom pushing Kazakhstan's average real GDP growth for the four-year period of 2000-03 to an impressive 10.6%.

Chart 1

Yearly GDP Growth Contribution by Demand



Sources: International Monetary Fund, *International Financial Statistics*; Asian Development Bank, *Key Indicators*; European Bank for Reconstruction & Development, *Transition Report*; Reuters; D&B

Rapid economic growth continued in 2004, with real GDP growing by an estimated 9.4%. As in the previous year, this expansion was fuelled by a combination of rising oil prices, expanding oil output, strong private consumption and the continuing surge in energy sector investment. On the supply side, an 11.5% rise in oil production was the main driver of a 10.1% expansion in industrial output. Although poor weather conditions hampered the agricultural sector (+0.1%), this was easily outweighed by continuing strong growth in the services sector (+10.8%), driven in large part by growth in the banking and financial services industries.

National Accounts Data

Recent International Monetary Fund assessments of Kazakhstan's national economic statistics have highlighted significant weaknesses in the quality and timeliness of GDP data. The poor coverage and production of financial statistics adversely impacts on GDP-by-industry data and the IMF notes substantial shortcomings in the estimation of GDP by final expenditure, particularly fixed capital formation. It is therefore of no surprise that GDP estimates by final expenditure are not consistent with GDP estimates by industry. Sizeable statistical discrepancies thus appear in historical GDP growth figures.

Components of Growth

Table 3
Contributions to Growth

	2002	*2003*	*2004e*
Real growth rate (%):			
Private consumption	9.3	8.7	9.0
Gross fixed capital formation	11.2	8.5	10.6
Government consumption	-1.0	8.8	1.4
Exports	-2.0	11.7	20.1
Imports	5.1	8.7	17.2
Real GDP	**9.8**	**9.2**	**9.4**
Share of GDP (%):			
Private consumption	60.3	56.3	51.2
Gross fixed capital formation	24.0	24.0	23.0
Change in inventories	3.3	2.6	2.5
Government consumption	11.5	11.1	10.8
Exports	47.2	48.6	56.6
Imports	-46.3	-42.6	-44.1
Contribution to real GDP growth (percentage point):			
Private consumption	5.7	3.1	4.7
Gross fixed capital formation	2.4	1.9	2.3
Change in inventories	0.4	-0.2	0.2
Government consumption	-0.7	0.9	-0.4
Net exports	1.7	3.7	4.0

Sources: Asian Development Bank, *Key Indicators*; European Bank for Reconstruction & Development, *Transition Report*; *Reuters*; D&B

Private Consumption

In 2003, strong industrial output and general economic buoyancy helped to reduce unemployment and boost real wages, resulting in private consumption growth of 8.7%. In 2004, private consumption is estimated to have grown by 9.0%; as a result of continued strong economic growth with real income per capita growing by 13.0% and the unemployment rate declining to 8.4% by the end of the year from 8.8% at the previous year end. Positively, government public works programmes and measures aimed at supporting small and medium enterprises development helped to boost employment demand in 2004. The increasing availability of bank credit was also supportive for private consumption during the year.

In the two-year forecast period, the outlook for private consumption remains favourable. Strong economic growth and efforts to expand Kazakhstan's oil output capacity will continue to create new jobs and boost real incomes. Government initiatives to reduce urban-rural inequalities, expand social safety nets and diversify the economy should also help to support private consumption. Government efforts to improve living standards are also likely to gain fresh impetus from the presidential election due in 2006. We forecast private consumption growth of 8.2% and 7.5% in 2005 and 2006 respectively.

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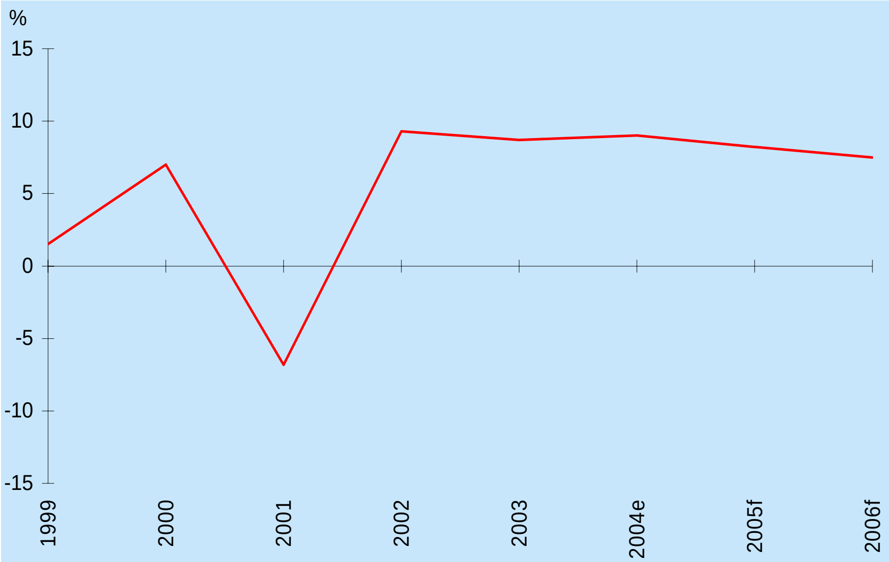
Chart 2
Private Consumption



Sources: International Monetary Fund, *International Financial Statistics*; Asian Development Bank, *Key Indicators*; D&B

Gross Fixed Capital Formation

The accelerated development of Kazakhstan's energy sector (see **Long-Term Economic Potential**) has underpinned the rapid growth of private investment in recent years, while public investment has risen during periods of high oil prices (see **Government Consumption**). Nonetheless, throughout most of the 1990s, fixed capital investment as a percentage of GDP was on a broadly downward path, hindered by the precarious high-inflation environment and the need to import capital goods (from both Western and CIS markets), which had to be paid for in hard currency. Gross fixed investment stood at just 13% of GDP in 1999, having fallen 10 percentage points since 1993.

However, after a period of intense uncertainty in the immediate aftermath of the Russian financial crisis, the economic turnaround that began in mid-1999 (characterised by accelerating exports, stronger industrial production and a more supportive monetary environment) led to a gradual improvement in investor sentiment. Furthermore, large projects in the hydrocarbons sector, notably the construction and upgrade of pipelines and new exploration contracts, prompted a substantial rise in private investment from between 2000-03. In 2004, rapid credit (see **Money Supply**) expansion, and continued efforts to expand Kazakhstan's energy output capacity (both oil and gas) resulted in strong (estimated) fixed investment growth of 10.6%.

Going forward, the overall short-term outlook for fixed capital formation remains strongly positive. Significantly, oil and gas condensate production is expected to rise from 59.4 million tonnes in 2004 to 65.6 million in 2005. Government efforts to strengthen the non-extractive sectors of the economy and key infrastructures should also help to support fixed investment. As a result of these factors, D&B expects fixed investment to grow by 9.7% and 9.0% in 2005 and 2006 respectively.

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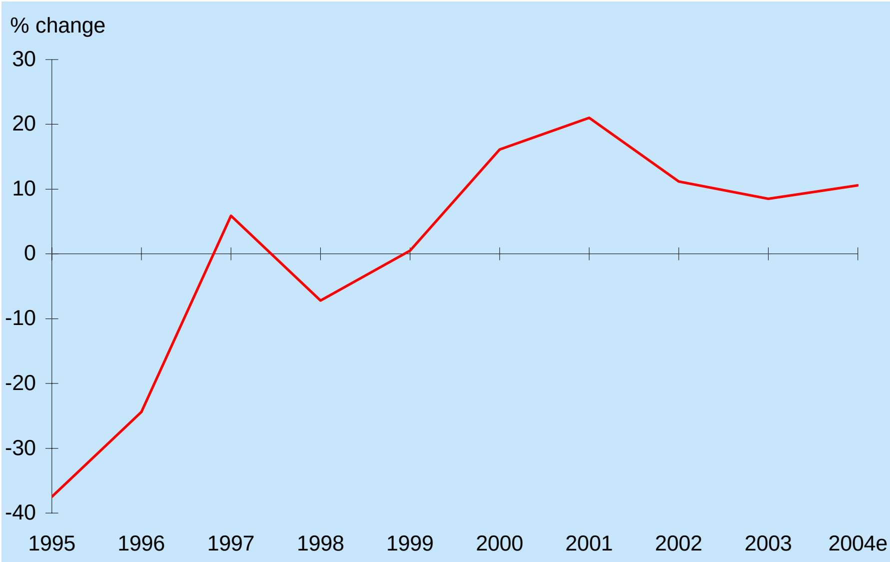
Chart 3
Gross Domestic Investment



Sources: Asian Development Bank, *Asian Development Outlook*; D&B

Government Consumption

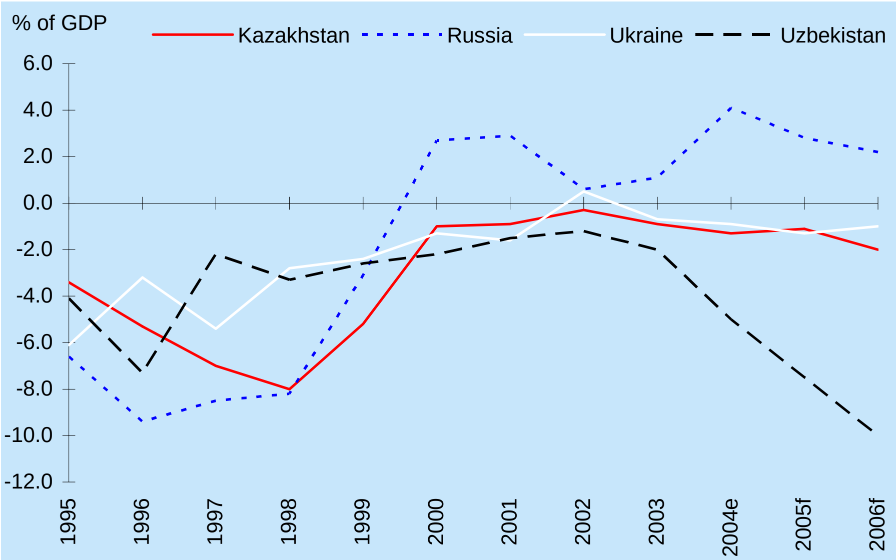
Throughout most of the 1990s Kazakhstan's experienced sizeable fiscal deficits due to due to rising expenditures and substantial revenue shortfalls. An inefficient tax system and poor public fiscal management contributed to weak revenues over this period. IMF-supported measures to improve fiscal management have focused on efforts to strengthen tax collection and administration, rationalise expenditure, overhaul the pension system and accelerate privatisation (see **Commercial Risk**). However, in line with the improvement in economic growth, Kazakhstan's fiscal performance has improved considerably since the start of the current decade, with fiscal deficits amounting to less than 1.0% of GDP in every year between 2000 and 2003.

National Fund for Kazakhstan

Throughout the 1990s, the government consistently failed to save windfalls from the oil sector to protect against periods of relative malaise; if, during periods of high oil prices, the government places a permanent demand on the budget, expenditures will be unsustainable when the oil price falls. However, in August 2001, a presidential decree established the National Fund for the Republic of Kazakhstan (NFK) and, in January 2002, a further decree detailed the role of the NFK: to collect the benefits of high oil prices in order to stabilise the budget during more volatile periods and to save funds for when resources have been depleted (around 2050). The NFK has been divided into a stabilisation fund (to hold not less than 20% of total assets) and a savings fund. The mechanism used by the government to allocate revenues between its central budget and the NFK is complex, involving, among other things, the collection of revenues from 12 companies in the natural resource sector, with funds also being transferred to the NFK from special bonus payments and privatisations in the sector. Total assets of the NFK have grown from USD1.4 billion at the end of 2001 to a USD5.2 billion in April 2005.

In 2004, the general government budget (including savings of oil revenues added to the NFK), recorded a sizeable surplus equivalent to 2.3% of GDP. Even after excluding NFK savings equivalent to 2.6% of GDP, the budget only recorded a very manageable deficit equivalent to 1.3% of GDP, against 0.9% of GDP in 2003. Despite a significant increase in social spending (health, education, welfare and housing), the fiscal balance remained largely under control owing to an even greater increase in revenues reflecting improved tax administration, and sizeable increases in oil and gas related revenues.

Chart 4
Government Balance



Sources: European Bank for Reconstruction & Development, *Transition Report*; D&B

The revised version of the 2005 budget (passed in parliament in May 2005) envisages a higher budget deficit equivalent to 1.7% of expected GDP, reflecting an anticipated widening in the growth differential between revenues and expenditures (with the latter including a sizeable 32% increase in salaries for state employees from the start of July 2005). However, despite higher planned expenditure, in D&B's view, the underlying assumptions of the government's budget are likely to prove too conservative. Based on D&B's forecasts for real GDP growth (8.5% against the government's 8.0%) and the average price for Brent crude (USD51.1 p/b against the government's USD42.0 p/b) we forecast a lower deficit equivalent to 1.1% of GDP in 2005. In 2006, election-related pump priming and a lower oil average oil price (we forecast USD47.5 p/b) will result in a higher deficit equivalent to 2.0% of GDP.

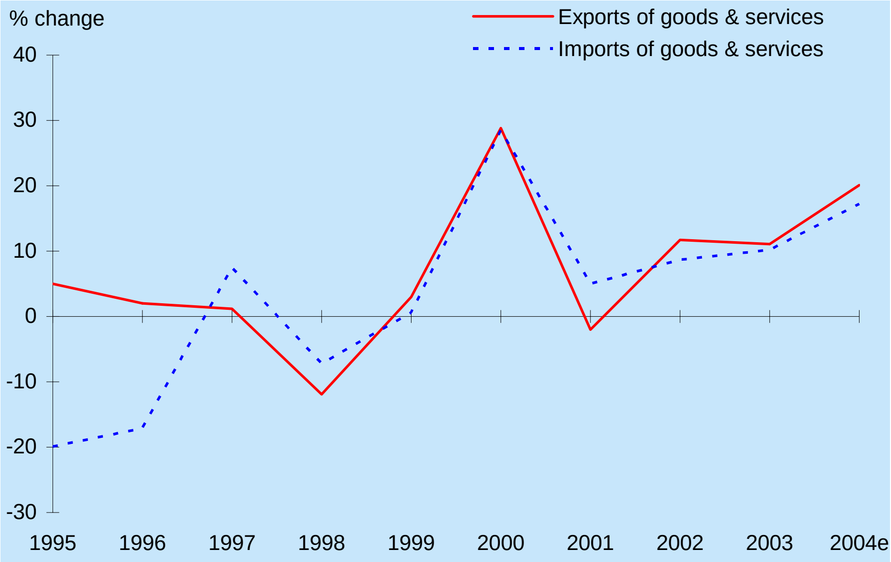
Net Exports

In 2004, merchandise exports (see **External Economic Risk**) surged by 53.7%, driven by expanding output and higher market prices for oil, gas and metals. Reflecting strong domestic demand and Kazakhstan's heavy reliance in imported capital goods, total merchandise imports also grew at a remarkably robust pace of 47%. However, the relatively faster growth rate of exports helped to expand the trade surplus by over 65% to USD7.0 billion. Extrapolating from balance of payments data, we estimate net exports to contribute 4.0 percentage points in 2004.

The upward trend continued in the early part of 2005, with merchandise exports and imports growing by 41% year on year and 37% year on year respectively in the first two months of the year, resulting in a 47% year on year expansion in the trade surplus to USD1.5 billion. As in the previous year, oil was the main driver of exports revenue (accounting for 58% of the total), reflecting both higher average market prices and expanding output. In 2005 as a whole, the government is expecting an 10.4% rise in oil and gas condensate output to 65.6 million tonnes. Meanwhile, D&B is forecasting a further rise in the average price of Brent crude to USD49.1 p/b from USD38.3 p/b in 2004. Despite strong oil prices throughout the forecast period, the growth contribution of net exports is expected to decline in the forecast period due to the continuing strength of import demand.

Chart 5

Export and Import Growth



Sources: International Monetary Fund, *International Financial Statistics*; Synthesis, *Kazakhstan Economic Trends*; Reuters; D&B

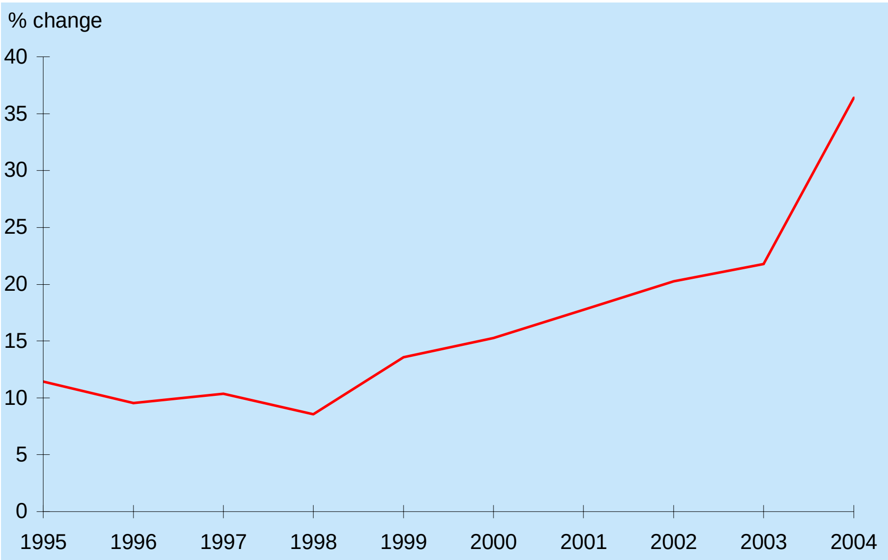
Monetary Environment

Money Supply

Falling interest rates and the rise in the tenge value of the central bank's external assets following the devaluation of the currency in April 1999 spurred a rapid 84% increase in broad money in 1999. Prudent management of the exchange rate (see **Exchange Rate Risk**) and government efforts to prevent inflation spiralling out of control contributed to more moderate money supply growth in subsequent years, with M2 growth declining to 27% by 2003.

Chart 6

Money Supply (M3)



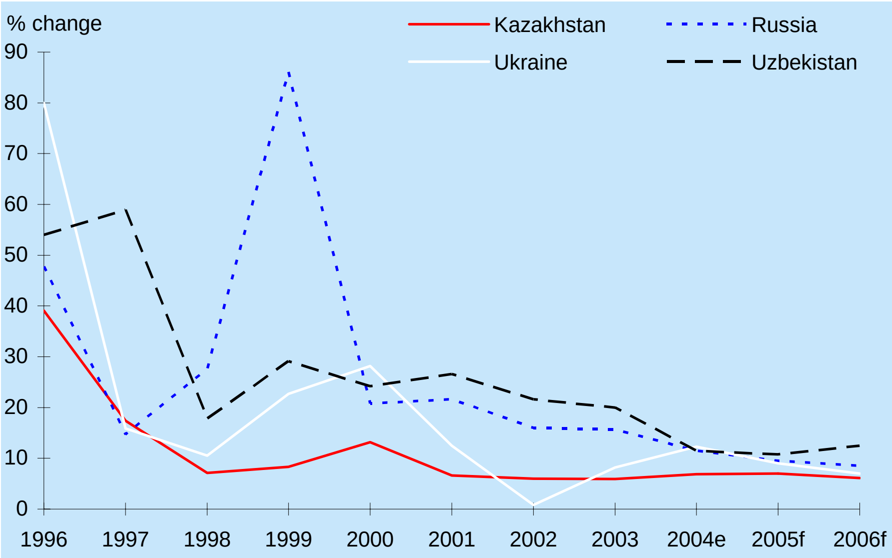
Source: International Monetary Fund, *International Financial Statistics*

In 2004, M2 growth accelerated to 36.4% or 25.8% of GDP as banks stepped up lending activities to consumers and SMEs. Going forward, banks are expected to continue drawing in higher levels of deposits (particularly into foreign exchange-denominated accounts), which will be reflected in stronger bank capitalisation levels and will enable continued strong credit expansion in the future. Although this will be counterbalanced to some extent by moderating economic growth, we still expect the stock of broad money to grow by 20-25% in 2005 and 2006.

Inflation

Kazakhstan's rate of inflation has been on a broadly declining trend since it peaked at 1,157% at the end of 1994: by 1996 annual average consumer price inflation had fallen to 39.1% and was in single figures (7.3%) in 1998. Following the devaluation of the tenge in 1999, (year-end) inflation rose to 17.8%. However, the government's prudent macroeconomic management enabled prices to be held in check, with year-end consumer price inflation (CPI) remaining below 7.0% between 2001 and 2003

Chart 7
Annual Inflation



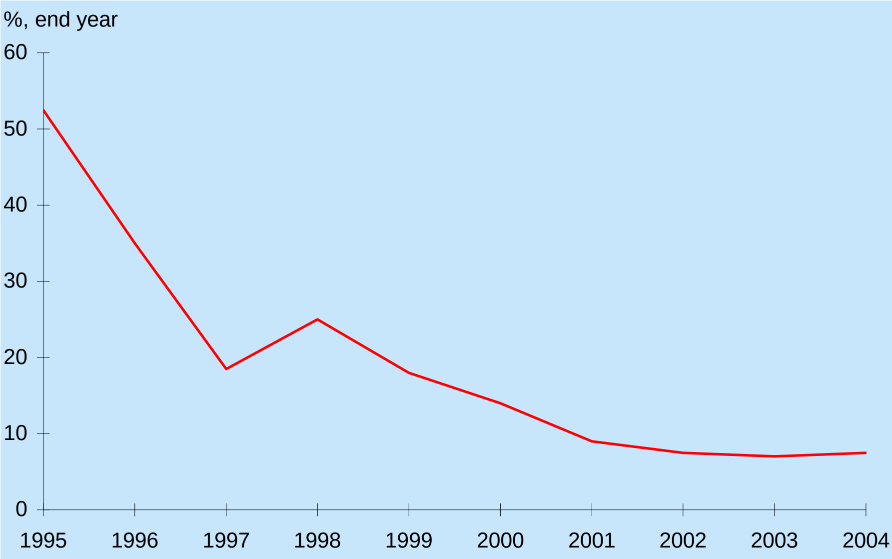
Sources: International Monetary Fund, *International Financial Statistics*; D&B

In 2004, despite strong domestic demand, and rising monetary aggregates, the end of period inflation rate was contained to 6.9%, within the central bank's revised target range of 5.6-7.0%. In first quarter of 2005, inflation accelerated to 1.9% over the previous quarter, prompting the government to increase its 2005 inflation forecast to a range of 5.0-7.0% from 4.9-5.0% previously. In D&B's view the upper end of this range is more realistic: taking into account the inflationary effects of rising real incomes (including planned government salary increases) and the continued rise in numerous cost push factors (such as higher prices for gasoline and transport services); we forecast year-end inflation of 7.0% in 2005. In 2006, moderating domestic demand is forecast to help reduce the (year-end) inflation rate to 6.1%.

Interest Rates

The central bank does not publish information about deposit and lending rates and according to the IMF the economic policy relevance of monetary policy instruments remains limited. Nonetheless, in recognition of the inflationary impact of strong demand and rising money supply, in February 2005, the National Bank of Kazakhstan raised the refinancing rate by 50 basis points to 7.5%. On the commercial front, continued significant spread differences between lending rates and deposit rates are indicative of uncertainties in Kazakhstan's legal environment and the slow pace of structural reforms.

Chart 8
Refinancing Rate



Source: International Monetary Fund, *International Financial*

Short-Term Economic Outlook

Kazakhstan's economy has grown rapidly since 2000, driven by a combination of higher oil exports (owing both to generally rising prices and increasing output), rapid growth in investment and robust private consumption. As in recent years, in 2004 private consumption was supported by falling unemployment and rising real income levels, while investment retained its upward trend, supported by strong industrial activity and continuing expenditures aimed at upgrading Kazakhstan's oil producing and transportation capabilities. Despite strong economic growth, inflation remained broadly under control, with the year-end rate staying below 7.0% in 2004 (as it did in the preceding three years). The fiscal situation also remains basically sound: strong economic growth, high world prices for oil and metals (Kazakhstan's top two export items) and tight expenditure control resulted in a moderate deficit (excluding savings of oil revenues to the NFK) equivalent to 1.3% of GDP in 2004.

Going forward, the authorities are expected to continue following prudent macroeconomic policies, enhancing management of public accounts and maintaining a monetary policy supportive of low inflation and a competitive exchange rate. We expect all components of GDP to make positive contributions to growth over the short term, with overall growth driven in particular by strong private consumption and (energy-related) fixed investment. However, these components of growth will not expand as fast as in recent years; consequently, we forecast real GDP growth of 8.5% in 2005 and 7.3% in 2005, slower than the average 10.5% growth posted between 2001 and 2004. Despite more moderate economic growth, year-end inflation is forecast to edge up to 7.0% in 2005, before declining to 6.1% in 2006. On the fiscal front, we forecast deficits of 1.1% and 2.0% of GDP in 2005 and 2006 respectively (excluding transfers to the NFK); this assessment is predicated on D&B's oil price forecast of USD51.1 p/b in 2005 and USD52.7 p/b in 2006.

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Table 4
Short-Term Economic Forecasts

Forecast	*2005f*	*2006f*
Real growth rate (%):		
Private consumption	8.2	7.5
Gross fixed capital formation	9.7	9.0
Government consumption	1.8	2.5
Exports of goods & services	17.2	13.2
Imports of goods & services	15.2	11.0
Real GDP	**8.5**	**7.3**
Contribution to real GDP growth (percentage point):		
Private consumption	3.4	3.3
Gross fixed capital formation	2.5	2.3
Government consumption	0.9	1.1
Net exports	0.7	0.6
Inflation, end period (%)	7.0	6.1
Discount rate, end period (%)	7.5	7.5

Source: D&B

Long-Term Economic Potential

Kazakhstan has considerable potential for high rates of long-term economic growth. The country has enormous reserves of oil, gas and other raw materials; it lies on a strategic cross-roads between China, the Middle East and Russia; it has achieved a high degree of political stability by regional standards; it has a well-educated and technologically literate population; and the low costs of labour and capital will continue to give the country a significant comparative advantage for many years to come. In addition, Kazakhstan boasts one of the best records in the former Soviet Union for economic reform, although admittedly comparisons are weak.

Since the mid-1990s, the government has generally set about creating a stable environment for economic development, liberalising prices and trade, privatising both small and large firms, reforming the financial sector and integrating itself with the European and global economies. Indeed, the high levels of annual GDP growth seen since 2000 have been based largely on the rapid growth of exports and a high level of inward investment.

Nonetheless, significant obstacles to growth remain. The economy is highly exposed to the volatile Russian market, as evidenced by the recession that followed the collapse of the rouble in 1998. In addition, the economy has yet to diversify and thus remains highly dependent on the volatile global prices of oil and a few raw materials. Meanwhile, disputes over borders, the status and division of the Caspian (see **Hydrocarbons Sector**), smuggling, and the risk of Islamic insurgency in other Central Asian states have strained regional relations, threatening the free movement of goods and people across its borders. Furthermore, the government still has to implement a host of reforms and privatisations, corruption is endemic and the shadow economy, albeit shrinking, remains significant.

Population

In terms of population, Kazakhstan is the fourth largest of the former Soviet republics, with a population of approximately 15 million, significantly less than in either Russia or Ukraine. Kazakhstan's population has declined in recent years, falling by around 1 million during the 1990s. This drop reflects both a dramatic decline in the birth rate and large-scale emigration, particularly of Russians, Ukrainians and other ethnic minorities, since independence. Emigration has hit Kazakhstan hard since these minorities were represented strongly at executive levels

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and in the higher-skilled sectors. However, the downward population trend is set to reverse during the next few decades: according to World Bank figures, the population will stand at 16.9 million in 2050.

Crucially, the overall size of the working population is also set to increase in the long term. If the present rate of employment is sustained, the growth in the numbers of workers has the potential to increase GDP growth by around half a percentage point a year between 2005 and 2014. In addition, labour productivity should rise as a result of further privatisation (and the concomitant improvement in labour-resource allocation), a steady increase in investment in technology and improvements in education and the technological literacy of the population.

The rise in the population over the next ten years will also see a fall in the proportion of dependants (those aged 0-14 and over 64 years old) to workers (aged 15-64), thereby easing the strain dependants place on the fiscal budget. Kazakhstan’s age profile closely matches other transition states in the region, which are expected to experience similarly low dependency ratios in 2010. However, after 2015, this trend is expected to reverse, increasing the burden on government finances.

Technological Progress

Concentration of foreign investment in the oil and gas sector has contributed to two-tier technological development. While foreign investors are aiding the upgrade of technology in the hydrocarbon sector, many other areas of the economy have largely been neglected.

Investment

The contribution that capital investment will make towards long-term growth depends on three main factors: the availability of funds; the propensity of private firms and the government to invest such funds; and the returns secured by the resulting investments. Levels of domestic investment fell significantly between 1994 and 2000. However, the declining trend reversed in 2000 and 2001, as investor sentiment staged an upturn following the uncertainty provoked by the 1998 Russian financial crisis. Going forward, domestic and foreign investment are expected to rise, with accelerated development of the hydrocarbons sector, expansion of the export base and growth of domestic savings facilitating an increase in the level of capital available to private firms.

Over the short term, a rise in the level of savings will continue to be inhibited by low average incomes and a relatively undeveloped banking sector. However, in the medium to long term, the savings rate should rise considerably, as it has done in a number of other transition states. In particular, a steady increase in real wages, as witnessed in recent years, will boost the amount of disposable income, while the continued strengthening of the banking sector should encourage Kazakhs to deposit more money in the country’s banks. In addition, reform of the country’s pension system should contribute to a much higher level of savings as employees pay a compulsory 10% of their wages into retirement accounts. However, in order to raise the savings rate closer to levels seen in the West, Kazakhstan will need to expand both the range of investment products and the attractiveness of the products to the wider population

Hydrocarbons Sector

Prior to independence, Kazakhstan was the largest producer of oil among the Soviet republics after Russia. Although output dropped to just over 400,000 barrels per day (bpd) during the first half of the 1990s, the republic has since begun to realise its huge production potential (with the aid of considerable foreign investment), producing 54.9 million tonnes of oil and gas condensate in 2003 (more than 1 million bpd). Untapped and undiscovered oil reserves are believed to dwarf proven oil reserves, which are estimated to be 17 billion barrels. In perspective, in 2000, Russia's proven reserves stood at 49-53 billion barrels, Mexico's at 28 billion barrels, and those of the United Arab Emirates at 43-98 billion barrels. Meanwhile, Kazakhstan's proven gas reserves amount to 65-70 trillion cubic feet (cf), placing the republic in the top 20 countries in the world in terms of gas resources (in 2000, Uzbekistan's proven reserves stood at around 66 trillion cf, Russia's at 1,700 trillion cf, and those of the US at 167 trillion cf). Kazakhstan also has coal reserves of around 38 billion tonnes and is currently the largest exporter of coal to former Soviet states.

A key issue in the development of Kazakhstan's oil production and export potential has been the division of the Caspian Sea. Bordered by Russia, Kazakhstan, Azerbaijan, Turkmenistan and Iran, the Caspian contains six, largely undeveloped, hydrocarbon basins: total proven oil reserves are estimated at 17-33 billion barrels, but undiscovered reserves could be substantially higher. However, chiefly because of the Caspian's huge hydrocarbon potential, Kazakhstan has been embroiled in a decade of dispute with the other littoral states over the status and division of the sea (prior to 1991, the Soviet Union and Iran divided the Caspian in accordance with long-established bilateral treaties).

An agreement to divide the sea along 'modified medium' lines has been signed with all the former Soviet states involved and licences for oil exploration along these lines have been issued to oil consortia. However, Iran and Turkmenistan are claiming areas under Azerbaijani licence and object to the method of division; crucially, Iran believes the sea should be divided equally. Unless all states can agree, final resolution is unlikely and military force to protect mutually claimed areas cannot be ruled out. Indeed, in June 2001, Iran forced a British Petroleum exploration vessel out of disputed waters, although the area had been licensed to the oil company by Azerbaijan. Nevertheless, in addition to onshore development, Kazakhstan has a number of offshore programmes in operation, including exploration of the potentially lucrative Kashagan block in the Caspian.

The dispute over the Caspian Sea notwithstanding, the hydrocarbons sector is the driving force behind Kazakhstan's economy and will continue in this role for many years to come. Well in excess of USD10 billion has already been invested in oil and gas exploration and exploitation since 1991 and another USD50 billion is expected to be invested over the next 40 years. The early oil investments (in the form of international joint ventures with state oil company Kazakhoil, production-sharing agreements and exploration concessions) are now starting to pay off: oil production increased from 530,000 bpd in 1992 to more than 1 million bpd in 2003 and is expected to reach upwards of 2 million bpd by 2010. The government's frequently stated long-term aim is to more than triple total annual oil production (from current levels) to more than 3 million bpd by 2015.

Major Oil and Gas Fields

A large number of oil and gas fields are already in production, with more expected to come on stream over the next five years. However, the largest share of output, both now and in future years, comes from the Tengiz, Karachaganak and Kashagan fields:

- *Tengiz:* Kazakhstan's largest foreign investment is the USD20 billion Tengizchevroil development, a joint venture between Chevron (45%), Mobil (25%) and Kazakhoil (25%) formed in 1993. Production at the onshore Tengiz field increased from 25,000 bpd in 1993 to around 260,000 bpd in 2002. Production could rise further to 400,000 bpd in 2005 and a peak of 750,000 bpd in 2010, provided sufficient export transportation routes are available.
- *Karachaganak:* The onshore Karachaganak field, under development by the Karachaganak Integrated Organisation (led by British Gas and Agip) since 1998 (in accordance with a USD8 billion final production sharing agreement signed in 1997), has estimated reserves of oil and gas condensate of 2.3 billion barrels

and 16 trillion cf of natural gas (more than 40% of the country's proven natural gas reserves). Production from Karachaganak is expected to reach as much as 350,000-400,000 bpd of condensate in the next few years.

- *Kashagan:* In 2000, the Offshore Kazakhstan International Oil Company (since named the Agip Kazakhstan North Caspian Operating Company, Agip KCO) made a major discovery in the Kashagan block off Kazakhstan's Caspian coast. Italian ENI (Agip's parent company) won the battle to operate the Kashagan field in February 2001. Since then, Agip KCO has discovered oil in a second well (Kashagan West). Although production is now not expected until 2008, a June 2002 estimate by Agip KCO suggested that the Kashagan field has 7-9 billion barrels of proven reserves and around 38 billion barrels of probable reserves, almost eight times the conservative estimate (5.4 billion barrels) of the country's total proven reserves. Based on these estimates, Kazakhstan could eventually become one of the top five oil producers in the world.

However, in addition to disputes over the legal ownership of the Caspian, and battles between energy companies for operating and exploration rights (often involving protracted discussions with the government), Kazakhstan's energy industry also has to contend with the very considerable problem of how to get its output to the market. Kazakhstan's traditional dependence on Russia for a significant proportion of oil and gas exportation (under the Soviet Union, all of the republic's oil flowed through pipelines that were integrated into the Russian system) has obstructed the development of the hydrocarbon sector. Correspondingly, development of new pipelines has been an important policy objective of the Kazakh government.

Oil and Gas Pipelines

Following independence in 1991, it became clear that land-locked Kazakhstan was unable to export significant volumes of oil or gas independently of other former Soviet republics and was therefore hostage to external political and commercial decisions, including tariff charges on the use of transportation routes. Over the past decade, sea and rail transportation has been used to export oil across the Caspian, through Azerbaijan, Georgia and/or Russia and across the Black Sea. However, despite the opening of the Tengiz-Novorossiysk pipeline in late 2001, a substantial proportion of Kazakh oil continues to exported via the Atyrau-Samara pipeline, through the Russian pipeline system.

As regards gas, there are currently no pipelines linking Kazakh gas fields directly with consumers. Consequently, Kazakhstan is presently a net importer of gas through a multi-country pipeline system; this makes gas power susceptible to supply disruption.

The Tengiz-Novorossiysk CPC Pipeline: The Caspian Pipeline Consortium's (CPC) USD2.5 billion, 990-mile pipeline connecting Kazakhstan's largest operational oil field with the Russian Black Sea port eventually became operational in November 2001. The completion of the CPC pipeline was a milestone in Kazakhstan's economic history because, for the first time, it gave it an export route that was outside the control of Russian state oil pipeline operator, Transneft (which only has a limited stake in the project). The CPC pipeline has a current capacity of more than 560,000 bpd; planned upgrades could boost increase the pipeline's capacity to as much as 1.3 million bpd by 2010.

Baku-Tiblisi-Ceyhan (BTC) Pipeline: In September 2002, construction began on the 1,730 kilometre BTC Pipeline, connecting the Azerbaijani port of Baku to the Turkish Black Sea port of Ceyhan, via Tbilisi in Georgia. The project is estimated at USD2.9 billion, to be funded by the Turkish, Georgia and Azerbaijani governments, as well as BP-Amoco, multilateral institutions and other private investors. The BTC is expected to open in latter part of 2005; when complete it should be able to carry 50 million tonnes a year. Negotiations for the construction of the controversial pipeline took years, with considerable political and commercial obstacles. Although at present Kazakhstan has no direct involvement in the BTC project, government officials have hinted at various times that they may consider committing Kazakh oil via the BTC pipeline in the future. Any such agreement would probably require Kazakh oil to be shipped across the Caspian from the port of Aktau to Baku (for reloading onto the BTC pipeline).

The Sino-Kazakh Pipeline: In late 2004, work began on a 3000 kilometre long pipeline linking Atasu (eastern Kazakhstan) to Dushanzi in China's Xinjiang province. The whole Sino-Kazakh pipeline will cost about USD3 billion and at its planned time of completion in 2011 could be capable of delivering around 20 million tons of Caspian Sea crude oil annually to western China. However, the most important segment of the Sino-Kazakh pipeline, the 1,000 kilometre long Atasu-Alashankou section (capable of delivering 10 million tonnes of crude oil to China annually) is scheduled for completion by the end of 2005.

Other pipelines still in the negotiation and planning stages are:

Trans-Caspian Gas Pipeline: To run from Turkmenistan to Erzerum in Turkey, via Baku, the Trans-Caspian pipeline is still in the early design stages and is likely to involve many more years of protracted discussions.

Central Asia Oil Pipeline: Still very much in the theoretical stages, an eastward oil pipeline (from Kazakhstan via Turkmenistan and Afghanistan to Pakistan) to meet South Asian energy demand is being discussed. However, given the immense political and security considerations, in addition to the vast cost of such a project, D&B does not expect this pipeline to become a reality for at least another 15 years, if at all.

Long-Term Economic Outlook

Assuming that the Kazakh government continues to maintain sound relations with foreign investors, particularly in the energy sector, and that the capacity to export oil and gas by pipeline, train and ship keeps pace with production, the energy sector is likely to expand dramatically over the medium to long term, contributing to annual long-term economic growth rates in excess of 6%. The resulting surge in oil revenues also has the potential to transform the country's economic base, provided it is used prudently. However, economic growth will be inhibited if the government fails to use its oil wealth to develop the country's infrastructure or demurs on its programme of liberalisation and restructuring such that the country becomes wholly dependent on one source of income. Furthermore, should the volatile oil price fall dramatically, putting into question the viability of oil extraction and transportation routes, development of the hydrocarbon sector could slow significantly, with a knock-on effect on hydrocarbon-dependent sectors and other industries being developed with the aid of revenues and investment from the oil and gas sector.

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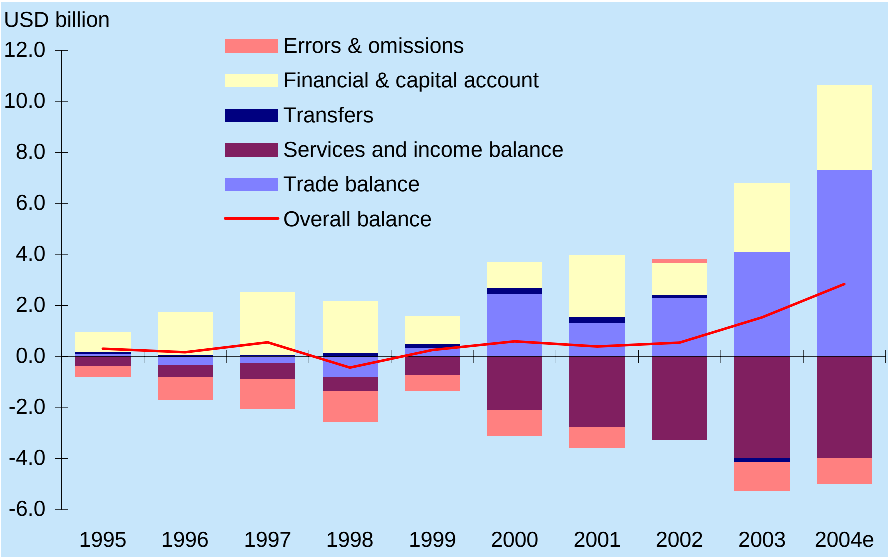
External Economic Risk

> ***Key Point:*** Kazakhstan's external outlook is fundamentally positive: rising oil output and high market prices for the country's major commodity exports will support small current account surpluses equivalent to 0.7% and 0.2% of GDP in 2005 and 2006 respectively.

Balance of Payments Performance

Kazakhstan has traditionally registered balance of payments surpluses, with the current account recording a deficit and the financial and capital account posting a surplus. Indeed, since 1995, annual balance of payments surpluses of between USD0.16 billion (0.8% of GDP) and USD1.5 billion (4.7% of GDP) have been recorded, with 1998 the only exception (when a deficit of USD0.44 billion, 2.0% of GDP, was posted). Nevertheless, the external accounts remain highly vulnerable to changes in the hydrocarbons sector, including oil and gas prices, the development of new fields and the construction of transportation links (see **Long-Term Economic Potential**).

Chart 9
Balance of Payments



Sources: International Monetary Fund, *International Financial Statistics*; Reuters; National Bank of Kazakhstan; D&B

In the unlikely event of a withdrawal of foreign investment from the oil and gas sector, the reduction in imports of capital goods and remittances outflows from foreign workers would probably not balance out losses on the financial account. Consequently, in addition to the adverse implications for the wider oil and non-oil economy, D&B would expect this scenario to result in a significant downturn in the overall balance of payments and a rapid rise in the risk of default.

Current Account

Kazakhstan has run a current account deficit virtually every year since independence as a result of limitations in its export capacity and, more recently, increased demand for imports of capital and consumer goods. This deficit has been encouraged by the readiness of foreign institutions to lend funds to Kazakhstan to purchase the equipment necessary for developing its capital stock and infrastructure and by the substantial capital goods imports destined for the oil and gas sector.

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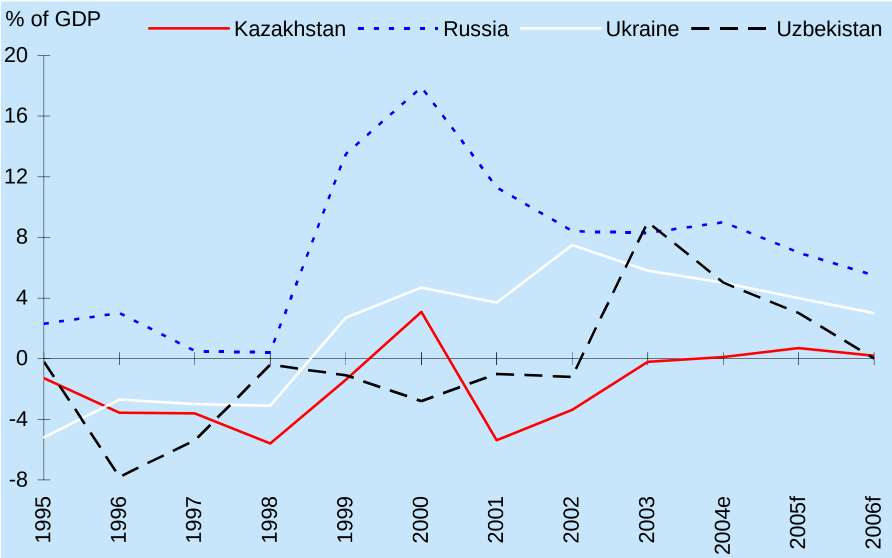
The deficit reached its widest point in 1998 (USD1.2 billion, 5.6% of GDP) as a result of the economic downturn in Commonwealth of Independent States (CIS) economies prompted by the Russian financial crisis and global oil price weakness. However, the devaluation of the tenge and an upturn in oil prices narrowed the deficit in 1999 with same factors helping to create a surplus in 2000 (the only recorded surplus since independence). However, the next two years saw the return of the deficit.

In 2003, merchandise exports soared by 32%, due mainly to further oil output growth (total oil and gas condensate output increased by 8.6% to slightly above the landmark 1 million barrels per day level) and significantly higher oil prices averaging USD28.8 per barrel (p/b). Although imports also grew at the fast pace of 18.4%, this was easily outweighed by faster export growth, resulting in a narrowing of the current account deficit to 0.2% of GDP. In 2004 merchandise export growth accelerated to 53.7%, reflecting further increases in oil production and prices (the market price of oil averaged USD38.3p/b in 2004). Increases in prices and the output of other key commodities such as metals and natural gas also helped to increase the trade surplus to USD7.3 billion from USD4.6 billion in the previous year. In turn, the increased trade surplus helped Kazakhstan achieve an overall current account surplus of USD0.2 billion (around 0.1% of GDP).

Chart 10

Current Account Balance



Sources: International Monetary Fund, *International Financial Statistics*; D&B

Going forward, in 2005, Kazakhstan's trade and current account balance should be supported by strong oil prices and further oil output expansion: we expect an average oil price of USD51.1p/b (see **Global Economic Outlook**), while oil and gas condensate output is expected to easily match (and possibly exceed) the government's annual target of 65.6 million bpd (representing a 10.4% increase over 2004 output). Despite these positive factors, export growth is likely to be largely counterbalanced by substantial growth in oil-related capital imports. On balance, we forecast a small current account surplus, equivalent to 0.7% of GDP in 2005.

Positively, exports in 2006 will continue to be supported by higher production and a slightly higher average oil price (USD52.7 per barrel). However, given the continuing strength of domestic demand, we are still forecasting a slightly lower current account surplus of around 0.2% of GDP in 2006. Given the continuation of strong import demand for consumer and capital goods, we forecast a lower current account surplus of around 0.2% of GDP in 2006.

Export Profile

Kazakhstan's primary exports, oil and gas condensate (mineral products) and metals contributed USD8.3 billion and USD2.6 billion to exports in 2003 respectively, compared with USD5.9 billion and USD2.2 billion in 2002. Although data for 2004 were unavailable at the time of writing, the rankings of goods by share of total exports is unlikely to have changed much from 2003. Continued expansion in the share of mineral products is to be expected given the higher volume and value of oil exports. However, the dominance of raw materials, in particular fuel and metals, indicates the extent to which Kazakhstan is still reliant on a narrow basket of export commodities, thus highlighting its vulnerability to changes in commodity prices, particularly of oil, gas and metals. As such, diversification of the country's export base will remain a key policy objective for the Kazakh government over the medium to long term.

Table 5

Principal Exports

% of total exports	*2002*	*2003*
Mineral products	61.2	64.3
Base metals & related articles	23.1	20.4
Chemical products	4.3	3.4
Vegetable products	4.2	5.1
Pearls, precious stones	2.8	1.9
Machinery & electrical equipment	1.2	1.2
Textiles & related articles	1.2	1.2

Source: Asian Development Bank, *Key Indicators*

A decade on from the collapse of the Soviet Union, Kazakhstan's primary export market is still Russia. However, export destination figures for the past five years suggest that Kazakhstan may gradually be reorienting away from many of its direct neighbours in favour of more industrialised economies. As Kazakhstan slowly disentangles itself from Soviet era, Russia-dependent infrastructure, particularly oil and gas pipelines and refineries (see **Long-Term Economic Potential**), a shrinking proportion of Kazakh exports is likely to be destined for its northern neighbour. In theory, Kazakhstan is in an ideal geographical position to mitigate losses during periods of regional malaise by switching exports to other regions where it can demand a higher price for its exports.

Table 6

Exports by Destination

% of total exports	*2002*	*2003*
Russia	15.5	16.5
Bermuda	20.8	16.5
China	10.6	11.2
Italy	9.4	3.8
Switzerland	8.2	6.7
Germany	2.3	8.1
Ukraine	3.0	2.4
UAE	4.9	3.8
Iran	3.2	2.5
Poland	3.3	2.6

Source: International Monetary Fund, *Direction of Trade Statistics*

Import Profile

Imports of machinery and electrical equipment accounted for well over a quarter of all imports in 2003. This reflects the high import dependency of the hydrocarbon sector throughout its various development stages. Growing demand in this area is also a result of the notable expansion of Kazakhstan's oil and gas capabilities over

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recent years. Similarly, the lack of cross-country transportation routes means that imports of transportation equipment also rank highly in Kazakhstan's import profile (see **Long-Term Economic Potential**).

Table 7

Principal Imports

% of total imports	*2002*	*2003*
Machinery & electrical equipment	28.6	25.6
Mineral products	12.5	12.0
Base metals & related products	11.2	11.8
Chemical products	10.9	10.8
Transportation equipment	12.2	14.5
Prepared foodstuffs	5.1	5.1
Plastics & rubber	4.1	4.3

Source: International Monetary Fund, *Kazakhstan: Selected Issues and Statistical Appendix*

In terms of geographical composition, Kazakhstan remains dependent on Russia for over a third of its total goods imports. However, other former Soviet states and Central-Eastern European countries are no longer included in the republic's top ten import markets, together accounting for only around a tenth of Kazakhstan's imports in 2003. Meanwhile, imports from China saw a sharp increase in 2003, jumping from below 5% of total imports in 2002 to 18.7% of the total.

Table 8

Imports by Source

% of total imports	*2002*	*2003*
Russia	38.7	34.9
Germany	8.9	8.9
China	4.8	18.7
US	7.0	2.0
UK	3.9	2.0
Italy	3.3	2.8
Turkey	2.6	2.3
Ukraine	3.3	2.7
France	1.7	3.7
Japan	2.5	1.5

Source: International Monetary Fund, *Direction of Trade Statistics*

Financial and Capital Account

The financial and capital account (excluding errors and omissions) has enjoyed annual surpluses (between 4.3% and 11.1% of GDP) since the mid-1990s, chiefly due to sizeable net foreign direct investment (FDI) inflows and, to a lesser extent, foreign borrowing (see **Foreign Debt and Default Risk**). After reaching a record high of USD2.5 billion in 1997, the financial and capital account surplus fell steadily in each of the following three years, declining to USD1 billion by 2000. However, reflecting the steady increase in FDI) by 2003 the financial and capital account surplus had increased to USD2.7 billion (8.5% of GDP). In 2004, a record inflow of FDI is estimated to have increased the capital and financial account further to around 10.0% of GDP.

Foreign Direct Investment Flows

As the key component of the financial and capital account surplus, FDI in Kazakhstan is crucial in maintaining balance of payments stability. Given oil price volatility, and the endemic problems related to doing business in Kazakhstan, it is fortuitous that FDI is significantly less sensitive to short-term downturns than portfolio investment. Moreover, with the vast proportion (over 60% between 1993 and 2004) of FDI accounted for by the oil and gas sector (two commodities

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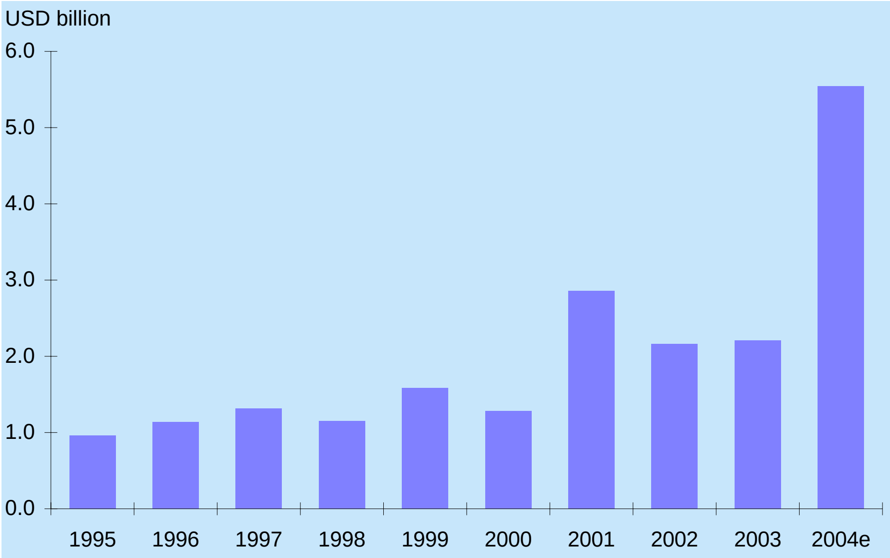
benefiting from highly inelastic demand), FDI in Kazakhstan is expected to remain resilient, in spite of problems in the investment environment (see **Investment Environment**).

Chart 11
Foreign Direct Investment Inflows



Source: International Monetary Fund, *International Financial Statistics*

In 2004 net FDI is increased to record a high of USD5.5 billion (estimated) from USD2.2 billion in the previous year, bringing cumulative net FDI in Kazakhstan since 1993 to in excess of USD21 billion. Looking forward, the short-term outlook for FDI in Kazakhstan seems assured by various unexplored energy prospects (such as Kashagan, see **Major Oil and Gas Fields**) and the US government's stated desire to reduce the US' reliance on oil from the Gulf states (US firms are responsible for around a third of all FDI in Kazakhstan since 1993).

Equities

The Kazakhstan Stock Exchange (KASE), in operation since September 1997, is a universal financial market, with trading in foreign exchange, government securities (including supranational bonds), corporate shares and bonds, and derivatives. However, given its very small market capitalisation of around USD1 billion and the lack of investor confidence in relevant legal provisions, the KASE does not represent a realistic source of funding for Kazakh firms. Equally, foreign investment in Kazakh equities is also almost non-existent.

Debt

Kazakhstan almost certainly has the most sophisticated bond market out of all of the former CIS states. Reflecting the general decline in global interest rates (over the period) and growing confidence in Kazakhstan's economic fundamentals, the yield on the US dollar-denominated Global 2007 bond fell from around 10.5% in 2000 to below 4.0% in mid-2003. In addition, the Kazakh corporate bond market has experienced rapid development since the first issuance in 2000, benefiting from the success of the country's pension system, which has accumulated USD2 billion in funds since 1998. In the absence of alternative investment options (the stock market remains an unviable alternative) these pension funds have helped to create demand for new corporate issues.

Bank Lending

Bank loans to Kazakhstan stood at around USD1 billion in 1997-99. After declining markedly in 2000, the stock of loans recovered again to around USD1 billion by the end of 2001. More recently, growing confidence in the Kazakh economy and the growing capital requirements of the country's booming oil industry have been helped to expand the outstanding stock of loans (to USD2.8 billion as of September 2004).

Table 9

Maturity and Sectoral Distribution of Bank Lending to Kazakhstan

USD million	***Mar-04***	***Jun-04***	***Sep-04***
Maturities:			
Up to and including one year	2,856	2,280	2,041
Over one year and up to two years	119	122	62
Over two years	686	817	710
Unallocated	152	118	69
Total	**3,813**	**3,337**	**2,882**
Sectors:			
Banks	2,211	2,014	1,697
Public	303	199	259
Non-bank private sector	1,299	1,122	926
Unallocated	0	2	0
Total	**3,813**	**3,337**	**2,882**

Source: Bank for International Settlements, *International Banking and Financial Market Developments*

Foreign Debt and Default Risk

Kazakhstan renounced any claim to liabilities generated by the Soviet Union on independence, transferring all debt and some disputable assets to the Russian Federation. Since then, the country has borrowed only modest sums from abroad. In the mid-1990s, poor management of borrowings and the issuance of government guarantees for trade credits and loans to the public and private sectors caused the republic to encounter some debt problems, but this was essentially an issue of bureaucracy and weak governance rather than insufficient funds.

Aided by international financial institutions, debt management has since improved. Although total external debt as a proportion of GDP has been on an upward trend since 2001, this has mainly been due to the accumulation of private (i.e. commercial debt not guaranteed by the state), which stood at an estimated USD32.0 billion at the end of 2004. Favourably, risk related to corporate sector debt is mitigated considerably by the fact that most of it is linked to Western-backed oil and gas investment projects, which presumably have been planned to generate sufficient resources to finance associated interest and amortisation costs.

Meanwhile, in terms of public debt, Kazakhstan's track record is clearly positive: since 1998, the proportion of public debt (including liabilities guaranteed by the government) as a percentage of total external debt has declined from 40.3% to an estimated 13.1% at the end of 2004. Kazakhstan's external debt profile has also been aided by the fact that the vast majority of its debt is of a medium- or long-term nature, much of which has been lent on concessionary terms. In addition, the real burden of US dollar-denominated external debt (both public and private) has also been eroded by the strength of Kazakh currency in recent years (see **Exchange Rate Risk**).

Table 10

Foreign Debt

	2001	2002	2003e	2004e
Non-gaurenteed external debt	11.4	14.7	19.2	28.3
Total public external debt	3.8	3.5	3.6	3.7
Total external debt, end of period (USDbn)	**15.2**	**18.2**	**22.9**	**32.0**
Total external debt (% GDP)	**68.4**	**73.9**	**76.8**	**68.9**

Sources: National Bank of Kazakhstan, D&B

Improving macroeconomic stability and external liquidity (including a stable public debt profile) have prompted a number of agencies to upgrade Kazakhstan's ratings. In October 2002, international rating agency Moody's Investors Services upgraded Kazakhstan by two notches to Baa3, thus making Kazakhstan the first country in the CIS to achieve investment grade status. In May 2004, Standard & Poor's also upgraded Kazakhstan's long-term sovereigns rating to BBB-, with a stable outlook (investment grade). Citing the government's improved creditworthiness, in October 2004, Fitch Ratings became the last of the major rating agencies to upgrade Kazakhstan's long term foreign currency rating to investment grade. Going forward, Kazakhstan's external debt performance should remain broadly positive over the two-year forecast period, subject to the following conditions:

- maintenance of prudent fiscal policy, including the continued diversion of oil-related revenues into the National Fund;
- continuing strong FDI inflows into the financial and capital account, contributing to balance of payments stability;
- no significant deterioration in international sentiment towards Kazakhstan that would substantially influence interest rates on existing debt or reduce access to capital markets; and
- exchange rate stability (see **Exchange Rate Risk**), ensuring no substantial rise in the value of hard currency-denominated debt.

It should be noted that given the sensitivity of the fiscal and external accounts to oil prices and Kazakhstan's inability to reduce such vulnerabilities substantially over the short term, a sharp drop in the global oil price could cause many, if not all, of the above assumptions to falter in a relatively short space of time. In the event, National Fund assets (currently estimated at USD3.7 billion) and foreign exchange reserves could provide a temporary cushion, but continued ability to service debt obligations would depend on the duration of the downturn, the extent of the drop in the oil price, the government's ability to reschedule fiscal spending and compress imports, and the durability of foreign direct investments.

Foreign Exchange Reserves

In line with rising oil revenues, Kazakhstan's stock of foreign exchange reserves has risen significantly since independence. Despite slight depletion in 1998 (when the Russian financial crisis led to a relatively high current account deficit) as of April 2005, reserves stood at USD8.7 billion (including gold but excluding the assets of the National Fund, see **National Fund for Kazakhstan**), up from USD0.6 billion in 1993. This was sufficient for 7.3 months of import cover and above the widely recognised 3.0-month figure regarded as safe by the International Monetary Fund (IMF). Higher oil output, strong oil prices and increased borrowing from abroad are expected to push central bank foreign currency reserves steadily higher in the two-year forecast period.

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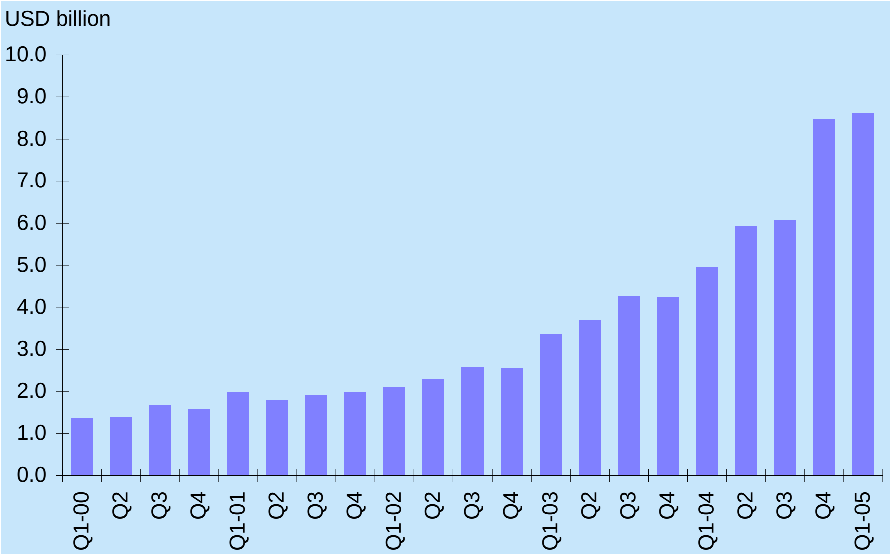
Chart 12
Foreign Exchange Reserves



Source: International Monetary Fund, *International Financial Statistics*

Exchange Rate Risk

Exchange Rate Regime

The central bank has the stated aim of adhering to a floating exchange rate system. Nevertheless, since mid-2000, it has intervened several times in the money market in order to avoid the 'Dutch disease' scenario, whereby a sharp rise in exports from one sector (in Kazakhstan's case, oil) causes the exchange rate to appreciate to the extent that other exporting industries become uncompetitive internationally. Since the second half of 2000, prudent macroeconomic management of fiscal accounts and declining inflation have supported the central bank's efforts to maintain the stability of the tenge vis-à-vis the US dollar and, crucially, to prevent the real appreciation of the tenge against the Russian rouble, thereby maintaining competitiveness against the country's key trading partner.

Exchange Rate Trends

With the aid of central bank interventions in the money markets and a strengthening domestic economy, the stability of the tenge has improved in recent years. After a sharp 18.9% nominal decline against the US dollar in 2000, the tenge fell by a nominal 3.2% and 4.4% in 2001 and 2002 respectively (to average annual rates of KZT146.7:USD and KZT153.3:USD). However in 2003 and 2004, the tenge strengthened against the US dollar by 12.6% and 15.3% in real terms, driven by large export earnings and foreign exchange flows stemming form from increased private borrowing and FDI. The expected persistence of these factors is likely to maintain upward pressure on the tenge during the two-year forecast period.

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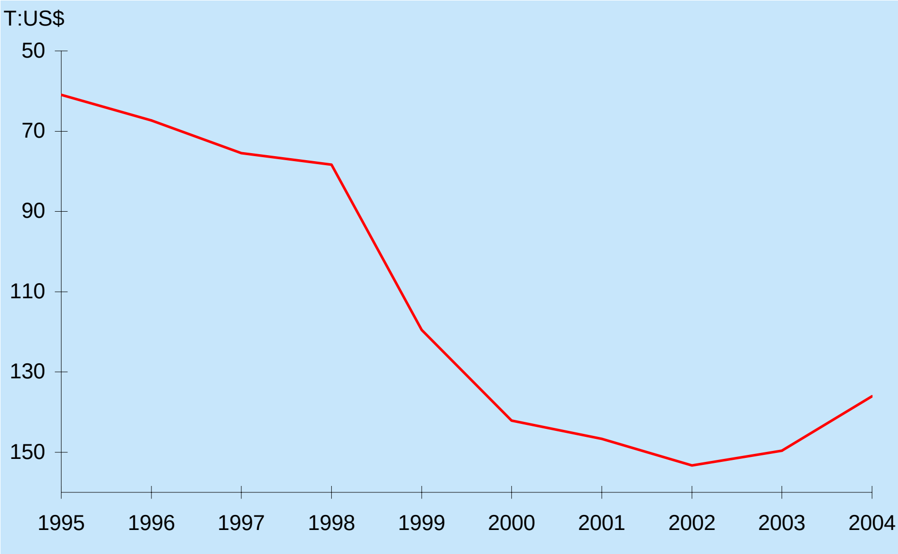
Chart 13

Tenge:US Dollar Exchange Rate (Inverted Scale)



Source: International Monetary Fund, *International Financial Statistics*

External Economic Outlook

Kazakhstan's broadly positive short-term external economic outlook is predicated on the following key assumptions:

- relatively strong global oil prices of USD51.1p/b and USD52.7p/b in 2005 and 2006 respectively;
- the continued expansion of Kazakhstan's oil production and transportation capabilities, and the ongoing inflows of FDI entailed by this;
- the absence of external shocks that would prevent Kazakhstan from continuing its positive economic trend.

Table 11

External Forecasts

% of GDP	*2005f*	*2006f*
Current account balance	0.7	0.2
Financial & capital account balance	4.7	5.3
Overall balance of payments	5.4	5.5
Import cover (months)	7.3	7.7

Source: D&B

As a result of rising oil output and high market prices for Kazakhstan's major commodity exports (oil, metals and gas), in 2005 the current account surplus is forecast to rise to 0.7% of GDP from 0.1% of GDP in 2004. In 2006, oil output will continue to rise and oil prices will remain strong. However, due to strong domestic demand and weaker global demand, we still forecast a small reduction in the current account surplus to 0.2% of GDP in 2006. The stock of external debt will continue to rise in the forecast period, although this will mainly be due to the accumulation of private debt (i.e. commercial debt not guaranteed by the state). On the currency front, upward pressures on the tenge will persist in the forecast period due to a combination of strong export earnings and higher foreign exchange flows stemming from increased private borrowings and FDI.

Trade Environment

Key Point: Kazakhstan's trade environment is relatively open and there are no major official restrictions to doing business in the republic. The external trading regime is being brought into line with international practices as part of the country's efforts to integrate into the world economy.

Trade Overview

In the aftermath of the collapse of the Soviet Union in 1991, Kazakhstan, like all the other former Soviet republics, experienced a number of acute external shocks. First, trade with the other republics became subject to international border controls; second, the other republics began to charge world market prices for the goods they exported to Kazakhstan; and third, Kazakhstan lost the trading partnerships provided by the Council for Mutual Economic Assistance, which collapsed in the early 1990s when its constituent members began to insist on hard currency trade payments.

However, since then Kazakhstan has succeeded in establishing one of the most liberal trading regimes out of the 12 countries in the Commonwealth of Independent States (CIS). Moreover, while Russia remains the country's most important trading partner, Kazakhstan shows signs of re-orienting a larger amount of its trade towards Europe, China and the rest of the world (see **Export Profile** and **Import Profile**).

Kazakhstan has been a World Trade Organisation (WTO) accession candidate since 1996. Its bid stalled in October 1998, but regained some momentum in 2001 following the fourth working party meeting in July that year. Nevertheless, the republic must make significant improvements in order to gain membership, including tariff changes, improved market access to services and the abolition of restrictions on the employment of foreign labour. Although membership efforts were aided by the US' decision to upgrade Kazakhstan to 'market economy' status in 2002, accession to the WTO is unlikely to occur in the two-year forecast period.

Current Account Exchange Regulations

Kazakhstan has adopted the obligations of Article VIII, Sections 2, 3 and 4 of the International Monetary Fund's (IMF) Articles of Agreement. Countries accepting these obligations agree not to impose restrictions on the making of payments and transfers for international transactions, or engage in discriminatory currency arrangements or multiple currency practices without IMF approval.

The National Bank of Kazakhstan controls exchange transactions, supervises authorised banks, regulates open foreign exchange positions and has the authority to reintroduce surrender requirements. In 1998 the central bank introduced legislation that permitted the payment of wages in foreign currency. Foreign companies are also free to repatriate tenge earnings made inside Kazakhstan.

Tariff Barriers

Kazakhstan has adopted the international tariff nomenclature as the basis of its tariff schedule; however, a full tariff schedule has yet to be published. Tariff rates change frequently and corruption is a serious problem among customs officials. The average weighted import tariff is approximately 9%, and the number of tariff lines with rates above 20% has been reduced to below 40. Kazakhstan's relatively low average import tariff is explained by the fact that trade with Russia (Kazakhstan's main trade partner) is duty free, pursuant to its membership of the five-country Eurasian Economic Community (EAEC, formerly known as the Customs Union agreement). However, as is the case with its trade with the other former Soviet republics, the

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government reserves the right to impose ad hoc restrictions, either for political reasons or to protect against cheap foreign goods flooding the domestic market.

The Customs Code (updated in April 2003) gives a description of the duties of the customs administration body and includes general provisions relating to the variation of customs fees (including special customs and anti-dumping fees). Each year customs issues a new set of order regulations and instructions. However, these documents are frequently not published, complicating the customs process and increasing the scope for error and graft. Similarly, lack of adequate instruction or regulation in relation to the implementation of customs exemptions has opened this area up to ad hoc and non-transparent interpretations by customs officials, thereby adding to the pre-existing problems of excessive red-tape and widespread corruption.

Licences

The government has removed the need for import licences on most commodities. However, for health and security reasons, a number of imported commodities, such as pesticides, medicine, drugs, nuclear materials, certain chemicals and industrial waste are subject to licensing requirements. Import licences are granted by the Ministry of Economic Relations.

Trade Agreements

In May 1992, the US and Kazakhstan signed a trade agreement providing for reciprocal most-favoured-nation (MFN) tariff treatment of products of both countries. In April 2002, Kazakhstan became the first former Soviet state to be granted the higher status of ‘market economy’ by the US, enabling a deeper development of bilateral ties. Meanwhile, the republic has secured trade and co-operation agreements with the EU, as well as a bilateral trade agreement with Uzbekistan and multilateral trade and border agreements with the Kyrgyz Republic, China and Pakistan. In addition, Kazakhstan belongs to the Economic Co-operation Free-Trade Area (ECO), established in 1992, which also includes Afghanistan, Azerbaijan, Iran, the Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan and Uzbekistan. Members have agreed to economic co-operation, including tariff reduction.

Kazakhstan is a member of the EAEC, along with Belarus, the Kyrgyz Republic, Russia and Tajikistan; Moldova and Ukraine currently have observer status. Trade among the five EAEC countries is generally duty free but protective measures may be applied between the member states. Although EAEC member countries have not yet established a common external tariff, they are working on developing co-ordinated customs procedures that would reduce the cost of transhipment through the EAEC region for US goods destined for Kazakhstan. In addition, Kazakhstan allows the import of goods from some very poor countries free of duty or at a reduced rate within the Generalised System of Preferences.

Non-Tariff Barriers

Documentation

Bill of Lading: No special requirements. Follow instructions in contract. Mail and parcel post shipments require postal documentation in place of a bill of lading, while air cargo shipments require an airway bill, with the number of copies issued based on the requirements of the transporter and the importer.

Certificate of Origin: A certificate of origin is required. The general form as sold by commercial stationers should be used (unless the Kazakh importer sends special forms with the contract) and should be issued in accordance with the number of copies requested by the importer, usually two.

Commercial Invoice: Among other data usually required under the terms of the contract are: the country of origin; details of the packing materials; the marks and numbers of the packages; the weights (net, gross and tare), quantity and a description of the goods; unit prices and total shipment value; the selling price to the purchaser; and the place of final dispatch from the country of export. All data in the invoice must accord with the contract terms.

Insurance Certificate: The terms of the contract determine whether the seller or the buyer obtains insurance for the shipment in question. D&B advises that when the seller has obtained the right to purchase insurance, the seller should follow the instructions of the importer and insurance company closely to ensure that no problems arise.

Preshipment Inspection: The preshipment programme has been suspended since 1 November 1996.

Pro-Forma Invoice: May be requested by an importing organisation at some stage in the contract negotiations; follow importer's instructions in this matter.

Packing List: Must contain a complete summary of the shipment in question.

US Shipper's Export Declaration: Required if the value is more than USD2,500.

Other Documents

Certificate of Conformity: This document is required for the release of goods for free circulation when such goods are subject to mandatory standards certification.

Import Transaction Passport: Under central bank regulations, this document must be submitted to customs for purposes of currency control. Advance import payments before 180 days require prior registration with the central bank. Customs control checks the details in the passport against the contract and shipping documents presented by the importer when the shipment reaches the border.

Sanitary Certificates: Kazakhstan has strict quarantine, health, food and drug controls. All goods of animal or vegetable origin require an appropriate sanitary or phytosanitary certificate indicating freedom from disease.

Countertrade

In 1995, Kazakhstan banned all trading components from carrying out import and export barter transactions. The measure was taken to regulate monetary settlements between trading components, and ensure the stable implementation of the budget's revenue element. Nevertheless, countertrade is officially conducted with neighbouring republics, particularly in the provision of energy, including swap agreements on electricity and gas provision with the Kyrgyz Republic. In addition, a considerable degree of 'suitcase trade' is believed to take place, both within Kazakhstan and with neighbouring former Soviet states. Given the nomadic roots of native Kazakhs, the size of the country, the relatively high percentage of the people that live in rural areas and the lack of development of vast areas of the Kazakh steppe, barter is likely to remain substantial within the country.

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Commercial Risk

Key Point: The commercial risk situation in Kazakhstan is somewhat mixed. Although the banking sector has developed strongly in the past few years, the credit environment remains unfavourable and recent scandals illustrate the widespread problem of the corruption.

Credit Risk

Credit risk in Kazakhstan remains a significant concern, despite concerted attempts by the government in recent years to create a basic legal framework for private business activities, including a bankruptcy law. The business sector is heavily burdened by substantial past arrears. In addition, there is significant scope among debtors to prevent, slow or otherwise obstruct the enforcement of proceedings aimed at securing the retrieval of debts.

Moreover, in light of the substantial rise in credit supply since 2000, there is growing concern that the commercial sector is obtaining loans from the banking sector without adequate risk assessments being carried out. This could lead to an unwelcome increase in the average debt-to-equity ratios in the commercial sector and leave banks heavily exposed to any kind of cyclical economic downturn. Furthermore, the division of credit quality among export sectors is unequal, with the oil and gas, and metals sectors estimated to account for the largest share of financially sound entities. In accordance with this, Kazakhstan's economic dependence on the hydrocarbon sector has tended to crowd out investment in other areas of the economy, starving them of much-needed funds for development.

Payments Experience

Usual Terms: Letters of credit are the norm for established business dealings with Kazakhstan, although confirmed letter of credit terms are recommended on all new contacts. Less restrictive terms could be considered for companies operating in the oil and gas sector, although exporters should monitor price developments closely.

Usual Terms	
Minimum Terms:	Letter of Credit
Recommended Terms:	Confirmed Letter of Credit
Usual Terms:	10-30 days

Transfer Situation: Local and foreign exchange/bank delays are around average for the region, although the latter is gradually falling as the banking sector restructures. Foreign reserves (including gold) of USD8.7 billion in April 2005 – providing 7.3 months of import cover - and the assets of the National Fund (USD5.2 billion at the end of April 2005) provide a further cushion against external shocks.

Transfer Situation	
Local Delays:	2-3 months
Foreign Exchange/Bank Delays:	2-3 months
Import Cover:	7.3 months

Export Credit Agencies: Credit insurers continue to treat companies in Kazakhstan with considerable caution. Although the provision of insurance has become more extensive in recent years, most export agencies continue to apply numerous restrictions. Exporters are likely to find the availability of credit insurance is better, and restrictions on it significantly more accommodative, in the oil and gas sectors,

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for Western-based entities and those companies with a high degree of Western involvement.

Export Credit Agencies	
US Eximbank	Full cover available
Atradius	Short-term cover available subject to approved letter of credit, no discretionary limits
ECGD	Full cover available
Euler Hermes UK	Short-term cover available, but restrictions may apply

Financial Sector Risk

Kazakhstan probably has the strongest banking sector out of all the former Soviet states. The Russian financial crisis of 1998, in particular, represented a significant turning point since the subsequent market consolidation rooted out undercapitalised, inefficient and poorly managed institutions. In more recent years, having been strengthened by past reforms, the Kazakh banking sector has found itself well placed to capitalise on the country's energy-led investment boom. Financial sector reform measures enacted since 2000 have included: the adoption of international baking standards; the relaxation of foreign investment restrictions; deposit insurance; legislation to simplify bank closures; measures to strengthen compliance with Basle principles; and the introduction of consolidated supervision requirements.

Going forward, continued fast economic growth and the extension of efficiency enhancing reforms means that the short-term outlook for the banking sector remains good. The scope for further short-term growth in the sector is illustrated by the fact that banking assets to GDP in Kazakhstan were still below 30% in 2004, far below typical levels in developed economies. Likewise, while the levels of private sector loans to GDP had increased to 30% of GDP by the end of 2004 (from just 10% in 1999) this was still below the 100% level achieved in some eastern European Emerging Markets. Meanwhile, the still high number of domestic banks relative to Kazakhstan's population of around 15 million, suggests further consolidation can be expected. The main negative consideration is the possibility that in the context of fast growth and high liquidity (reflecting the rapid expansion of private deposits) banks may be overextending themselves by making imprudent loans to high-risk enterprises, thereby exacerbating credit risk (see **Credit Risk**).

Corruption

Corruption in Kazakhstan is prohibitively high. In Transparency International's 2004 survey of corruption perceptions, Kazakhstan received a score of 2.2 (where 0.0 indicates most corrupt and 10.0 least corrupt), ranking it as among the bottom 25 out of a total of 146 countries surveyed. For the purposes of regional comparison, Kazakhstan's corruption ranking was worse than Russia (which had score of 2.8) and Belarus (which had a score of 3.3).

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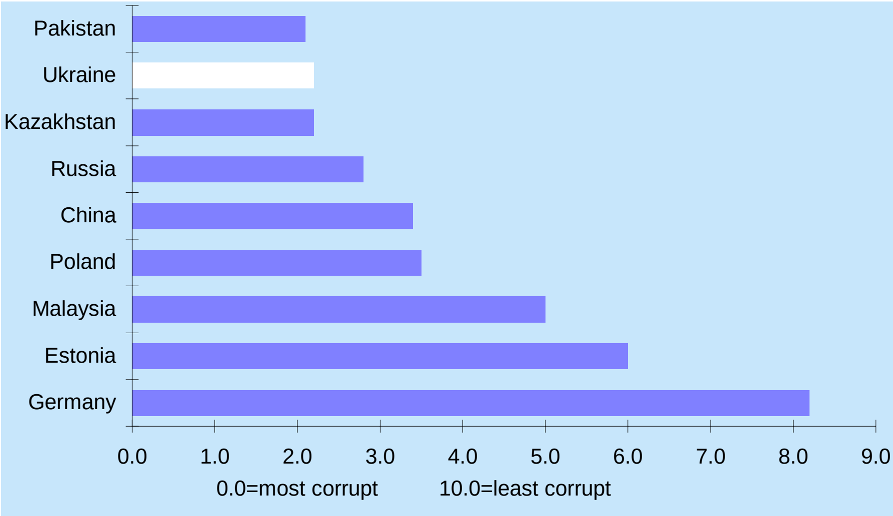
Chart 14
Corruption Perceptions for Selected Countries, 2004



Source: Transparency International, *Corruption Perceptions Index*, http://www.transparency.org

The ongoing 'Kazakhgate Scandal' illustrates the scale and nature of the country's corruption problem. In 2002, it came to light that President Nursultan Nazarbayev had secretly deposited around USD1 billion of state money in a private Swiss bank account. The issue only came to light after the US government and Swiss banking officials began investigating the movement of funds related to the government's sale in 1996 of a 25% stake in the Tengiz oil field to US energy firm, Mobil Oil Corp (now known as Exxon Mobil). As a result of these investigations, some USD120 million of Kazakh government funds remain frozen in Swiss bank accounts at the behest of US investigators.

News of the scandal coincided with the arrest of a number of prominent opposition Kazakh politicians and led to a related US investigation into allegations that a US consulting firm had bribed two high-ranking Kazakh government officials (named as Nazarbayev and ex-Prime Minister Nurlan Balgimbaev in media reports) in order to secure the Tengiz contract for US oil firms. In March 2003, prominent US oil consultant James Giffen was arrested and charged with two separate violations of the Foreign Corrupt Practices Act in his dealings with the Kazakh government around the time of the aforementioned oil deal. Giffen's trial, which is now scheduled to begin in January 2006, has the potential to embarrass both the US and Kazakh governments, as well as damaging relations between the two countries. In his earlier pleas for the case against him to be dropped, Giffen reportedly argued that he was in close contact with the White House and the US Central Intelligence Agency at the time of the oil deals.

Other Commercial Risks

In 1992, Kazakhstan began to implement a system to protect intellectual property rights. Legislation includes laws covering copyrights, trademarks and patents. Kazakhstan is a party to the Convention Establishing the World Intellectual Property Organisation, the Paris Convention for the Protection of Industrial Property, the Madrid Agreement Concerning the International Registration of Trade Marks, and the Patent Co-operation Treaty. In mid-1998, Kazakhstan ratified the Eurasian Patent Convention and later on in the same year it became a member of the Berne Convention of Copyright Protection. However, despite being a member of such bodies, implementation of intellectual property rights in Kazakhstan remains weak.

Commercial Risk Outlook

The commercial risk situation in Kazakhstan is somewhat mixed. On the positive side, Kazakhstan probably boasts the strongest banking sector out of all the members of the Commonwealth of Independent States, and is expected to continue building on this success over the next few years. As in recent years, fast economic growth and the extension of efficiency enhancing reforms are expected to aid the development of the banking sector. The scope for further short-term growth in the sector is illustrated by the fact that the ratio of banking assets to GDP in Kazakhstan is still far below typical levels in developed economies. Meanwhile, given the still high number of domestic banks relative to Kazakhstan's population of around 15 million, further consolidation can be expected.

The principal negative consideration with respect to banking is the possibility that in the context of fast growth and high liquidity (brought about by the rapid expansion in private deposits) banks may be overextending themselves by making imprudent loans to high-risk enterprises. Similarly, the credit risk environment in general, while benefiting from recent years of rapid economic growth, continues to be constrained by the high incidence of past arrears and inadequate means of recourse. In particular, despite efforts to improve bankruptcy regulation, debtors retain considerable scope to slow or obstruct the enforcement of proceedings to secure the retrieval of debts.

Meanwhile, corruption remains a serous concern, affecting all levels of Kazakh society. The most recent Transparency International report places Kazakhstan in the lowest (worst) quartile of countries surveyed. The suggestion that recently acquired oil wealth has increased Kazakhstan's susceptibility to corruption is supported by the ongoing 'Kazakhgate' scandal, which has exposed corruption among the country's political elite and threatens to complicate relations with the US.

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Investment Environment

Key Point: The government has generally been committed to fostering an investment environment attractive to foreign investors. However, in recent years, complaints about unhelpful government intervention have been rising.

Investment Overview

The government has actively encouraged foreign direct investment (FDI) into the country, recognising its value in helping to update the country's infrastructure and integrate its economy with the developed world. To this end, various incentives have been put in place to attract foreign enterprises, including free economic zones, tax relief programmes and guarantees against detrimental changes in taxation and legislation. Kazakhstan also has a number of natural advantages, primarily its huge reserves of fossil fuels and minerals, but also its strategic position between China, Europe and Russia, its large and well-educated population and its relative political stability.

Nonetheless, a number of obstacles still inhibit investment in Kazakhstan, such as a shortage of brown-field investment projects, poor infrastructure and its landlocked geographic location. More worryingly, in recent years, unhelpful government intervention has been increasing. In particular, in addition to the longstanding obstacles of excessive bureaucracy and corruption (see **Corruption**), in recent years businesses have complained about: the growing tendency to challenge contractual rights (see **Foreign Direct Investment Environment**); the legislation of preferences for domestic companies; the creation of mechanisms for greater government intervention in foreign company operations (particularly procurement decisions); and unhelpful tax laws (see **Taxation**).

Nonetheless, despite all these concerns, the country should maintain its leading position in the Commonwealth of Independent States (CIS) as a destination for FDI in the short to medium term, with investors unavoidably drawn to the country's huge energy resources. Strong global demand and rising prices for most of Kazakhstan's commodity exports should help to underpin foreign investor interest during the two-year forecast period.

Capital Account Exchange Regulations

The authorities have been steadily liberalising controls on capital. After some years of flux, the country's capital account exchange regulations are now fairly stable. In general, foreign investors may freely conduct transactions on capital and money market instruments, derivatives, credit operations and direct investments. However, large transactions require the approval of the National Bank of Kazakhstan:

- *Controls on Capital and Money Market Instruments:* Purchases of capital market securities, bonds or other debt securities and money market instruments by non-residents in excess of the equivalent of USD100,000 must be registered with the central bank. Sales must be approved by the central bank.
- *Controls on Derivatives and Other Instruments:* The sale of commercial and financial credits by residents to non-residents requires a licence from the central bank when the operation has a maturity of more than 180 days. The sale of such credits by non-residents to residents requires a certificate of registration with the central bank when the operation has a maturity of more than 180 days or exceeds a value equivalent to USD100,000.
- *Controls on Real Estate Transactions:* Transfers from non-residents in payment for property rights and other rights to real estate in an amount above the equivalent of USD100,000 require registration with the central bank.

- *Controls on Personal Capital Movements:* Loans by non-residents to residents of more than 180 days and in an amount equivalent to more than USD100,000 are subject to registration with the central bank.

The central bank also maintains controls on the liquidation of direct investment.

Foreign Direct Investment Environment

The government has taken significant steps towards establishing a favourable investment climate. In 2004, Kazakhstan attracted FDI of USD8.4 billion, an 83% increase over the previous year. In keeping with the prevalent trend since Kazakhstan's independence, the mining and quarrying sector accounted for the largest share of this inward investment with an inflow USD5.4 billion in 2004. By geographic composition, the US continued to be the most important foreign investor in Kazakhstan with investments totalling USD3.1 billion in 2004. The list of largest foreign investing firms in Kazakhstan includes many of the world's largest energy companies such as Chevron, Exxon Mobil, TotalFinaElf and Shell.

Despite Kazakhstan's generally positive investment environment, some firms have experienced problems with their investments. In several cases this has stemmed from the government's expectation of immediate results from the injection of foreign capital and an unwillingness to wait for infrastructure to be built or for new technologies to be introduced; for example, the Belgian company Tractabel had its accounts frozen and its access to infrastructure blocked in 1998 when the government accused it of failing to honour its commitments. The American power company AES suffered a different problem in 1998 when a change in policy by the Kazakh government deprived the firm of access to the southern section of the national power grid. In late 2002, US/Kazakh joint venture firm, Tengizchevroil, temporarily suspended investment (estimated at USD3 billion) in the second-phase development of the Tengiz oil field after a disagreement with the government about the terms of their original 1993 agreement.

More recently, firms have expressed concerns about the scope for legal variability implied by the 2003 Law on Investments (see **Foreign Investment Laws**) and about the potential impact on profitability of a new tax code for oil exports, which came into effect at the start of 2004 (see **Taxation**). Although lax enforcement can work favourably in some instances, investors should be aware that unwelcome new regulations can emerge suddenly in Kazakhstan, which may lead to contractual disputes with the government. For example, in June 2002, the government passed new regulations requiring firms in the extractive industries to give preference to 'local content' in their work (such as employing local workers). Although the government later agreed to fine tune the detail of the new regulations (to reflect economic realities), similar issues could quite easily resurface in the future.

Taxation

The following amendments to Kazakhstan's tax code became effective from January 2004:

- The maximum rate of personal income tax was reduced from 30% to 20%, with the new rate varying between 5-20%, depending on income level.
- The social tax on Kazakh personnel was reduced from a fixed 21% to a range of 7-20% depending on income.
- The social tax on expatriate managerial and engineering personnel was reduced from a fixed 11% to a range of 5-11%, depending on income.
- Value-added tax was reduced from 16% to 15%.
- Corporate income tax was unchanged at 30%.

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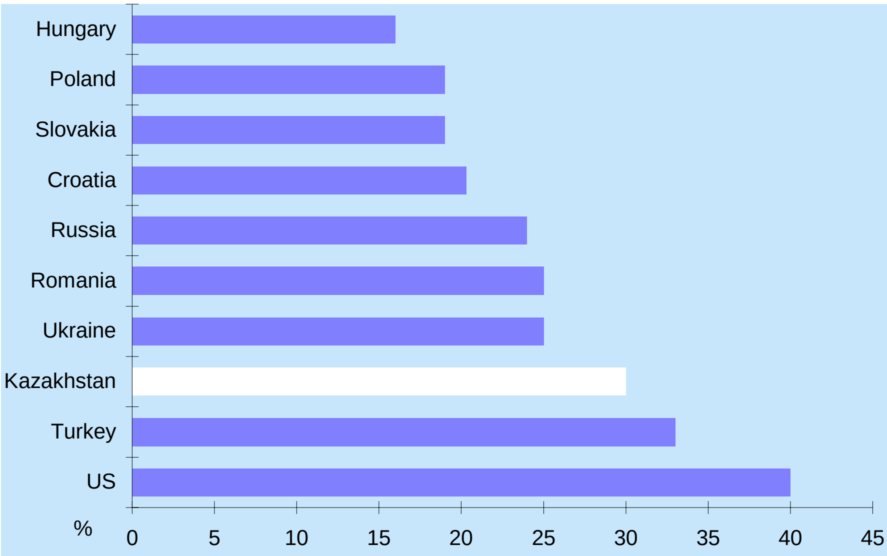
Chart 15
Corporate Tax Rates in Selected Countries, January 2004



Source: KPMG, *Corporate Tax Rate Survey*

The government also adopted a controversial new oil export tax, which also became effective in January 2004. The legislation applies a different tax rate depending on prevailing market prices for oil, ranging from as low as 1% for oil prices of USD19 per barrel (p/b), to as much as 33% for prices of USD40p/b or above. Although the new legislation will not apply to firms working under existing production sharing agreements (PSA), it was not been well received by foreign energy firms, who suspected it would have an adverse impact on the profitability of their Kazakh operations.

Foreign Investment Laws

In principle, foreign investors enjoy equal rights with domestic investors, such that they may in general freely export and import capital, remit profits out of Kazakhstan and repatriate their investments. Foreigners may invest in capital of foreign origin by establishing an enterprise, or by acquiring shares in an existing enterprise. There are few restrictions on foreign investment in Kazakhstan, although foreign ownership in the banking sector and telecoms is limited to 25% and 20% respectively; in addition, the purchase of land is currently prohibited.

After long debate, the Law on Investment in Kazakhstan became effective in January 2003, replacing previous legislation, particularly the Law on Foreign Investment (1994) and the Law on State Support for Direct Investment (1997). The law stipulates that the terms of past government contracts with foreign companies signed before the entry of the new law will be protected against future legal changes until they expire. However, according to the new law, this protection does not apply to new contracts; this means that new contracts are theoretically subject to alteration in response to any future domestic or international treaty legislation.

At the time of the legislation numerous foreign investors expressed unhappiness with the potential for ‘instability’ in new contracts. Investors also expressed reservations about the broad scope for interpretation envisaged by the new law with respect to situations mandating changes in domestic laws; among other things the new law makes reference to potentially contentious justifications (for changes in law) such as ‘national and ecological security, health and ethics’. In addition, some investors have expressed displeasure at the lack of clear mechanisms within the new law for access to international arbitration, the narrowing of investment dispute definitions and the absence of any pronouncement affirming the finality (binding nature) of international arbitration judgements.

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Company Organisation

The majority of standard Western forms of business entity (general partnership, limited partnership, private company) may be established in Kazakhstan. However, two forms of company are generally preferred: closed joint-stock companies (i.e. a joint-stock company in which a shareholder selling shares must first offer them to the other shareholders) and limited liability partnerships. Registered representative offices and branches permit foreign companies without local partners to carry out limited business activities subject to certain conditions.

Portfolio Investment

Stock Market

The Kazakhstan Stock Exchange (KASE) was formally launched in September 1997 and currently trades in foreign exchange, derivatives, corporate bonds and shares, and government securities. Trading in state securities is mainly conducted over the counter, owing to the limited number of market players and the extensive use of repo operations. Trading in corporate shares is divided between A and B floors, with the more liquid stocks traded on the A floor. However, the low market capitalisation of the KASE, the low liquidity of its constituent equities and inadequate ancillary legislation means foreign interest in the Kazakh stock market is negligible.

Bonds

The Kazakh government has been issuing bonds since the mid-1990s. Government securities consist mainly of Treasury bills, although longer dated issues have also increased in recent years. As a reflection of Kazakhstan's strengthening macroeconomic fundamentals, domestic and foreign demand for government and corporate securities has generally been strong since 2000 (see **Debt**). In the short run, the outlook for Kazakh debt instruments is expected to remain positive, in line with the healthy economy and strong market appetite for relatively high yielding debt.

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Additional Sources of Information

Prime Minister's Office 11 Beybitshilik Street Astana 473000 Tel: 3172 32 31 19 Fax: 3172 32 40 89	**Ministry of Energy, Industry and Trade** 37 Beibitshilik Street, Astana 480091 Tel: 3172 33 72 20 Fax: 3172 33 71 64
Agency for Investment 10 Beybitshilik Street, Astana 473000 Tel: 3172 39 12 61/39 12 63 Fax: 3172 39 12 70	**Ministry of Finance** 60 Republic Prospect, Astana 473000 Tel: 3172 33 41 86 Fax: 3172 62 27 70
Chamber of Commerce & Industry of Kazakstan 26 Masanchi Street, Almaty 480091 Tel: 3172 67 00 52 Fax: 3172 50 70 29	**National Commission on Securities** 92 Maulenova Street Almaty 480012 Tel: 3272 62 33 55 Fax: 3272 50 76 99
National Bank of Kazakstan 21 Koktem 3, Almaty Tel: 3272 50 47 01 Fax: 3272 50 60 90	**State Customs Committee** 166 Pushkin Street, Astana 473000 Tel: 3172 75 04 47 Fax: 3172 75 30 16
American Chamber of Commerce in Kazakstan 531 Seyfullin Prospect, 3rd Floor Almaty 480091 Tel: 3272 58 79 18 Fax: 3272 58 79 21	**Ministry of State Revenue** 48 Abay Prospect Astana 473000 Tel: 3172 32-69-51 Fax: 3172 32-69-52

Credit Information

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International Risk & Payment Review: Provides timely and concise economic, political and commercial information and analysis on 132 countries. Available as a subscription-based internet service (www.dnbcountryrisk.com) and monthly update journal, the IRPR carries essential information on payment terms and delays. It also includes the unique D&B Country Risk Indicator to help monitor changing market conditions.

Exporters' Encyclopaedia: Information on 220 world markets to help customers decide where they can safely and profitably do business. Data provided include key contacts, transportation information, legislation affecting export commerce and tips on foreign business travel. Published annually in August plus ad hoc updates. English language edition.

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Country Risk Indicator Definition

D&B's Country Risk Indicator provides a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years. The risk indicator comprises a composite index of four over-arching country risk categories:

Political risk -	internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;
Macroeconomic risk -	the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth and a commensurate expansion in business opportunities;
External risk -	the current account balance, capital flows, foreign exchange reserves, size of external debt and all such factors that determine whether a country can generate enough foreign exchange to meet its trade and foreign investment liabilities;
Commercial risk -	the sanctity of contract, judicial competence, regulatory transparency, degree of systemic corruption, and other such factors that determine whether the business environment facilitates the conduct of commercial transactions.

The DB risk indicator is divided into seven bands, ranging from DB1 through DB7. Each band is subdivided into quartiles (*a*-*d*), with an *a* designation representing slightly less risk than a *b* designation and so on. Only the DB7 indicator is not divided into quartiles.

Indicator	**Meaning**	**Explanation**
DB1	Lowest risk	Lowest degree of uncertainty associated with expected returns, such as export payments, and foreign debt and equity servicing.
DB2	Low risk	Low degree of uncertainty associated with expected returns. However, country-wide factors may result in higher volatility of returns at a future date.
DB3	Slight risk	Enough uncertainty over expected returns to warrant close monitoring of country risk. Customers should actively manage their risk exposures.
DB4	Moderate risk	Significant uncertainty over expected returns. Risk-averse customers are advised to protect against potential losses.
DB5	High risk	Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.
DB6	Very high risk	Expected returns subject to large degree of volatility. A very high expected return is required to compensate for the additional risk or the cost of hedging such risk.
DB7	Highest risk	Returns are almost impossible to predict with any accuracy. Business infrastructure has, in effect, broken down.

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