PREVENTING THE OIL CURSE: THE ROLE OF GOVERNMENT POLICY IN KAZAKHSTAN

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Abstract

Kazakhstan, as a country with the oil-export-driven economy, has a danger of facing the oil curse. This thesis answers the question: What policy should the government of Kazakhstan choose in order to prevent the oil curse? Based on the literature analysis, this work constructs major symptoms of the resource curse and puts them into analytical framework for an observation of their presence in the process of the oil sector development in Kazakhstan. The thesis defines that Kazakhstan has an oil-dependent economy and is under the risk of the oil curse. Taking into account successful cases of beating the curse and current conditions of financial crisis, it provides policy recommendations for facilitation of the oil curse symptoms.

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List of Abbreviations

CIS – Commonwealth of Independent States

FDI – Foreign Direct Investment

FSU – Former Soviet Union

GDP – Gross Domestic Product

IEA – International Energy Agency

KMG – Kazmunaigaz

MTEF – Medium-Term Expenditure Framework

NBK – National Bank of Kazakhstan

NFRK – National Fund of the Republic of Kazakhstan

NMP – Net Material Product

RER – Real Exchange Rate

SME – Small and Medium Enterprises

TOT – Terms of Trade

INTRODUCTION

Every blessing ignored becomes a curse

(Paulo Coelho)

Nowadays oil is one of the most tackled topics around the globe. Oil is national wealth. It is an asset for the countries which possess it. However, many of these countries can not understand that extracting oil they reallocate the asset, converting it from the form of oil into another form such as oil revenues. And if the oil revenues are not properly managed and do not lead to economic growth, then it means that oil extraction only decreases national wealth. This is actually what happened to many resource-abundant countries and is called the ‘resource curse’.

This work analyzes the case of Kazakhstan, an oil-rich country which after its independence in 1991 had to manage huge oil reserves in weak conditions of transition and currently may have a potential danger of the oil curse. Thus, the aim of the thesis is, first, to define what symptoms of the oil curse Kazakhstan has, and, second, to answer the main research question “What policy should the government of Kazakhstan choose in order to prevent the oil curse?”. The analysis focuses on the role of government policy in causing, avoiding and beating the curse. It identifies the symptoms of the oil curse in Kazakhstan throughout three periods: the first decade of transition (1991-2000), the oil boom (2000-2006) and financial crisis (2007-2009). And in the end it provides policy recommendations to cope with the identified curse symptoms.

The existing literature mostly analyzes separate symptoms of the oil curse in Kazakhstan, but not the curse itself. These works discuss Dutch disease (Egert and Leonard 2007; Kutan and Wyzlan 2005), political challenges (Krause and Lucke 2005), the oil fund primarily in a comparative study with Azerbaijan (Kalyuzhnova 2006; Oxresearch 2006), foreign direct investment (Borisocheva 2005) and oil revenue redistribution (Najman et al. 2005). The analysis in this thesis tackles all these symptoms. The other literature is trying to answer the question whether oil will be a curse or a blessing for Kazakhstan (Strauss 2000; Kalyuzhnova et al. 2002; Pomfret 2005; Pomfret 2006) and the answer is always hesitating where the authors prefer to wait and keep observing the country. All these works are academic without provision of recommendations to solve the problem discussed. And there are just a few works (Krause and Lucke 2005; Kalyuzhnova 2006) which are policy papers. However, these papers, first, are comparable analyses of Kazakhstan and Azerbaijan, and second, they tackle not an overall problem of the oil curse, but some its components such as oil funds (Kalyuzhnova 2006) and political challenges (Krause and Lucke 2005).

Thus, the significance of this thesis is in following. First, the research includes *all major symptoms* of the resource curse and tries to identify which of them Kazakhstan currently has. Second, it provides *policy recommendations* for coping with existing symptoms. This means that the thesis encompasses both academic and policy features. Last, and very important, this work is very relevant not only because it tackles globally important natural resource problem, but also because there is *no such work* where *current financial crisis conditions* are taken into account in tackling the oil curse.

The research is constructed as follows. Chapter one, based on the analysis of existing relevant literature, first, summarizes the symptoms of the resource curse in order to observe them in chapter two, the case of Kazakhstan. Second, it shows the link between the resource curse and government policy and how government policy can *enhance* the curse symptoms. Third, it looks at successful cases of beating the resource curse and observes the factors which can help to *facilitate* the curse symptoms. Chapter two provides practical observation of the oil sector development in Kazakhstan, identifies existing symptoms of the oil curse (which are theoretically constructed in chapter one) and shows importance of government policy in causing these symptoms throughout three periods mentioned before. Chapter three is policy recommendations for beating the symptoms of the oil curse, identified in chapter two.

Chapter 1: Relationship between Resource Curse and Government Policy: Theoretical and Practical Observation

During the last four decades of a vigorous natural resource exploration scientists and policy makers around the world have been analyzing the paradox of resource wealth combined with underdevelopment, political and economic instability, poverty and social conflicts. In other words, the paradox states that resource-rich countries with an export-driven resource sector and large revenues grow slower and show socioeconomic underperformance in comparison with resource-deficient states. This paradox is known as the resource curse.

Prior to the late 1980s the majority of researchers saw natural resource abundance more as a blessing than as a curse (Lewis, 1955; Higgins, 1968; Drake, 1972; Krueger, 1980) whereas just a few of them treated resource wealth as a disadvantage for the socioeconomic well-being (Prebisch, 1950). However, throughout the last two decades (late 1980s-2009), when more resource-rich countries started to perform lower growth rates than it was expected, the number of researchers supporting the resource curse phenomenon has significantly increased. That is why this chapter is concentrated primarily on the recent studies.

Based on this assessment of the recent studies, the literature analysis in this chapter:

1. defines the role of government policy in causing, avoiding and beating the resource curse through an identification of the major resource curse symptoms
2. applies practical evidence using successful cases of dealing with the curse in order to construct the common 'factors of success' which positively contribute to the government policies of coping with the curse

This first chapter is of big importance, since the defined symptoms of the resource curse will be applied to the second chapter and 'factors of success' will be used in the third chapter to provide policy recommendations to answer the main research question of the overall work.

1.1 Resource Curse and Government Policy: Drawing the Direct Link

This section of the chapter is analytical and, based on the appropriate information in the existing literature, explains how government policy contributes to the resource curse and strengthens its symptoms/effects, which will show direct correlation between governance and the curse. This section will primarily show what factors and actions lead to failure in beating the curse.

The recent evidence shows that most resource-rich countries have not been able to manage high revenues from the natural resource extraction and exports (Stevens, Dietsche 2007: 56-65). Some countries have been experiencing one or several symptoms of the RC, others - the RC itself. These *symptoms* define the nature of the RC, reveal the level of potential danger for economic development of a country and, thus, have to be precisely determined as follows.

1.1.1 Dutch disease and crowding out

This symptom of the RC is considered to be highly significant and the most notable in the literature (Alichi and Arezki 2009: 3-4). The major meaning of this phenomenon is that resource-rich states fail to keep a competitiveness of manufacturing sector (Sarraf and Jiwanji 2001: 3). The appreciation of the RER due to foreign exchange inflows through export of the resources brings about domestic inflation through excessive spending effect which discourages savings and can lead to market distortions (Ernst 2007: 3). Moreover, when the resource sector grows and becomes too large in comparison with the other economic sectors, it has the effect of crowding out the rest of the economy. Consequently, it becomes difficult to secure factors of production for the non-resource sectors (Stevens 2003: 13). This crowding out effect leads to two more consequent effects: inflation and deindustrialization. First, it contributes to general inflation already triggered by Dutch disease, because the supply of no-more-tradable goods shrinks and creates demand imbalances. Second, it moves the resources to the booming sector from the rest of the economy and, afterwards, it moves them back when the labor demand in the natural resource sector decreases (Ernst 2007: 3).

1.1.2 Revenue volatility and dependence on the NR sector's revenues

Affected by sharp price fluctuations over short time periods, the revenues from the natural resource exploitation are extremely volatile. This makes it dangerous to rely on these revenues and undermines the certainty in the fiscal policy pursuance. According to Sachs and Warner (1997), often the windfall revenues are consumed rather than invested or saved. This consumption makes the whole economy dependent on the volatile resource revenues and, when the prices drop down, it leads to dramatic budget deficit and macroeconomic instability.

1.1.3 Enhanced role of the state

In most regimes the state is the owner of the natural resource and the government is the first receiver of the revenues from their exploitation. This increases government interest in the resource sector and enhances its intervention (Ascher 1999). Some researchers argue that increased government intervention is a bad sign and leads to government and market failures (Mikesell 1997), others state that enhanced role of the state helps to avoid the resource curse. However, the best answer to the question of how much governance countries need is not in the quantity, but in the quality of the government management.

This symptom of the resource curse is as significant as Dutch disease and encompasses many aspects through which the link between government policy and the resource curse will be gradually observed. The problem of the enhanced role of the state can be analyzed from two major perspectives: *institutional and macroeconomic,* where government policy is a crucial influential factor.

1.1.3.1 Institutional perspective

Despite the initial level of institutional development for the moment of natural resource discovery, institutional problems can appear or be enhanced *after* the discovery. It is claimed that the size of the overall impact of the resource booms depends on institutions since they determine the extent to which resource revenues can be manipulated and misallocated (Robinson et al. 2005: 1). Institutional problems, where governance plays a role, include the following. First, they include r*ent-seeking, corruption and ignorance.* Large inflow of revenues into the government's hands increases its temptation for corruption and rent-seeking. Usually, main actors in profit-seeking activities are elites, bureaucracies and government agencies. Since government is the main revenue receiver and, thus, main rent-seeker, it abuses its power and manipulates revenue circulation. Eventually, a lack of strong institutions 'entitles' governments with a monopoly power in the economy (Wenders 1987). This monopoly power, in turn, decreases government motivation to control money movements, since they occur within the governmental network, and increases government ignorance. This weakens economic institutions.

The second institutional problem is *enhanced anti-democracy*. There is a positive correlation between the resource curse and authoritarian tendencies (Ernst 2007: 3). Joseph Siegle (2007) provides the following observation:

"…80% of all hydrocarbon-rich countries are autocracies…only 4 of the 33 hydrocarbon-rich countries qualify as democracies… Stated differently, on a democracy scale of 0-10, the average hydrocarbon-rich country scores a zero."

Authoritarian rulers use the revenues from the resource sector to keep them in power, to suppress opposition groups and media. They create repressive apparatuses and direct governance according to their personal interest (Karl 2005: 25). This weakens political institutions.

Most of the resource-rich countries are developing and have a weak institutional base (Siegle 2007: 35). This weak institutional base through further NR exploitation worsens even more institutional quality and curses already cursed resource-abundant country. This process of institutional deterioration is endless unless the government policy is changed. The root of the problem is in governance. Civil society, NGOs and external actors can only influence the situation, but they can not change it without a government will. If the enhanced role of the state/government only weakens political and socioeconomic institutions (that is usually the case of resource-rich countries), it consequently leads to poor decision-making by the government and has an extremely significant negative influence on macroeconomic policies and social stability.

1.1.3.2 Macroeconomic perspective

Macroeconomic problems are connected with an inadequate government policy dealing with Dutch disease. Macroeconomic problems, where governance plays a role, include the following. The first problem is f*ailure in investment decisions*. Often in countries, which are rich with resources, the decisions are built on the weak institutional base and, therefore, unproductive. The money earned from the resource sector is often used by authorities in their personal interest. Sometimes governments in resource-rich countries start to spend the resource sector revenues for the social projects such as healthcare and education, but end up with failure and damaged projects, since the revenues vary over short time periods, are very volatile and unreliable.

The second problem is f*ailure in industrial policy*. Often the government policy fails, because the subsidies become unsustainable with the fall of revenues (Sarraf and Jiwanji 2001) and protectionism creates moral hazard problem and reduces incentives to form competitive manufacturing industries (Stevens 2003: 16).

The third problem is d*eterioration of the human capital quality*. High revenues divert government attention from the process of institutional and human development and make government neglect education. Thus, the resource abundance leads to slowing skill accumulation which negatively influences quality of human capital and economic growth.

The forth problem is *declined administrative and fiscal efficiency combined with weak monetary/exchange rate policy*. Governments in developing resource-rich countries with their weak institutions are usually administratively ill-prepared for efficient revenue allocation. It leads to excessive spending through the failure in investment decisions. The periods of declined revenues exacerbate this problem. That is why government's capacity to maintain an appropriate tax-raising during the booms is the most necessary for stabilizing economic imbalances. Moreover, fiscal policy has to be supported by monetary policy. Government has to cooperate closely with the central bank, since the central bank is the main manager of the exchange rate. If the central bank keeps the foreign exchange from resource revenues as reserves, then government expenditure policy will have the main impact on further macroeconomic stability and the impact is going to be inflationary. If the central bank starts operating foreign exchange, then government has to take into account both impacts – from its expenditure and from central bank's operations (McKinley 2005: 6-8). A wise combination of fiscal and monetary policies can balance out the effects of inflation and appreciation of nominal exchange rate.

Based on provided analysis of the resource curse symptoms, the ways of government reaction on them and institutional and macroeconomic problems, it can be said that government holds almost sole power to deal with the curse in its hands. Government has a major role in institution building and macroeconomic regulation. So that the RC effects can be alleviated, avoided or beaten through an effective government policy provision, thorough policy implementation and strict supervision. This section has built the direct link between governance and the resource curse through the negative contribution of government policy to the RC. In contrast, the next section will draw the same link, however, through the positive 'curing' contribution of government policy to the RC.

1.2 Successful Cases of Beating the Resource Curse: World Experience

This section will show what *factors* lead to success in beating the resource curse. Since the work encompasses not one, but all aspects of the resource curse, it is impossible within one work to make a thorough analysis of undertaken policies of beating the curse in chosen countries. That is why this section is aimed to provide a brief observation of the government actions in three countries which led to success in coping with the curse. Based on this observation, it will identify the factors of this success which will serve as a base for the construction of recommendations for the case of Kazakhstan in chapter three.

There are not many successful cases of beating the curse in the world history. Among them are cases of the USA, Canada, Australia, Norway, Indonesia, Chile, Ghana and some other. Unfortunately, there is no successful experience of combating the curse among such transition countries like Kazakhstan. Thus, this section observes three cases of Norway, Botswana and Indonesia. The case selection was based on the following aspects. The first aspect is oil. Since Kazakhstan's problem is in rapid oil sector development and the oil prices are the most fluctuate among all natural resources, the oil creates more vulnerable conditions for countries to beat the curse. That is why the analysis includes oil-rich Norway and Indonesia. However, inclusion of a country with a different resource diversifies an observation and gives a possibility to find similarities in beating the curse which are commonly useful. That is why the analysis includes diamond-rich Botswana. The second aspect is poor initial conditions, which are low growth rates and bad living conditions, at the moment of a resource boom which is related to Kazakhstan. Indonesia and Botswana come into this category. And Norway as a country with good initial conditions will show whether there is some factor of success which is common with Botswana and Indonesia. Despite these reasons to select the cases, each case is unique and direct transplantation of the policies from successful cases can not be the right choice. However, an identification of the success factors which are common among chosen cases will help to find an individual approach for preventing the curse in Kazakhstan.

1.2.1 Norway

According to Sachs and Warner (1999), Wallerstain (1999) and Torvik (2001), after oil discovery Norway vigorously started to implement not one or two policies gradually, but a combination of policies at once, attacking any potential symptom of what we call now the "resource curse". The government used transfers and price subsidies in order to support domestic producers in the non-resource sectors. It did not ignore human capital and invested heavily in the educational process. The government held counter-cyclical policies through tightening credit in order to suppress inflation preventing Dutch disease and to keep the labor force employed preventing the crowding out effect. Income was regularly coordinated through the wage control programs during different periods of price fluctuations. Norwegian income policy is considered to be one of the most centralized and strictly organized and coordinated. It helped to make wages in manufacturing sector the highest in order to avoid labor force movement and deindustrialization. Thus, Norway provided diversification of revenues not relying only on the petrodollars. Fiscal policy was preserved from spending effects through an "expenditure-limitation policy" and creation of the Petroleum Fund and "Usage Rule" that provides a limitation for the use of the Fund's money to the extent of annual four percent return of the Fund

(Larsen 2003: 16-19). The Petroleum Fund was built up by the assets outside the domestic economy. This prevented the spending effect and limited real exchange rate appreciation. Moreover, the Petroleum Fund's assets are controlled not just by the Central Bank, which is entitled to run it, but also by other actors. For example, the decisions on Fund's transfers must be approved by parliament (Gelb and Grassmann 2008). In addition, civil society groups participate in resource revenues allocation by sharing their own opinion. Such fiscal policy, where expenditure of the oil revenues was strictly limited, can be considered as flexible, since it can adapt to further changes in the size of revenues being not dependent on it. Through all these actions the Norwegian government maintained the strong industrial and investment policy, shielded human capital from deterioration and had a fiscally effective revenue management. Thus, in Norwegian case oil is the engine of growth.

Besides all these policies, there is one more very important factor which made such intensive government macroeconomic policy feasible and effective (Larsen 2003; Mehlum, Moene and Torvik 2005). This factor is strong institutions. Well-functioning economic and political institutions made it easier to control the process of government policy implementation and prevent rent-seeking. High levels of democracy, human development, strong norms of solidarity in Norway significantly contributed to the success in beating the curse.

In the case of Norway strong institutions were a crucial factor of success, since at the time of oil discovery in 1970s good institutional base, healthy democracy and sustainable level of economic development were among initial conditions. Thus, for the moment of oil reserves discovery Norway was an economically developed country with stable democratic institutions which provided full transparency and encouraged public to participate directly in government policy implementation (Ernst 2007: 6). However, the world experience contains other cases of success in beating the RC where the initial conditions did not show high levels of socioeconomic development. Among them are Botswana and Indonesia.

1.2.2 Botswana

During the period of 1966 and 1989 Botswana had the world's fastest economic growth indicators (World Bank 1991, 1998, 2001). However, earlier, in 1966, it was included to the poorest countries in the world. The main reasons for its rapid economic growth were discovery of large mineral reserves, primarily diamonds, and, what is the most important, the way the government managed to avoid the pitfalls of the resource booms and to make growth sustainable in a long-run.

Botswana has avoided the symptoms of the resource curse due to its macroeconomic policy which included two objectives (Hill, Mokgehti 1999). The first objective was to make economic growth stable avoiding external debt. In order to follow this adopted macro-objective government, first, accumulated international reserves. This helped to avoid excessive spending during the boom times (Sarraf and Jiwanji 2001: 10-11). When the revenues were increasing the government kept expenditures fixed and transferred these additional revenues into foreign exchange reserves. Government decisions created flexible policies and had administrative and fiscal efficiency. The second objective was to encourage diversification. The government of Botswana paid much attention to the management of foreign exchange as a tool to support diversification through accumulation of the foreign exchange reserves.

Even though Botswana was among twenty five poorest countries in the world and had weak economic conditions by the time of diamond discovery (UNDP 2006: 23), it managed to avoid the curse. Successful results of the government policy were gained not just due to effective macroeconomic policies, but, like in Norway, due to stable developed institutions and government will to strengthen institutional capacity using its diamond income. Norway and Botswana had different initial economic conditions, but both of them had strong institutions and government will to fight rent-seeking and increase national wealth. The next case has a lack of both good initial conditions and good institutions; however, the country also managed to beat the curse.

1.2.3 Indonesia

Indonesia with its huge hydrocarbon resources was one of the poorest states in the world at the time of oil discovery in 1970s. It is considered to have unstable institutions and fractious politics (World Bank: Cambodia 2007: 2). However, it has taken opportunities for effective resource management and has avoided the curse with the following policies. First, there was a political will to promote sustainable economic growth, social stability and to avoid rent-seeking. Second, politicians and technocrats had close relationships and formed a flexible and fast-reacting system of policy implementation. Third, despite of not having transparency and fiscal obedience, the government ran very flexible and cautious macroeconomic policy (Grassman 2008). During the oil booms the government was fast in decisions: made exchange rate devaluation, expenditure reductions and conducted economic reforms in order to adjust economy to a new level of revenues. Last, up to 20% of investments in the time of oil booms were allocated to non-booming sectors in order to keep economy diversified (World Bank: Cambodia 2007: 3). These actions undertaken were an outcome of government's quick reaction to the size of oil revenues. An interesting thing here is that institutions were not significantly improved over the time of beating the RC; however, the RC itself was beaten and the countries had a significant development progress. The reason for this is the fact that rent-seeking, corruption and other weak institutional conditions *were not worsened* by the resource booms, the government kept them at least stable though weak. The President of Indonesia, Suharto, could manage to keep corruption "within the limits of what the market would bear" (UNDP 2006: 27). However, this does not work for the long-term. During the financial crisis of 1997-1998 Indonesia had harder time, than other Asian countries and many researchers argue that the reason was a combination of rapid growth due to the oil exploitation and weak institutions which harm an economy when they are ignored (Pan 2005). Thus, Indonesia having poor initial conditions and weak institutions could manage the oil wealth with its strong government will and fast policy reaction on macroeconomic changes. However, in a long-run such policy can not be sustainable if weak institutions are still in present.

1.2.4 Factors for avoiding the resource curse: final observations

This subsection constructs the factors of success in beating the resource curse based on the previous observation of the world cases. Despite different initial conditions, institutions and economic development, Norway, Botswana and Indonesia have common features needed for effective implementation of government policies to cope with the curse. There are three main factors. The first is *fast government's reaction* on macroeconomic changes. Norway and Botswana when the natural resource was discovered undertook a big combination of policies in order to 'attack' a potential problem from all sides. Due to its fast reaction and immediate change in policies, the government of Indonesia could manage to avoid the spending effect when the oil prices went up. The second factor, and the most important, is *strong institutions* which promote transparency and prevent corruption and rent-seeking. Strong institutions in Norway helped to manage effectively the Petroleum Fund and run transparent fiscal policy. In Botswana they enhanced effective policy implementation, despite poor initial conditions. In contrast, Indonesian weak institutions were an obstacle to have stable growth in a long-run. The last factor can be considered as a component of strong institutions. However, for such countries, like Indonesia without strong institutional base, this factor should be separate, since it can contribute to success in beating the curse. This factor is *government/political will* to manage oil revenues effectively. If countries with weak institutions have at least political will to conduct the reforms against the resource curse, then it can be the first step for combating the curse. However, consequently these countries have to make institutional changes to stay away from the curse for a long period. These factors will make the policy implementation to cope with the curse more effective.

This chapter, first, has provided the symptoms of the resource curse, which will be applied in chapter two in order to prove that Kazakhstan has a danger to experience the oil curse. Second, it has built the link between the curse and government policy and showed that government has almost sole power to cope with the resource problem. Third, it has analyzed three world successful cases of beating the curse and identified the factors of success which will be used to construct policy recommendations for Kazakhstan in chapter three.

Chapter 2: Development of the Oil Sector in Kazakhstan: Resource Curse Symptoms and Government Policy

This chapter provides practical observation of the oil sector development in Kazakhstan, identifies existing symptoms of the oil curse (which were theoretically constructed in chapter one) and shows importance of government policy in causing these symptoms throughout three periods:

- the first decade of transition (1991-2000);
- the oil boom (2000-2006); and
- the financial crisis (2007-2009).

The first section, that is the first period of transition, shows the first and fast steps of economic recovery, which influenced the speed and the way of oil sector development. It also provides the *first resource curse symptoms* appeared with the increased oil exploitation. The second section is the most detailed, since it describes the oil booming time where all currently existing oil curse symptoms took place. Thus, the second section identifies *current oil curse symptoms* in Kazakhstan. The third section makes this work very relevant, since it provides *new conditions*, formed by the financial crisis, for coping with the symptoms, identified in the second section. These new conditions are obstacles for the government to construct a sustainable policy for preventing the oil curse and have to be necessarily taken into account.

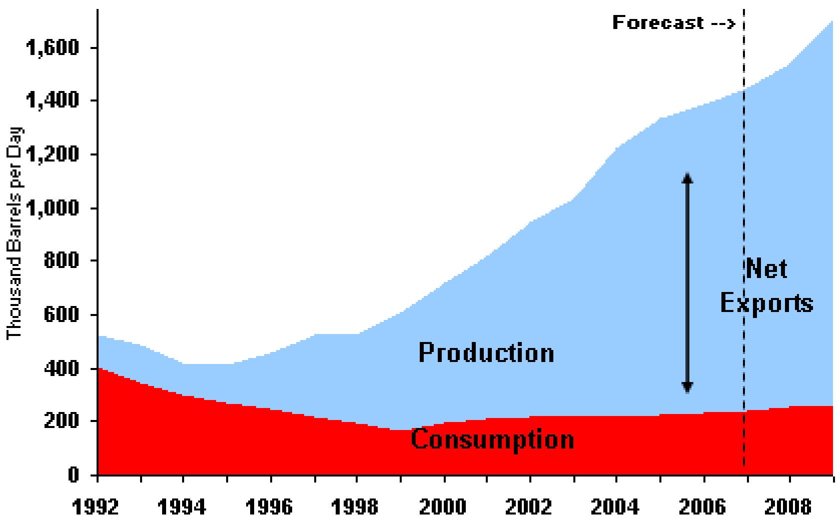
2.1 During the First Decade of Transition/ 1991-2000

For Kazakhstan getting independence in 1991 meant a totally new path of development full of enormous challenges. Two major challenges were switching from the system of central planning to a market economy and building trading links from scratch, not only with former republics and other countries, but also with new production systems, since all former Soviet Union (FSU) countries had a period of politico-economic deterioration.

Despite all initial difficulties, Kazakhstan undertook many efficient reforms. The Kazakh government stabilized distortions in trade, liberalized prices, improved the budget process, conducted privatization of small and medium enterprises (SME) and partial privatization of the electricity sector, and maintained a framework for the attraction of foreign direct investment (FDI) to the NR sector. Vigorous banking sector and pension system reforms followed the chain of structural changes. All these changes positively influenced the speed of Kazakh industrial development.

During the Soviet time Kazakhstan's economy was concentrated primarily on coalmining and agriculture. However, after 1991 industrial concentration shifted to the oil sector. According to the International Energy Agency's (IEA) Short Term Energy Outlook, oil production stagnated during the first decade of transition (1992-1998), then started to grow significantly and is predicted to increase to 1,71 million bbl/d in 2009 (Figure 1).

Figure 1. Oil production and consumption in Kazakhstan (1992-2009F)



Source: EIA, International Petroleum Monthly. Forecast: Short Term Energy Outlook

Kazakhstan succeeded in FDI attraction due to an effective government strategy of oil sector rehabilitation. It received the highest foreign investment inflows ($24 billion) during the first decade of transition among all CIS countries (EBRD Transition Reports 2000 and 2004).

The oil sector started to develop. This brought *the first symptoms* of the resource curse: enhanced corruption and rent-seeking, which made already weak institutions deteriorate more. Countless corruption scandals, regarding governmental officials' bribery deals, negatively influenced the speed of the recovery. Among the most famous cases of official corruption are a bribe of one million USD to the Vice-Premier Abdullayev in order to postpone the negotiations with Chevron in 1992, a bribe of seventy eight million USD to the President of Kazakhstan, Nazarbayev, and Prime Minister, Balgimbayev, in order to keep in secret a number of hidden oil deals in 1998 (Olcott 2002: 148). All in all, an official macroeconomic report of 1996 indicates a $500 million national loss caused by hidden corrupt transactions during the first years of independence (Olcott 2002: 148).

As an outcome of the government policy of FDI attraction, despite initial financial and industrial problems and enhanced rent-seeking, aggregate oil production was recovered by 1997. The state controlled only fifteen percent of total oil production through KMG, the rest eighty five percent were managed by foreign companies. Since the first year of rehabilitated oil production, 1998, up to the beginning of the oil boom period, 2000, the share of oil exports in country's GDP increased by three times, from 7,5% to 24,1% (Table 1).

Table 1: Oil Output and Exports, 1998-2000

	1998	**1999**	**2000**
Oil production (mmt)	25.6	29.4	35.4
Oil exports (mmt)	20.4	23.7	29.4

Oil exports ($m.)	1,650	2,164	4,429
Oil exports (in % of GDP)	7.5	12.8	24.1
World oil price ($/bbl)	13.1	18.0	28.2

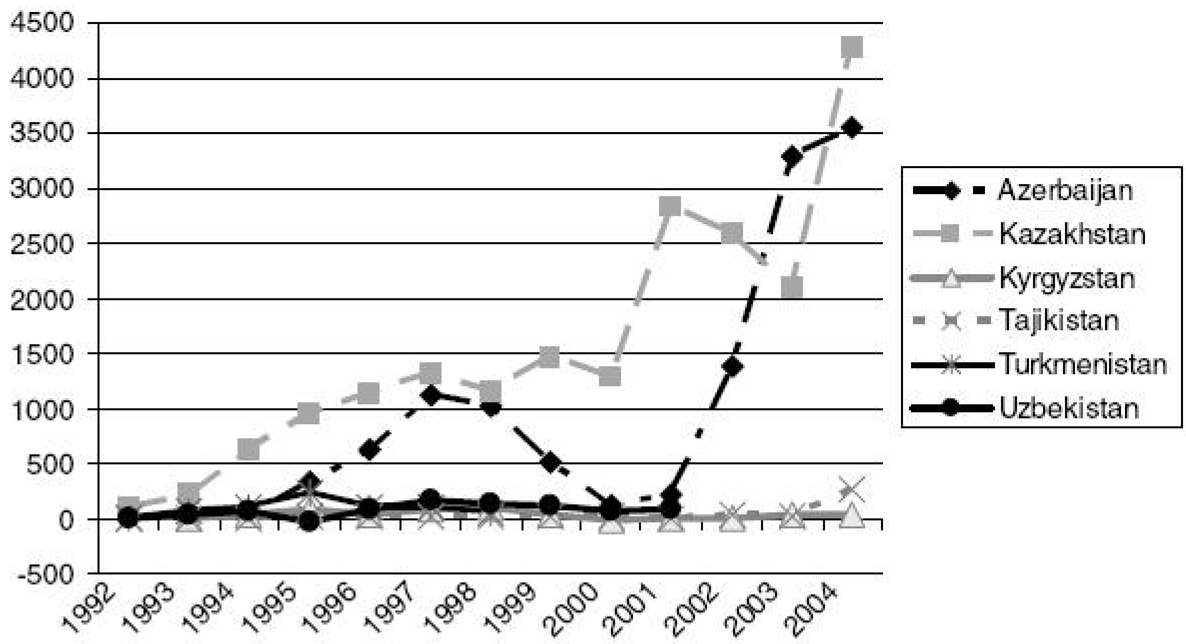
Source: International Monetary Fund, 2003b

In sum, during the first decade after the dissolution of the Soviet Union, government policy played a crucial role in economic recovery in Kazakhstan. Active ambitious actions and reforms gave operational power to the oil sector. On the one hand, fast development of the resource sector helped to revive the rest economy; on the other hand, increased oil revenues enhanced the interest of the state in controlling the sector, thus, increased rent-seeking and corruption among governmental officials. This created stronger incentives for the state apparatus to develop oil sector and extract higher profits, has led to subsequent economic dependence on the revenues from the oil sector and can bring about more substantial macro-problem, which is the ‘oil curse’.

2.2 During the Oil Boom/ 2000-2006

Due to large FDI inflows and penetration of foreign companies to energy sector, the share of Kazakh exports to the CIS and Baltic states shrank from 58% to 27% and increased to the rest of the world by 31% during the period 1995-2000. Among resource-rich countries of Caspian region, Kazakhstan competed just with Azerbaijan in terms of FDI attraction and, eventually, had greater success (Figure 2). This intensive investment accumulation promoted rapid expansion of the oil sector in Kazakhstan in the second decade of independence. However, this full government concentration on the oil sector as the only, considered at that time, strongly growing sector made non-oil sector collapse. This was the beginning of the process of economic dependence on oil revenues where many curse symptoms can be seen.

Figure 2. Caspian Sea Region, Foreign Direct Investment, million USD



Source: UN/ECE Common Database

This period of oil sector development was the most active because of the boom. That is why it will be thoroughly analyzed with the aim to observe the oil curse symptoms and government strategy to manage oil revenues. This period will be analyzed by identifying the presence of the following symptoms in Kazakhstan: Dutch disease, efficiency of fiscal policy and negative institutional changes.

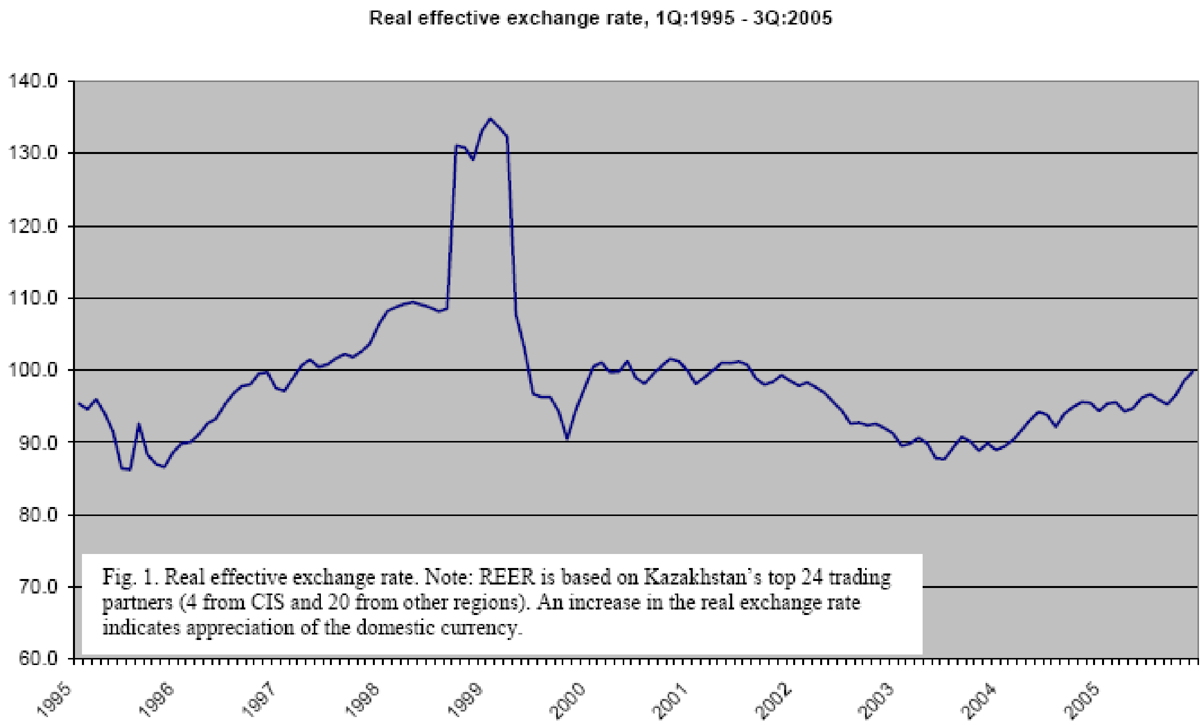
2.2.1. Dutch disease

Since Dutch disease is a disease of industrial non-diversification due to the RER appreciation after the increase in oil prices, RER appreciation and industrial diversification are the issues/symptoms to tackle here.

2.2.1.1 RER appreciation

During the first decade of independence the government had already practiced different exchange rate regimes. In 1994 in order to stabilize economy it maintained monetary policy which was built on "an almost fixed exchange rate regime" and was successful (World Bank 2005: 37). This monetary policy was also held during the crisis of East Asia in 1997 and during the Russian crisis of the ruble devaluation in 1998. It was a big government mistake not to maintain a floating exchange rate during the crisis of 1998 since the competitiveness against Russia was lost. Finally, in 1999 the exchange rate was allowed to float. Consequently, domestic currency depreciated for a while, and after the increase in oil prices in 2000 the exchange rate trend indicated a real appreciation of the tenge (Figure 3). After these trials and mistakes in managing the exchange rate, the National Bank of Kazakhstan (NBK) admitted its hesitation about having any explicit or implicit exchange rate target (World Bank 2005: 37). Being in transition and having no significant experience in exchange rate policy, the Bank's policy was exposed to the risks of Dutch disease.

Figure 3. Real Effective Exchange Rate, 1995-2005



Source: National Bank of the Republic of Kazakhstan, Real Effective Exchange Rate Index

There are some research studies that empirically analyze the existence of the Dutch disease symptoms in Kazakhstan. Kuralbayeva et al. (2001) confirmed the fact of decreasing influence of inflation on the RER and the significant role of real wages in changes in the RER. They also found that the terms of trade (TOT)[1] have a significant correlation with the RER (12-17%) (Aitmambet 2005: 9). Another study (Kutan et al. 2005), extending that of Kuralbayeva et al., modified in terms of more variables and longer time period, also showed a significant impact of the oil prices on the RER changes (42%) (Aitmambet 2005: 9). An uncertain exchange rate policy of the NBK and this empirical evidence show that Kazakhstan was facing the Dutch disease symptoms.

There were some government's attempts to avoid this symptom. In 2003 the President adopted a new Innovative Industrial Development Strategy (IIDS) for 2003-2015, which is aimed to provide diversification of manufacturing industry and exports of goods and services with high value added. According to this strategy, the government regulates stability of the tenge not through the RER management, but through inflationary policy. This strategy was a big step forward. However, due to increasing oil prices and increasing oil production the RER appreciation was unavoidable. Moreover, according to the IIDS, the period of 2003-2005 was the first part of the Strategy (the first out of three) and was a period of preparation to the Strategy realization. It means that during this period no significant changes were made in terms of both industrialization and inflationary regulation. Thus, the RER, being directly and irresistibly influenced by the changes in oil prices, was appreciating.

2.2.1.2 Industrial diversification

Intentional neglect of the manufacturing and agricultural sectors for the sake of the oil sector development brought about their collapse by the end of 1990s. Agriculture employed one third of the labor force, however, its revenues accounted for just about ten percent of GDP (Pomfret 2005: 869). Overdependence on oil sector during the first years of the oil boom (2000-2003) made the government inattentive to the quality and impacts of the industrial policies it was

[1] TOT – ratio of export prices to import prices

undertaking. Eventually, all government's policy mistakes brought about a decline in agricultural productivity growth rates whereas the oil sector kept expanding its production. The manufacturing sector was not also provided with any incentives to increase production and it kept being dependent on imports. The share of manufacturing in the overall production had also dramatically declined.

The government made some attempts to avoid non-diversification. In 2003 it started to maintain new national programs, strategies and institutions directed on support of diversification. There were established Development Bank of Kazakhstan and Investment Fund of Kazakhstan in order to finance investment projects with high priority according to the IIDS. These institutions sponsored all development projects during the period of 2004-2006. Starting from the second half of 2006, which is the beginning of the second part of the Strategy (2006-2010), the projects were supported by the National Fund of the Republic of Kazakhstan (NFRK) formed of the oil revenues. This started to affect positively non-oil sectors, but the speed of the oil sector growth was enormously higher than any other sector's (Pomfret 2005: 870). The government's attempts did not help to avoid the symptom of non-diversification. Since all these established institutes and the NFRK operate under the government power, there is always rent-seeking. All operations are bureaucratic which discourages private sector from any participation. In addition, it is claimed that the IIDS' projects are mostly of low quality in terms of returns and risks; otherwise, they would have been given to commercial banks to finance them (Aitmambet 2005: 16-17). Thus, despite formal improvements towards industrial diversification, such as adoption of new strategies and establishment of new institutions, the problem of diversification was significant in the period of the rapid oil sector growth of 2000-2006. In a combination with the RER appreciation it seriously exposed Kazakhstan to the risks of Dutch disease.

2.2.2 Efficiency of fiscal policy

The fiscal policy aspect will be discussed based on its two main components: revenue and expenditure policy.

2.2.2.1. Revenue policy

Starting from 2001 the FDI inflow reached two billion dollars a year with its eighty five percent going to the natural resource sector (IMF 2004: 18). General revenues of the government were strongly and positively impacted by the growth of oil sector through the fiscal receipts, which were accounted for twenty percent of the total national income (IMF 2004: 18). In 2004 the government adopted tax code amendments, which included one additional very beneficial tax that is the rent tax on export of crude oil. Since the oil exports were growing rapidly, this tax raised the oil income in the general government's revenues from sixty five to eighty five percent (US Department of Energy 2004). Among main revenues from the oil exploitation are (Najman et al. 2005: 5):

- export sales of crude oil;
- tax applicable to subsurface users which includes excess profit tax (EPT) or production-sharing agreement (PSA);
- taxation of business profit;
- indirect taxation; and
- other taxes (land, property taxes, licenses, etc.).

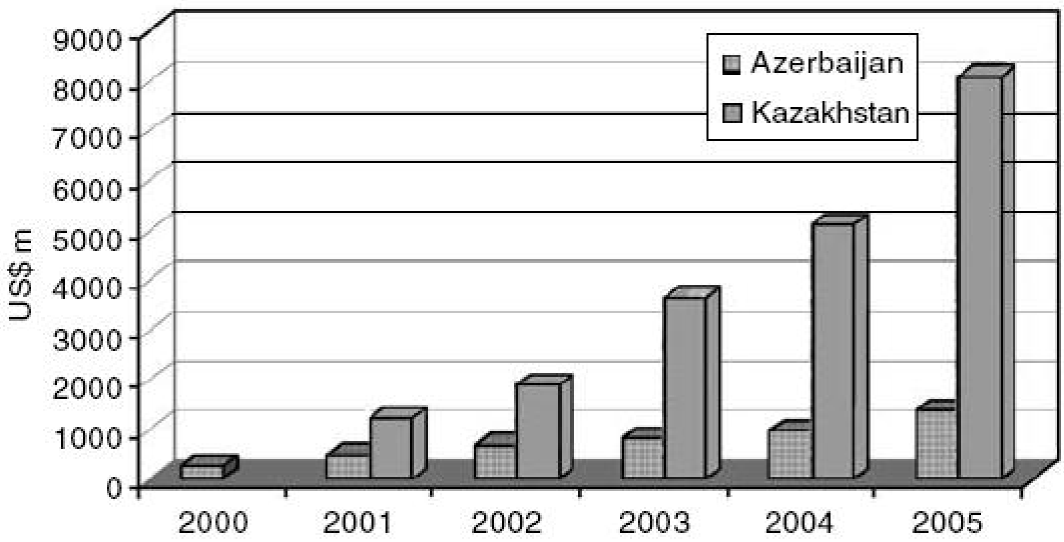
Due to increasing oil production, an appropriate taxation system and, which is more important, rising oil prices Kazakhstan's budget accumulated two billion dollars a year on average during 2000-2006 and was forecasted to reach more than seven billion by 2010 (Najman et al. 2005: 5-7). Obviously, this was very beneficial for Kazakhstan, however, it created some problems. High oil revenues and open rent-seeking opportunities, based on the weak transparency institution and high level of corruption, relaxed overall government taxation policy. The taxation policy had to be directed not only on the oil sector, but also on the non-oil sectors of economy and had to control income variations in order to secure future from unexpected drop in oil revenues. In addition, tax revenues accumulated from the oil sector were not transparent. According to the tax legislation, payments by foreign companies, operating in Kazakh oil industry, to the government were under secrecy. This could be changed, but there was no government will for this. All changes in favor of oil revenue maximization were crossed out by weak transparency.

2.2.2.2 Expenditure policy

In order to strengthen the oil revenue management, the government established the National Fund of the Republic of Kazakhstan (NFRK) in 2000. The fund is aimed to operate as a stabilization and savings fund. The NFRK is managed by the following primary governors: the president, Nazarbayev, the prime minister, the heads of the two parliament chambers, the minister of finance and the NBK chairman. The President has absolute power over the special Management Council of the fund. Only two out of six primary governors do not report directly to the President. However, none of the six have a power to manage the fund. They serve only as advisers to the President. It means that Nazarbayev fully controls revenue allocation (Kalyuzhnova 2006).

Capitalized by the oil revenues in a form of previously discussed taxes, the National Fund is invested in liquid equities abroad and encompasses two functions: stabilization (25%) and long-term investment (75%). The main mission of the NFRK is to save resources for the future generations and securitization of the domestic economy. So that during the first years of the oil boom, the oil revenues were not spent for current expenditures, but were saved and invested abroad. The manner in which the NFRK is organized is duplicated from the Norwegian strategy of running the fund.. By 2005 the reserves of the NFRK accounted for more than eight billion dollars, whereas, or instance, in Azerbaijan, the country which managed to establish its stabilization fund earlier, the reserves barely exceeded one billion dollars by the same time (Figure 4).

Figure 4. Funds of the NBRK and the SOFAZ (the State Oil Fund of the Azerbaijani Republic), 2000-2005, in million USD



Source: Kalyuzhnova, Y., 2006, 603

A creation of the NFRK was a wise and fast step towards higher economic development and higher reliability of the revenues from the oil sector. However, there were two problems. The first problem was lack of transparency in NFRK budget reporting. The reports include just main abstracted categories of revenue accumulation and revenue allocation with no additional information about explicit detailed categories of tax payers and expenditure destinations, with no explicit calculations. This makes the NFRK budget not transparent and decreases public trust to the government's actions.

The second problem was connected with transmission channels through which a part of the oil revenues was redistributed to society. A household survey analysis made by Najman et al. (2005:

7-10) provided evidence that the oil boom did not have any positive influence on the living standards in the regions where oil is produced, whereas it did have a positive influence in the capital and metropolitan cities full of elite. As Najman et al. claim, the major revenue transmission mechanism is unofficial redistribution, which results from unregistered transactions. Currently (2009) these two problems also hold true. Even though the formal outcomes of the NFRK creation look sustainable and reliable, there are also informal outcomes, which are not easily visible, and lead to the leakage of revenues. These informal outcomes are impediments to the real profit and wealth maximization.

Thus, weak transparency and rent-seeking opportunities in revenues policy, relaxed tax policy, a lack of transparency in NFRK reporting, unofficial channels of revenue redistribution and oil revenue management concentrated only in the President's hands allow to claim that the fiscal policy in the context of high oil revenues were not efficient.

2.2.3. Negative institutional changes

During the period of 2000-2006 there were no significant positive institutional changes. On contrast, democratic and transparency institutions were deteriorating. The president of Kazakhstan had been ruling the state in a quasi-authoritarian manner running so-called 'managed democracy'. All processes of revenue accumulation and allocation were under his direct control or the control of his 'clan': e.g. his daughter, the head of political movement supporting president, or his son-in-law, the head of the state oil and gas pipeline company TransNefteGas. Clan governance was the way in which the country was governed. So the oil boom did not improve *political institutions*, but even enhanced them to be more centrally controlled.

As to *transparency institutions*, there was made progress, when Kazakhstan agreed with the Extractive Industries Transparency Initiative (EITI) to publish the first report on the oil revenue inflows in 2005. However, generally the weak institutionalization of the state became even weaker. Increasing oil revenues enhanced high level rent-seeking and corruption, increased a number of unregistered transactions and hidden incomes. Thus, the oil boom mostly 'contributed' to initially weak institutional base in Kazakhstan.

Due to progressive development of the oil and banking sectors and fast economic growth during 2000-2006, the government significantly increased expenditures for the nationally prioritized programs such as health care, agriculture, education, etc. (*REGNUM Information Agency*, 2006). These expenditures were relying primarily on increasing oil revenues, and, thus, were not sustainable (*REGNUM Information Agency*, 2006). The budget was supported by guaranteed transfers from the National Fund, and almost all oil export revenues, started from 2006, were spent on expanded programs. This has consequently led to increased budget deficit.

Besides the increased spending of the National Fund's revenues on long-term social programs, which makes government more dependent on oil incomes, there are other symptoms of the resource curse, which have become stronger. First, expanded 'clan interests' limit competition in private sector, what decreases any incentive to produce more and contributes to deindustrialization. Second, despite the Strategy of Industrial Development, there is infrastructure crisis in agricultural and industrial sectors, which slows down the development of non-oil sectors. This infrastructure crisis is a result of limited competition in industrial sector and import dependence (*REGNUM Information Agency*, 2006). Infrastructure crisis, limited competition and import dependence have facilitated non-diversification and stimulated inflation.

The period of the oil boom during 2000-2006 has brought Kazakhstan to a new level of development with the establishment of the NFRK, Development Bank of Kazakhstan and Investment Fund of Kazakhstan, tax code amendments, more experience in monetary and fiscal management. However, three main symptoms of the oil curse were identified: the likelihood of

Dutch disease, not efficient fiscal policy and deteriorated institutions. It can be seen that weak control over the RER appreciation, limited by clan interests competition, infrastructure crisis, not sustainable industrial policy and, as a result, economic non-diversification and overall dependence on the natural resource sector, enhanced the role of the state due to increased opportunities for rent-seeking, and weak institutions create a serious danger of facing the oil curse. All these problems still hold true (2009), since the period of financial crisis (2007-2009) has not allowed keeping the programs of industrial diversification, inflationary policy and long-term targets of economic growth as they were. Financial crisis has become an obstacle on the way of realization of macroeconomic plans and has created new worse conditions for the economic stabilization.

2.3 During the Financial Crisis/ 2007-2009

The financial crisis of 2007-2009 has stopped realization of macroeconomic policies and industrial strategies, which the government was vigorously undertaking. Moreover, it has created additional problems, which has switched policy emphasis from the problem of oil-dependence to the financial and banking problems. The financial crisis has not created any new symptoms of the resource curse, but *has enhanced the old ones*, 'inherited' from the time of the oil boom (2000-2006). However, it has created *new conditions* for coping with the danger of the oil curse. That is why this section presents these new conditions in order to take them into account while providing policy recommendations for preventing the oil curse in chapter three.

Due to very high oil prices in the period of 2007-fall 2008, oil exports counted for about ninety percent of total Kazakh exports (Saidov, 2009). However, all oil revenues were directed to support financial markets, which were dramatically distorted by the crisis. In addition, social policies, expanded during the oil boom and supported by guaranteed transfers from the National Fund, require continuing support from the republican budget, which is currently overburdened by other huge expenses. All this has brought about huge budget deficit. Table 2 shows that budget deficit was five times higher in 2007 and seven times higher in 2008 than that of 2006.

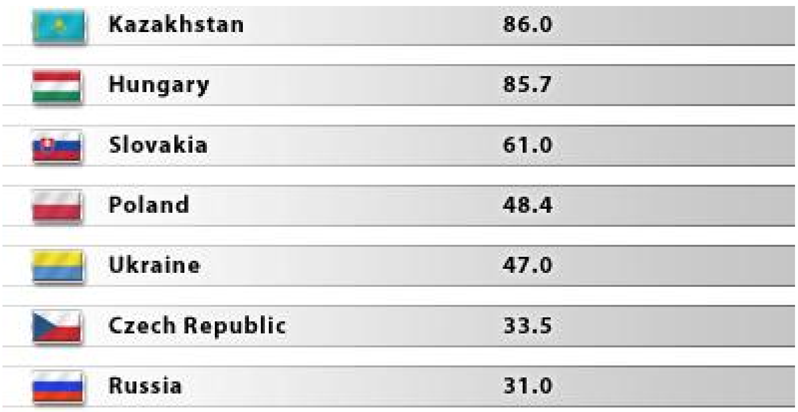
Table 2: Budget deficit/surplus, 2006-2008

	2006	2007	2008
Budget deficit/surplus (in billion tenge)	54,7	-212,5	-327,5

Source: Ministry of Finance of the Republic of Kazakhstan (table is constructed by the author, Ustyantseva N., based on the information from consolidated budgets for 2006, 2007 and 2008)

Among main reasons for these dramatic government expenses are the following. First, financial and banking sector was most dramatically affected by the crisis. Due to unsustainable management of financial assets, the financial system had become massively indebted to foreign lenders (Astakhov 2009). The market price of companies has decreased to more than sixty one percent, the quality of their credit portfolios has lowered, the volume of trades became 2.1-fold lower within eight months in 2008 compared to the same period in 2007 (Saidov, 2009). In the begging of 2009 externally held private sector debt was eighty six percent of GDP, which is more than that of the countries, dramatically affected by the crisis, such as Hungary, Ukraine and Poland (Figure 7). The government has created the fund of so-called stress assets with 122 billion tenge in order to support financial system of the country (*Energy Focus*, 2009).

Figure 7: Externally Held Private Sector Debt (as percent of GDP)



Source: STRATFOR, 2009

Second, due to decreased value of financial assets and companies and vulnerabilities on the world financial markets, investors started to leave Kazakhstani markets. An outflow of finances has created higher currency instability and lack of financial resources to run major companies. The government came up with a solution which was common around the world, but can not be sustainable in a long-run – nationalization of main companies and banks which are too big to fail (Astakhov, 2009).

Third, the construction sector was also seriously affected by the crisis. In recent years the construction sector was rapidly developing and massively credited. Lack of finances on national financial markets resulted in seventy percent freezing of construction in Kazakhstan (Saidov, 2009). The government allocated four billion dollars in order to complete main construction projects in Almaty and Astana. Eighty five percent of allocated money was from republican budget (Saidov, 2009).

Last, this government's allocation of money to support economy enhanced corruption, especially in government decisions. For instance, seventy-four construction projects which were bailed out belong to the people who are close to the President (Saidov, 2009). Moreover, conditions of the current crisis decrease market liberalization and the level of democracy, providing opportunities for Nazarbayev and his clan to consolidate control over financial system (Astakhov, 2009).

All these problems, increasing budget deficit and, what was more important, decreasing oil prices forced the government to lower tax pressure for the real sector, give export duties for oil products and cut expenditures by almost twenty percent for 2009-2011 (Saidov, 2009). One positive thing is that the government introduced a new Tax Code and the first Medium-Term Expenditure Framework (MTEF) in December 2008, which is "aimed at result" and provides a detailed budget plan for the next three years (*Kazakhstan Today*, 2008). This will help to clearly see and manage the budgetary process.

However, such an expansionary policy leads to inflation. In February 2009 the tenge depreciated by 22%, which made the banks' loans abroad appreciate in the real value and increased external debt of the country (*STRATFOR*, 2009). Even though one of the main reasons of this depreciation was ruble depreciation, expansionary policy also has its significant inflationary influence.

Thus, the financial crisis of 2007-2009 has brought new conditions for the government to cope with the danger of the oil curse, which makes this 'fight' more tense. Significant inflation, unstable domestic currency, industrial decline, consequent increase in unemployment, "freezing" investment projects, lack of investments, dropped consumer demand, enhanced corruption and dramatically distorted financial markets are new challenging conditions, in which the course of preventing the oil curse must be taken. This is a chance to find the ways to decrease oil revenue dependence, while the oil prices are low to rely on.

Chapter two has shown that during the first decade of transition, when the oil sector just started to develop, one symptom of the resource curse had already appeared which is enhanced corruption and rent-seeking in the resource sector. It was also observed that during the boom time three main resource curse symptoms took place. Finally, the chapter has provided new macroeconomic conditions which have to be taken into account in a provision of anti-oil-curse recommendations in chapter three.

CHAPTER 3: POLICY IMPLICATIONS AND FINAL RECOMMENDATIONS

Through the identified symptoms, chapter two has showed that there is a danger of the oil curse in Kazakhstan. It has also identified new severe conditions, as a result of the financial crisis, to cope with the curse. Based on this, chapter three will construct policy recommendations for preventing the oil curse in Kazakhstan.

Based on the analysis in chapter two, it can be said that in Kazakhstan there are two out of three ‘factors of success’ which were identified in chapter one as factors helping to avoid the curse. They are fast government’s reaction on macroeconomic changes and government will to manage oil revenues effectively. Kazakhstan was vigorous and ambitious in its reforms during the last two decades of independence. The government was able to adopt quickly the country to new market-based economy. Thus, it can be claimed that the government is well-organized to react quickly on macroeconomic challenges. Moreover, Kazakhstan has been moving towards international standards using world experience through establishment of the National Fund, through the first report on its oil revenue management for the EITI, through adoption of a new budget code with MTEF. It means that the government has its will to manage oil wealth effectively. However, there is a lack of strong institutions to promote transparency, prevent sent-seeking and corruption in the oil revenue management. This is a big impediment on the way of combating the curse symptoms and should be taken into account.

3.1 Fiscal policy

Even though the prices of oil started to go up last months (*Energy Focus* 2009), nobody can be sure that in current vulnerable, and somehow unpredictable, financial conditions, the situation on the oil market will take the V-shape. It can rather take the shape of W where the oil prices can be tricky and, first, go up making oil-rich countries again rely on them, and then drop down harming already harmed oil economies by decline in expected revenues. That is why fiscal policy is the most important instrument for the oil revenue management and will be the main aspect in this chapter to discuss.

For a long-term stability and growth, the government of Kazakhstan should try to maintain a modest fiscal discipline where real spending growth should not be more than real growth of the economy. This will help to avoid pressure on the exchange rate while implementing monetary policy. This will also minimize a need for economic sterilization, since the spending effect will not take place. Eventually, this will make the economy relatively stable, not depending on the oil income changes.

This modest fiscal discipline can be achieved through, first, efficient management of the National Fund's assets, and, second, through strict regulation and legislative support for the newly introduced Medium-Term Expenditure Framework for 2009-2011. The Expert Bureau *Energy Focus* (2009) says that oil revenues were invested in foreign assets which lost their liquidity and real value during two crisis years. However, some part of the Fund's assets should have been *regularly* directed to the real sector development projects without total concentration on FDI attraction. It means that due to unexpected severity of the current financial crisis, the duplication of the Norwegian Fund asset management did not, eventually, work out. Moreover, last years due to financial instability the government started to use almost 100%-oil income to support the economy.

In order to manage efficiently the NFRK assets, the following strategy can be used. The oil revenues should be invested in diversified foreign assets. The return on these assets, which is fixed, can be regularly used for the real sector development. The return in a form of foreign exchange inflow will not be as dangerous for monetary stability as the injection of a big fraction of oil revenues. Moreover, such relatively small financial injections to the economy will make the process of real sector development and economic growth gradual and, thus, stable. In addition, the NFRK's operations have to be as much as possible integrated into the state budget which will ease the revenue management and supervision over expenditure.

Currently, when the economy needs financial support, slowly increasing oil revenues can be carefully used just for supporting main development priorities, defined by the IMF (2009)[2] as infrastructure, health and education. Moreover, much other expenditure should be cut. Thus, MTEF is a key strategy for proper expenditure scheme.

Since MTEF was introduced just in December 2008, it should have the following improvements. First, to get full benefits of MTEF stringent conditions should be fulfilled. These conditions imply strong control over the whole process of budgeting. Since Kazakhstan has weak institutions of monitoring and control and, as an additional obstacle, a problem of corruption, more attention has to be directed to the institutional improvements. This can be gained through a higher degree of involvement into the budgeting process of external international experts and organizations on anti-corruption.

Second, technical improvements to expenditure and revenue forecasting should be provided. This will help to manage budget predictability more effectively. Moreover, all potential critical situations in a budget cycle can be more easily highlighted through increased level of predictability.

Third, sector ministries should be provided with appropriate incentives. This has to be done in order to actively involve sector ministries to provide fuller information which is required for the

[2] International Monetary Fund, 2009. "Republic of Kazakhstan – 2009 Article IV Consultation. Preliminary Conclusions of the IMF Mission"

improvements of costing programs and policies. Full information is a way for an objective process of the assessment of real costs and revenues without asymmetry problems.

Last, government accountability should be enhanced. According to the Open Budget Index (2008)[3], Kazakhstan has a score of 34%, which means that during the budget year (2008) Kazakhstan provided minimal information to the public in its budget documents. This makes it not easy for the people to keep government accountable for its public money management. It is also mentioned in the note to the Kazakhstan's Open Budget Index score that actually Kazakhstan publishes pretty full and detailed year reports but does not publish a review of a mid-year budget. So there is a need to strengthen public accountability through higher level of transparency by, for instance, publishing these mid-year reviews and provision of a comprehensive review on the budget implementation during the budget year.

Thus, modest fiscal discipline, enhanced fiscal responsibility to regulate revenue volatility through efficient NFRK asset management and improved scheme of the expenditure process should help to somehow stabilize currently distorted economy, decrease oil income dependence and promote growth in a long-run.

3.2 Monetary policy

After the February devaluation the tenge remains relatively stable, since the demand is weak. If this stability will hold for some more time, the monetary policy can be a little bit eased in order to support financial system. However, real interest rates should be kept positive in order to keep incentives for the people to put money to deposits and provide banks with some operational help.

[3] Open Budget Index 2008 Kazakhstan, International Budget Partnership. www.openbudgetindex.com (accessed June 12, 2009)

Since FDI keep coming to the economy due to increasing oil prices, the foreign exchange flows should be well-regulated and balanced, taking into consideration the situation in the banking sector which has to be kept stable.

Thus, given not any more deteriorating banking sector, stable inflation rate and slowly increasing oil prices, the monetary policy can be eased *to some extent*, however, all foreign exchange flows have to be strictly regulated. Moreover, with the modest fiscal discipline if held, the conditions to maintain monetary policy will be facilitated. However, it should be mentioned that when the financial situation will be stabilized there is a need to tight the credit by slowing the pace of credit expansion.

3.3 Industrial policy and human capital

In order to keep taken in the Strategy of Industrial Development direction of economic diversification, the government, first, should promote higher incentives for the labour force to work in non-oil sectors by, for example, making wages in the non-oil sectors dominant. Second, with further increase in oil prices (if it will happen), the government can increase taxes in energy sector and, thus, to lower an overall tax level. This will give more incentives for domestic private investments, create more job opportunities and decrease current unemployment. Third, creation of a good investment climate will attract more FDI to the economy and contribute to the development of non-oil industries. Last, lack of infrastructure necessary for the full operational activity of the non-extractive sectors should be eliminated by promoting free competition on domestic industrial market without any clan interests' intervention.

The quality of human capital is a crucial component of the success in diversification. Educational system should be responsive to the market needs. It means that educational policy has to be analytical, flexible over time and has to provide life-long learning opportunities. It is essential to keep investments in education among the most prioritized fields.

Thus, provision of higher privileges, good investment climate and higher competition in non-oil sectors in a combination with sustainable educational policy is a way to combat the existing symptoms of the oil curse.

3.4 Institutions

Strong institutions, as one of the factors which contribute to success in beating the resource curse, can be built if there is a government/political will for it. Since the government of Kazakhstan has a will to promote international standards and be more integrated in the world economy, it has a potential to build good institutions. Currently, when the institutions have deteriorated due to unstable socioeconomic situation, the main aim is to provide strict regulation of all financial flows, both foreign and domestic. Katz et al. in their work (2004) mentioned about establishment of an independent agency which has to regulate resource revenues, to monitor them and regulate the system of transparency. This is a good idea which can be applied to Kazakhstan. However, to make it more efficient, this agency has to be managed by both local and external actors and has to interact with the NGOs such as Revenue Watch, EITI, Publish What You Pay and such other. In addition, this agency should be a central actor to promote participation of civil society. Involvement of civil society in the process of oil revenue management is still a new and vast agenda and, thus, deserves much attention. One more instrument to improve institutions is the E-Government. The information provided by the E-Government, reports and newly adopted national programs should be publicly discussed. This will involve independent resource agency as well as civil society and will enhance currently limited freedom of media. All these actions, if accurately conducted, can lead to financial transparency, can decrease rent-seeking and corruption and consequently can contribute to realization of fiscal and monetary policies and prevent the oil curse in Kazakhstan.

This chapter has offered possible solutions for the government through fiscal, monetary and industrial policies to face the danger of the resource curse and combat its symptoms in current unstable conditions of financial crisis.

CONCLUSION

During the first decade of independence the government policy played a crucial role in economic recovery in Kazakhstan. Possessing the largest in the history of the Soviet Union oil field Tengiz, the government directed all attention to the development of the oil sector which was recovered by 1997. So the work observed that, on the one hand, fast development of the resource sector helped to revive the rest economy; on the other hand, increased oil revenues enhanced the interest of the state in controlling the sector, thus, increased corruption among governmental officials. This analysis defined the first symptoms of the oil curse: enhanced role of the state and rent-seeking.

The period of the oil boom has brought Kazakhstan to a new level of development with the establishment of the National Fund duplicated from the Norwegian Fund, creation of National Investment Fund, tax code amendments, more experience in monetary and fiscal management. However, there were identified three main symptoms of the oil curse: the likelihood of Dutch disease, not efficient fiscal policy and deteriorated institutions. Weak control over the RER appreciation, limited by clan interests competition, infrastructure crisis, not sustainable industrial policy and, as a result, economic non-diversification and overall dependence on the oil sector, enhanced role of the state due to increased opportunities for rent-seeking, and weak institutions created a serious danger of facing the oil curse. As the analysis showed, currently these resource curse symptoms still hold true, since the period of financial crisis has not allowed keeping the programs of industrial diversification, inflationary policy and long-term targets of economic growth as they were. Financial crisis has become an obstacle on the way of realization of macroeconomic plans and has created new worse conditions for the economic stabilization. These conditions include significant inflation, unstable domestic currency, industrial decline, consequent increase in unemployment, “freezing” investment projects, a lack of investments, dropped consumer demand, enhanced corruption and dramatically distorted financial markets.

This analysis of the oil sector development in Kazakhstan, first, provided the oil curse symptoms which present in Kazakhstan for the construction of policy recommendations. Second, it helped to understand what 'factors of success', identified in the first chapter based on the experience from successful cases of beating the curse, Kazakhstan has. Possessing two out of three factors, fast government's reaction on macroeconomic changes and government/political will to manage oil revenues effectively, Kazakhstan lacks the most important factor that is strong institutions to promote transparency, prevent sent-seeking and corruption in the oil revenue management. This is a big impediment on the way of combating the curse symptoms. However, two other factors can have a positive contribution to the anti-oil-curse policy implementation if the government will keep its will relatively stable and not affected by weak institutions.

Based on the assessment of the oil curse symptoms and taking into consideration financial crisis conditions, the work provides the following main recommendations. *In terms of fiscal policy*, modest fiscal discipline, enhanced fiscal responsibility to regulate revenue volatility through efficient NFRK asset management and improved scheme of the expenditure process should help to somehow stabilize currently distorted economy, decrease oil income dependence and promote growth in a long-run. *In terms of monetary policy*, the government's actions should be very flexible, since world financial markets are still vulnerable. However, if the situation in the banking sector will not deteriorate more, inflation rate will be relatively stable and oil prices will keep increasing, the monetary policy can be eased to some extent, however, all foreign exchange flows have to be strictly regulated. Moreover, with the modest fiscal discipline if held, the conditions to maintain monetary policy will be facilitated. However, when the financial situation is stabilized there is a need to tight the credit by slowing the pace of credit expansion. *In terms of industrial policy and human capital,* provision of higher privileges, good investment climate and higher competition in non-oil sectors in a combination with sustainable educational policy is a way to combat the existing symptoms of the oil curse. *In terms of institutions*, establishment of an independent agency which has to regulate resource revenues and include both external and local actors, and involvement of civil society in the process of oil revenue management will lead to financial transparency, can decrease rent-seeking and corruption and consequently can contribute to realization of fiscal and monetary policies and prevent the oil curse in Kazakhstan.

Since this work is primarily a policy paper which is aimed at the provision of effective recommendations based on the analytical observation of a case study, there can be one limitation. The limitation is relative unpredictability of the financial crisis and misinterpretation of its effects. Since the current crisis has broken many previous economic laws and is already broadly considered as unique, it can be interpreted in a way which can look correct today, but tomorrow can change the direction.

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