OIL WEALTH MANAGEMENT IN KAZAKHSTAN: 1991-2010

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Abstract

Oil wealth can be a curse or a blessing. Prudent management of oil wealth becomes important for success. This thesis analyses oil wealth management policies of oil rich Kazakhstan throughout three periods representing pre-boom, boom and crisis. Such division equips one with comparative perspective on major problems faced by the country and progress in government policies. Kazakhstan excelled and performed relatively well against common pitfalls of increased oil revenues. However, battle is still not won, and Kazakhstan continues to face oil-led problems. Therefore, several recommendations are given as a starting point for improvement.

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List of Abbreviations

ACP	Anti Crisis Plan
ADB	Asian Development Bank
CIT	Corporate Income Tax
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
IOC	International Oil Company
JV	Joint Venture
KRW	Kazakhstan Revenue Watch
KZT	Kazakh Tenge
mt	million tons
MTBF	Medium Term Budget Framework
NBK	The National Bank of Kazakhstan
NFRK	National Fund of the Republic of Kazakhstan
PSA	Production Sharing Agreement
RER	Real Exchange Rate
SK	Samruk Kazyna
SME	Small and Medium Enterprises
TOT	Terms of Trade
VAT	Value Added Tax
WB	World Bank

Introduction

Kazakhstan's oil and gas production and exports have steadily increased since 1991, especially after 2000 when oil prices boomed. With the region's second largest oil and gas reserves after Russia, Kazakhstan is expecting large inflows of oil and gas revenues in the years to come as oil expected to peak in 2020 (EIA 2009).

The country is no longer limited in financial resources and can substantially benefit from its resource abundance. Experience of many resource rich countries, however shows that "[…] a sudden influx of great wealth is not always a development "good"" (Karl 1997, 24), as many of them performed poorly than resource poor countries - phenomenon known as "resource curse". Many researchers tried to find answers what makes resource rich countries fail to sow the benefits of their resource abundance. Their arguments can be considered in two separate domains: economic as well as political.

The thesis stresses mainly economic domain (political is not studied due to space limit), as it is analyses economic policies of Kazakhstan in management of its oil wealth while analysis of macroeconomic quantitative data is less contestable than "measures of institutional quality" (Anker and Sonnerby 2007, 16). Furthermore, it identifies the role of the government as primary while state is the exclusive recipient of the oil revenues in most of the cases (Devlin and Lewin 2004, 5), that to greater extent determines the final effect and outcome of a resource abundance, i.e. whether it is a curse or a blessing (Davis, Ossowski and Fedelino 2003, 3). In this case, governments of the resource rich states are faced with the challenge of management of oil and gas revenues, precisely, challenge to find an optimum between immediate utilization of wealth and its long-term prudent management and design appropriate policies to deal effectively with the resource windfalls (Barnett and Ossowski 2003), to avoid the problems and pitfalls of resource curse.

However, Kazakhstan's dependency on oil and gas sector is less pronounced than in other oil rich countries (WB 2005, ii) and country experienced substantial economic growth and stability in the last decade, so study of the role of the government revenue management policies becomes important as initial conditions of Kazakhstan (weak or absent institutions, foreign rents, etc.) predicted fate of "rentier state" (Mahdavy 1970).

The first main objective of this thesis is to give answers to the research question: How did Kazakhstan perform in oil wealth management during the last two decades? Correspondingly, the second main objective is to point out what possible recommendations could help to perform well in future.

To achieve above-mentioned objectives, thesis compares economic performance and government macroeconomic policies in three periods with year 2000 being the turning point as oil prices boomed. Three periods are analyzed on presence of problems of resource curse and governmental responses on them.

The research is constructed as follows. Chapter one provides a framework of problems and common pitfalls associated with the resource revenue management. The author will identify and explain the main common economic as well as political problems. In chapter two possible recommendations will be given to avoid the identified problems and traps of oil and gas revenues management. For that, selected practices and institutions will be explained. Common recommendations would serve as a checklist for analysis of management policies in Kazakhstan. Chapter three concentrates on Kazakhstan. Using above mentioned periods, an analysis of policies to handle the (common) problems in the real case of Kazakhstan will follow. The analysis is supported by a comparison of the policies in the different periods. The results will give answers if government of Kazakhstan did well in oil wealth management

during the last two decades. Finally, in chapter four, the author gives recommendations for near future management.

Chapter 1: Resource Wealth and Resource Curse

Natural resource abundance does not automatically translate into development. Oil rich countries such as Nigeria, Angola, Sudan failed to "sow the oil" (Auty, 1990), while resource poor countries such as Japan, Singapore and South Korea advanced in economic development. This phenomenon has come to be known as the "resource curse", when natural resource rich countries, specifically oil and gas rich countries, lag substantially behind the resource poor countries in development and economic growth (Sachs and Warner 1997).

Various researchers tried to explain the causes of economic underperformance of resource-rich countries (Lane and Tornell 1996; Rodriguez and Sachs 1999; Gylfason 2001, etc.). Summing up their arguments, resource abundance leads to slowdown of economic growth via:

- currency (RER) appreciation that hampers competitiveness of other sectors (Dutch disease), (Devlin and Lewin 2004, 2),
- volatility of resource revenues that endangers fiscal policy and budgeting (Barnett and Ossowski 2003, 45), and
- weak institutions such as unclear property rights, defect legal system or weak market (Gylfason 2001, 4) that can lead to conflicts (in worst case to wars, Nigeria's and Angola's secessionist movements are attributed to corrupt government that misuses oil revenues (Bannon and Collier 2003).

Based on the analysis of available literature it is clear that resource abundance can be good or bad. The state as the exclusive recipient of the resource revenues in most of the cases (Devlin and Lewin 2004, 5), becomes primary actor, whose decisions to the greater extent determines the final effect and outcome of a resource abundance, i.e. whether it is a curse or a

blessing (Davis, Ossowski and Fedelino 2003, 3). In this case, governments of the resource rich states are faced with the challenge of management of oil and gas revenues, precisely, challenge to find an optimum between immediate utilization of wealth and its long-term prudent management and design appropriate policies to deal effectively with the resource windfalls (Barnett and Ossowski 2003).

This chapter provides a framework of problems and common pitfalls associated with the resource revenue management by identifying possible channels of their transmission into economy. Problems and pitfalls can be considered in two separate domains - economic and political terms. Economic domain will be discussed in detail as this thesis analyses economic management policy of oil rich country, Kazakhstan dealing with the problems and pitfalls that oil and gas revenues can bring. This chapter uses general term of "natural resource abundance" as any resource, be it fuel or wood can be a curse or blessing. This term implies abundance of oil and gas as well and applicable for oil rich Kazakhstan.

1.1 Economic problems of resource wealth

The negative economic effects of resource abundance can be illustrated amongst others with the use of boom-bust nature of resource prices (Devlin and Lewin 2004, 3-5). Oil has a special place among other resources due to strategic importance of oil in economy and high unpredictability and volatility of its prices. In times of a boom, revenue increases, in times of a bust, revenue decreases. There are two main problems associated with boom-bust characteristic of resource prices: Dutch disease and price volatility. These two represent channels of resource curse transmission into economy (Frankel 2010, 11).

1.1.1 Dutch disease

A price boom in oil and gas sector has three effects:

- spending effect,

- relative price effect and
- resource movement effect (Corden and Neary 1982).

The spending effect (Auty 2001) can be described in the following way: Export earnings from the resource production increase income of a country, hence the level of spending tends to rise. An increase in income stimulates consumption (increase in consumption might put pressure on prices and exchange rate), as a result, demand increases not only for domestic tradable and non-tradable goods but also for foreign ones. Prices for tradable goods do not rise because they are determined by the world market in case of the open economy (2001, 7).

Further effect of the increased resource revenue is a real appreciation of the currency or **relative price effect** (Auty 2001, 7). According to macroeconomic principles, increase in exports is compensated by the fall of the RER (appreciation) in order to bring trade in balance (Devlin and Lewin 2004, 3). Currency appreciation decreases domestic prices of exports and imports as well as the size of rents of the oil and gas sector. Prices of non-tradable goods such as services and real estate will rise and will not be affected by currency appreciation or reduced prices of imports (Auty 2001, 7).

Consequences of a booming oil and gas sector: increased prices of non-tradable goods will attract resources from tradable sector causing shift of labor and capital between the sectors or **resource movement effect** (Auty 2001, 7).

Besides that, oil boom might end up with increased imports and decrease in exports of non-primary (non-oil) tradable goods since appreciation of RER makes exports of these goods uncompetitive (Devlin and Lewin 2004, 2). If such tendencies continue, other non-oil tradable sectors would lose, since production becomes expensive. Boom of the oil and gas sector

might crowd out activity and profits of other sectors, primarily of traditional tradable manufacturing and agriculture (Cordon and Neary 1982), as it happened in Nigeria in 1970's, when agriculture exports were crowded out because of oil induced RER appreciation (Attipoe 1985, 141). Such tendency is inefficient for the economy, as extractive sector employs not so many people, on contrary, manufacturing and agriculture as "learning by doing" sectors offer more in terms of employment and skills (Frankel 2010, 4).

1.1.2 Commodity price volatility → Revenue volatility → Procyclicality

Next problem of oil is its price volatility. Oil is more volatile than other commodities (Frankel 2010, 10). Oil prices have a history of unpredictable hikes and slumps, in 2008 alone oil hit the record high $145 per barrel in July and in December it decreased to $30.28 (EIA, Petroleum Navigator). This fluctuation translates into unstable revenues accruing to governments in the form of taxes and export earnings, which partially make their way to the budget (Kalyuzhnova 2006, 586). A strong reliance on such revenues would undermine fiscal policy if no countermeasures are taken (Devlin and Lewin 2004, 5). In context of a boom, the common pitfall of oil producing countries is to spend all the revenue (Sachs and Warner 1997) in form of increased wages, transfers, subsidies and other public expenditures, as countries tend to think that boom period is permanent (Frankel 2010, 11). The real problem comes after the boom period is over (Devlin and Lewin 2004, 3). With increased spending from commodity revenues, the government commits itself to incremental increase of spending in future. To sustain the boom level of spending in times of a bust, government either cuts spending drastically (postponing productive investments), imposes high taxes in search for additional source of revenue (usually on imports, since demand on imported goods is high, which deteriorates already inefficient economy more) or borrows, which results in indebtedness of resource rich countries (Kalyuzhnova 2006, 586). In addition to increased

spending, government allows appreciation of RER, which makes adjustment efforts in fiscal and monetary policy costly (Devlin and Lewin 2004, 5).

1.2 Political problems of resource wealth

Resource abundance might exacerbate political problems such as conflicts over ownership of resources (Bannon and Collier 2003), or instances of corruption as increasing oil revenues in a context of weak institutions of control and accountability enhance chances of evasion and concentration of resources in hands of the few. Weak institutions in turn impede economic growth (Leite and Weidmann 1999), and might lead to authoritarianism (Ross 2001).

1.2.1 Rentier state, corruption, authoritarianism

Commodity revenue, especially oil revenues represent a rent. A rent deploys minimum of domestic resources, or as Beblawi defines it, rent "is not merely an income for landlords, but generally a reward for ownership of all natural resources" (1987, 49). In most resource rich countries, the state accrues the rent. Such situation bears a risk of emergence of a "rentier state" (Mahdavy, 1970), "…[a country] that [receive] on a regular basis substantial amounts of external rent." (Yates 1996, 11). Mahdavy and authors who followed him wrote about Arab oil exporting countries in 1970's but do not limit rentier state to the Middle East only. Period of 1970's is important due to increase in oil prices and nationalization of oil and gas sector that transferred large amounts of rents to the state and changed them into rentier states (1996, 12). Rentier state has its base in "rentier economy" (Beblawi and Luciani 1987), where economy is considered to be "rentier" if rent originates from abroad, the state is the exclusive recipient of the rent and, rent is generated by few; the rest just allocates or consumes (Beblawi 1987, 53). Dependence on rent discourages growth of productive sectors and promotes "rentier mentality" (Beblawi 1987, 52). Such mentality breaks relations between the state and people, as state relies more on rents not taxes as the base of the economy as it happened in

Nigeria, where oil rents accrued to a small group of top officials (Eifert, Gelb and Tallroth 2003, 110). Since state accrues less tax revenue, it becomes less accountable to people and susceptible to corruption (1987, 52), while principle of "no taxation without representation" is undermined and with that people's legitimate right to hold government accountable for the use of oil windfalls (Frankel 2010. 18). Moreover, dependence on resource rents weakens the government and institutions of democracy (Auty 1993), or outstrips strong government (Shafer 1994), as rent-seeking behaviour opens doors for favouritism (Leite and Weidmann, 1999, 20), and spending the resource revenues replaces "stateness" or state authority (Karl 1997, 41). Consequently, concentration of resource rents in hands of the government might lead to authoritarianism (Ross 2001), where oil revenues enable "repression effect" to take place - government buys or chokes off the opposition (2001).

1.3 Conclusion

Resource curse exhibited by the Dutch disease, volatility of resource revenues, procyclicality and increased chances of rent-seeking and corruption pose significant threats to the economic and political development of the resource rich country. Literature review presented in this chapter presented a clear case for government action in resource revenue management because it is mostly a government, whose decisions and action determine the outcome of "blessing – curse" challenge. There are several possible ways for the government to tackle and even defeat the resource curse. General recommendations and common practices and institutions aimed at combating the negative effects of resource abundance will be discussed in the next chapter.

Chapter 2: Possible solutions to resource curse

A country rich with non-renewable resources such as oil and gas can use them for successful development, but as we have seen, hydrocarbon revenues present potential threats to the economic and political performance of a country in form of revenue volatility, Dutch disease, rent-seeking and corruption. Natural resources belong to the people, and state as a representative of the people becomes responsible for the management of natural resource revenues. Moreover, government as the primary conductor of macroeconomic policy and recipient of those revenues is faced with a challenge on how to manage them in effective, efficient and sustainable way. More precisely, government as a "conduit" of the resources and their revenues to the economy (Devlin and Lewin 2004, 5), needs to find a balance between spending, investing them to earn a return and saving for the future generation as oil and gas are non-renewable and exhaustible (Davis et al. 2003, 273). Finding this balance is not an easy task because among others there is always a temptation to spend these oil windfalls on current projects and face the consequences of hasty spending only after boom period is over, because it is difficult to decide how much to spend and how to save for future generation and finally to prioritize spending items.

This chapter provides reader with recommendations, institutions and practices aimed at helping the governments to avoid the common problems and traps of oil and gas revenues management identified in Chapter 1. The recommendations on fiscal and monetary policies and funds would serve as a checklist against which management policies of Kazakhstan will be analyzed in Chapter 3.

2.1 Recommendations for effective use of windfalls

History and experience of resource rich countries have allowed several institutions, notably IMF and World Bank, to come up with general recommendations and guidelines for effective use of windfalls, so they can become blessing for a long time.

2.1.1 Fiscal policy

In terms of fiscal policy, following considerations should be taken into account (note, recommendation list is not exhaustible, author provides those recommendations, which might be helpful for a young producing country like Kazakhstan):

- Design appropriate fiscal regime for the extractive sector to ensure that government receives adequate amount of rent (Sunley, Baunsgaard and Simard 2003).
- Smooth expenditures to break up procyclicality of expenditures with oil and gas revenue by targeting non-oil balance (Barnett and Ossowski 2003, 61). This can be achieved by smoothing aggregate demand, most importantly consumption and government spending as these tend to put upward pressure on inflation and exchange rate (WB 2005, iii) and stabilize volatility of oil revenues by saving in a special fund, for example (Kalyuzhnova 2006, 586).
- "De-link revenues and expenditures" (Devlin and Lewin 2004, 6), would prevent excessive fiscal expansion and government expansion, which is difficult to reverse and costly in times of oil price bust. Governments would usually delay capital-intensive projects to sustain spending levels of boom times (Davis et al. 2003, 275). In this case, non-oil fiscal balance is an important indicator of fiscal sustainability (Barnett and Ossowski 2003, 51).
- Invest revenue in productive and durable assets or projects, most importantly into physical and human resources to support productivity of non-resource sector and long-

term social benefits (Barnett and Ossowski 2003, 56). These measures will help to mitigate effects of the real appreciation and ensuing sectoral imbalances (Kalyuzhnova 2006, 588).

2.1.2 Monetary policy and exchange rate policy

- maintain RER (WB 2005, iii).

Country has a choice between floating, fixed or anchor exchange rate policy to mitigate the medium term fluctuations of oil prices, thus of Dutch disease.

- Floating exchange rate – advantage is automatic adjustment in times of TOT shocks, so if oil prices rise, currency appreciates preventing adverse effects of large capital flows and vice versa, if prices decrease (Frankel 2010, 28).
- Fixed exchange rate – provides for commitment to low inflation and minimizes risk of speculative attacks and costs of trade (2010, 28).
- Intermediate (e.g. managed floating, target zone or band) – beneficial for transition economies with weak institutions (central bank), as it combines advantages of floating and fixed regimes. Exchange rate or inflation targeting sets a nominal anchor against which central bank is judged (2010, 28). However, inflation targeting can be disadvantageous for oil producing country, as it produces currency effects contrary to floating exchange rate, preventing currency appreciation in times of decreasing oil prices in order to keep inflation below the target. Therefore, it would deteriorate trade balance and economic activity (2010, 29). Frankel proposes peg the export price (PEP) regime, where oil price is fixed in local currency, which smoothes volatility of the real value of oil revenues (Frankel 2005, 14).

2.2 Institutions and practices to deal with resource curse

Several practices and institutions embody recommendations of international institutions to some extent, therefore they do not guarantee solution of oil related problems.

2.2.1 Caps on exports

The cap on export practice is aimed at reducing the price volatility, thereby protecting consumers from increases in prices. Such policy, on contrary, distorts the market since commodity is still traded internationally (Frankel 2010, 25).

2.2.2 Hedging the price risk on financial markets

This practice offers several instruments for price risk hedging, i.e. futures, forwards and options. Such instruments ensure against losses associated with unexpected price fluctuations. These instruments are simply "an agreement between two parties to buy or sell an asset at a certain future time for a certain price" (ECTS 2007, 81, 86). By this agreement, parties minimize the transaction costs in case of unexpected change in prices (Frankel 2010, 27).

Government involved in trade on financial market faces several limitations. Futures market is relatively small for emerging country commodity markets and life of the futures is too short to provide effective stabilization against price volatility. Oil boom period lasts three to four years that means that oil has to be sold six to eight years ahead to hedge and stabilize oil prices. Futures market last maximum for two years, too short for booming oil economy. Financial market would not able to provide enough insurance against the risks (Rigobon 2004).

2.2.3 Debt indexation to commodity prices

Another practice for volatility minimization is debt indexation to oil prices. Obligations of debt service are correlated with oil prices, so when oil price goes up, debt

service payment increases as well, in this way country prevents pro-cyclical debt accumulation, Indonesia stabilized its economy by paying its debt in boom times (Eifert, Gelb, Tallroth 2003, 112). However, issuing a commodity debt is costly and treated with caution on the market (Rigobon 2004).

2.2.4 Sovereign Wealth Fund

The previously described practices have disadvantages. Price control in form of capped exports represents market intervention, therefore, can have divergent effects (Frankel 2010), whereas hedging and debt indexation are hard to implement for a developing country due to a weak credibility on a world market (Rigobon 2004).

Therefore, what is left is a "self-insurance" by saving in a special fund (Rigobon 2004). Many countries decided to establish a Sovereign Wealth Fund (SWF; hereinafter referred to as fund) to tackle effectively the issues of resource curse. Common features of such funds "is that they are public sector institutions […] that receive inflows related to the exploitation of a non-renewable resource" (Davis et al. 2003, 280).

Last decade has witnessed a dramatic increase of funds worldwide (for example: Qatar Investment Authority, Revenue Regulation Fund of Algeria as well as National Fund of the Republic of Kazakhstan (SWF Institute, List of Sovereign Wealth Funds). Nevertheless, idea of accumulation of wealth in a fund is not new. The first fund, Kuwait Investment Authority, was established in 1953 (2008, 7). Today the main drivers for the creation of fund are excessive commodity revenues and continuous surpluses from export-driven economies. Currently there are 54 funds and their assets are estimated to be around $3 trillion (IMF 2008, 6). Furthermore, Morgan Stanley Global Research forecasts its increase to $12 trillion by 2015 (Jen 2007).

According to Monk (2010), funds equip governments with several benefits against the negative effects of oil and gas revenue increase:

- Stabilization targets harmful effects of price and revenue volatility. If revenue coming from extractive industry exceeds certain threshold, it goes to fund, in case if revenue is below threshold state uses fund assets to cover up difference in the budget – mechanism of contingent stabilization fund (Monk 2010). Fund absorbs uncertainty and volatility of oil revenues, thereby defining stable amounts of revenues available to the budget (Davis et al. 2003, 280). Built-in liquidity constraint mechanism, which makes certain revenues untouchable to budget, might prevent government from overspending (2003, 285).
- Sterilization insulates budget from real exchange rate volatility and Dutch disease by investing revenues abroad. Government or central bank may sterilize by saving revenues in form of the foreign deposits or exchange reserves (Davis et al. 2003, 287).
- Saving meets the goal of intergenerational distribution of wealth. According to Solow model, if people consume and do not save for future, future generations will face low capital accumulation, thus, potential economic recession. If people want that future generations enjoy the benefits of windfalls, they better save and leave resources in form of "technological knowledge or financial resources" (Monk 2010).

Besides, funds might be beneficial in terms of political economy of spending. Government is pressured to spend oil and gas revenues in times of a boom, presence of the fund might alleviate government of such pressures and limit short-sighted spending and borrowing (Davis et al. 2003, 289).

Funds accumulate substantial share of public financial assets that should be effectively managed. Fund's asset investment strategies as part of management vary across countries but

generally follow this pattern of investment: fixed income securities (35-49%), equities (50-55%) and alternative investment instruments such as real estate, private equity companies, hedge funds, etc. (8-10%), (Fernández and Eschweiler, 2008). Investment strategies depend on fund objectives (Davis et al. 2003, 294). Norway's Government Pension Fund Global as of 2010 invests 60% of assets into equities, 35-40% in fixed income securities and 5% in real estate (NBIM Investment Strategy). Government might better not consider investment into domestic financial assets as it would transfer price volatility to the economy (Davis et al. 2003, 294).

Establishment of the fund alone is not enough to achieve objectives of stabilization, saving and/or sterilization or to prevent government from overspending (Davis et al. 2003, 280). State is set to succeed in these objectives if there is prudent fiscal policy (Barnett and Ossowski 2003, 65). To support fiscal policy, some countries adopted fiscal rules targeting non-oil deficit in relation to non-oil GDP that helps to de-link expenditures from oil revenues (2003, 67). Moreover, government effectively manages oil and gas revenues if the fund is integrated into budget. Integration offers unified approach to all revenues and expenditures, coherent implementation of fiscal policy and coordinated work of budget and the fund (Davis et al. 2003, 291). Additionally to budget integration, it is recommended to have a MTBF. MTBF prevents government from heavy spending in times of revenue booms (Barnett and Ossowski 2003, 67).

2.3 Conclusion

Government's fiscal policy plays the most important role when it comes to oil and gas revenue management, while monetary policy options are limited to sterilization of foreign inflow of capital and nominal appreciation of the exchange rate. These options of monetary policy might not be possible if a country has managed float or fixed exchange rate regime due to growing non-oil sector incompetitiveness considerations (Barnett and Ossowski 2003, 64).

Fiscal policy of oil rich country should try to decouple expenditures from oil price volatility to prevent fiscal expansion in times of oil upturn, maintain and try to minimize its non-oil deficit and invest in durable projects, which would bring social benefits (2003). It might consider possibility of creation of a special fund, which offers additional advantages to fiscal policy: stabilization, saving and sterilization of oil and gas revenues (Monk 2010). Fund, however, is not a panacea to government overspending (Devlin and Lewin 2004, 6).

With knowledge on potential problems of oil and gas revenue management and possible ways of solving them, we now proceed to the analysis of economic situation and management policies of Kazakhstan.

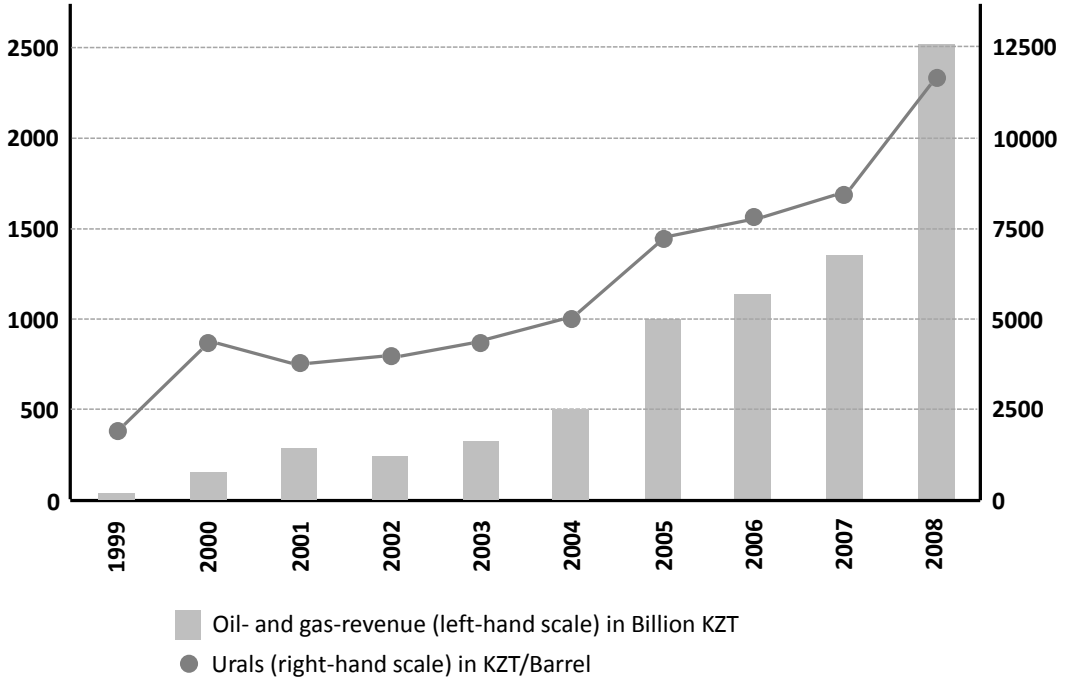
Chapter 3: Kazakhstan

The aim of this chapter is to show how Kazakhstan became reliant on oil and gas sector over time. First section presents brief overview of the sector, second section elaborates on major economic developments throughout three periods closely connected to oil and gas sector development and problems it brought, and these common problems were discussed in Chapter 1. Last two sections provide with the analysis on how governmental policies try to deal with the problems caused by large inflows of oil and gas revenues. In doing so, this chapter gives answers if government of Kazakhstan done well in managing its oil and gas wealth.

3.1 Oil and gas sector overview and its importance for the economy

Kazakhstan is rich on natural resources but economy is specialized in production and exports of primarily oil and gas. Share of hydrocarbons in total exports increased from 23.8% in 1995 to 52.8% in 2005, while share of ferrous metals (second largest export item) shrunk from 19 to 12.9% (KET 2001). Oil and gas sector attracted most of the FDI since 1990's, however, its exports and revenues are strongly dependent on world market prices, seen on Figure 3.1. Dependence on external factors makes exports and revenues of oil and gas sector vulnerable to uncertainty and unpredictability of world price dynamics but since this sector attracted most of investment, it will play dominant role in the near future (Kuralbayeva 2001, 8).

Figure 3.1: Oil and gas revenues and oil price (Urals)



Source: (Dosmagambet 2009, 2)

Additionally, reserves of oil and gas guarantee this sector leading position in production and exports for a long time. According to BP, proven reserves of oil in Kazakhstan are about 39.8 billion barrels or 3.2% of the world total oil reserves; proven reserves of gas make up 1.85 trillion cubic meters or 1% of world reserves. Reserve-to-production ratio for oil as for 2008 equals 70, meaning if production level remains at the 2008 level, reserves would last 70 years. With these reserves, Kazakhstan is on the ninth place in the world (BP 2009, 6). Consequently, production levels increased since 1990's, mostly due to development and production by IOCs. At 2008 production level, Kazakhstan contributed almost 2% to the world production, comparable to the production levels of the UK, Qatar and Indonesia (BP 2009, 9). Available reserves would allow Kazakhstan to increase production in the next years. In 2007, president Nazarbayev announced that by the 2015 Kazakhstan would produce 120 mt/day of oil with the start of production at Kashagan oil field developed by Eni in 2012 (Markus 2009). With increased production, Kazakhstan expects an increase in fiscal revenue to cover development of the country. This development approach is prioritized in state

development program "Kazakhstan-2030" promoted by the president (Kuralbayeva 2001, 9). Increased production and exports of oil and gas already bring substantial revenues to the budget. Dependence on world oil market makes the revenues unpredictable and volatile. Costs of volatility are high in short and long run, as we have learned from Chapter 1. Therefore, management of revenues primarily by government is crucial to avoid common problems of increased oil and gas revenues. Next section presents major economic developments of Kazakhstan closely connected to the emergence of oil and gas sector as dominant with particular focus on negative effects of large inflows of oil and gas revenues.

3.2 Emergence of oil and gas sector and impact on economy

Since break up of the Soviet Union, the development of the Kazakh economy can be divided into three periods, where year 2000 as a turning point saw surge of world oil prices and marked the begin of oil boom in production and exports in Kazakhstan:

- Pre-boom period (1991-2000),
- Boom period (2002-2006) and
- Economic crisis period (2007- present).

Such division gives one a comparative perspective on path of oil and gas sector emergence as dominant driver of economy, hence of complexity of problems driven by ever increasing oil and gas revenues.

3.2.1 Pre-boom years, 1991-2000

After break-up of the Soviet Union, Kazakhstan undertook series of reforms that were implemented at a moderate pace (Auty 2001, 260). Price liberalization, privatization, tightened monetary policy of central bank were completed by middle of 1990's (Auty 2001, 263). No matter how successful these reforms were, they did not lead to economic recovery.

Oil and gas production levels in this period declined until 1997, which can be explained by the delay of exploitation. Kazakhstan by itself was not able to exploit, develop and extract oil and gas fields due to its lack of capital. Kazakhstan signed first joint venture contracts with Chevron and Mobil in 1993 over development of Tengiz field and other PSA followed. By 1997, GDP picked up due to increasing flows of foreign investments into oil and gas sector. It was in this period when oil and gas sector started to gain importance in economic development of the country, attracting over 80% of total FDI between 1993 -2000 (Tsalik 2003, 136).

While oil and gas industry attracted most of FDI and contributed the most (52.8%) to total exports, it had negatively affected other sectors (Kuralbayeva 2001, 8). With minimal employment redistribution throughout 1990-1997 into agriculture and tradable sectors (in 1997 it employed one-fifth less than expected), economy of Kazakhstan signalled signs of Dutch disease (Auty 2001, 268). Non-resource sector of economy shrunk drastically, its share in total industrial production decreased by half between 1990-1997, while oil and gas sector's share increased from 31% in 1990 to 66% in 1997 (Markov 1998, 95). Share of manufacturing in GDP fell by more than half between 1990-1995 and agriculture by two-fifths (Auty 2001, 265), leading to collapse of both sectors (Kuralbayva 2001, 11). Decline of these sectors made many people unemployed, who could not get support because of ineffective fiscal policy. Budget of the country ran deficit of 7% of GDP in 1997, which was financed by foreign borrowing. Foreign borrowing was covered by one-third of public expenditures (Auty 2001, 265). Such unwise fiscal policy had social consequences. Share of population living below the poverty line increased to 50% (EBRD 1999, 232), and share of shadow economy increased to one-third of GDP (Johnson et al. 1997). Moreover, sudden inflow of foreign capital contributed to the real currency appreciation (Auty 2001, 268).

Despite increased FDI, economy of Kazakhstan experienced economic recession: between 1990 – 1997 there was 37% decline of GDP (EBRD 1999, 233), due to the absence of access to the world market for oil and gas exports (Russia controlled pipelines), and poor implementation of privatization reforms (Pomfret 2003, 17-18). Furthermore, Russian crisis in 1998 delayed economic recovery until 2000.

Considering these facts author concludes that pre-boom years saw emergence of the oil and gas sector as the engine of economic growth but at the same time, it exposed:

- economy to Dutch disease effects (loss of competitiveness of manufacturing and agriculture) and
- revenue volatility (increase of budget deficit and foreign debt).

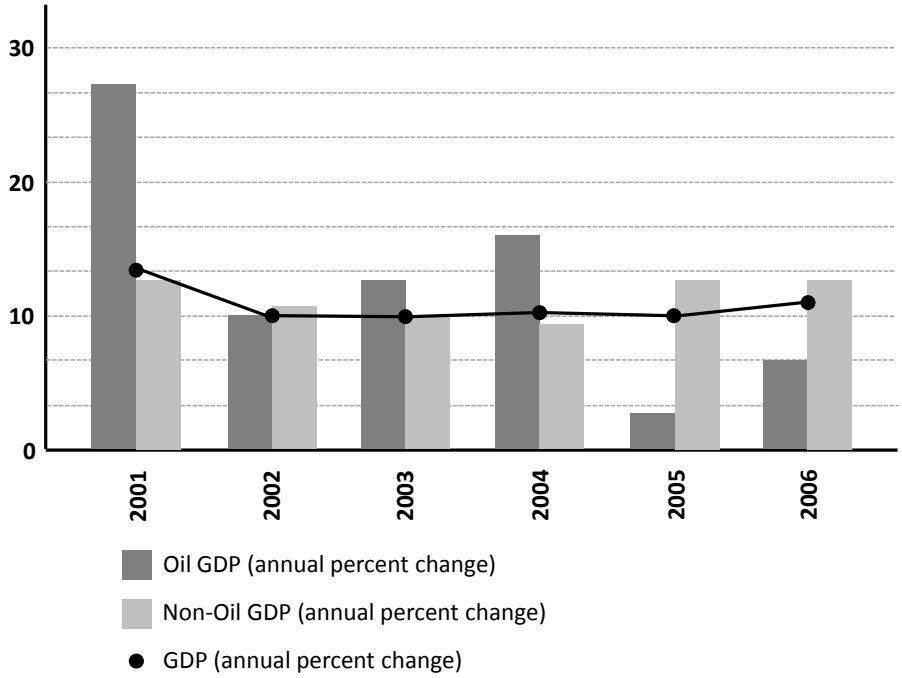
Additionally, increased revenues opened up opportunities for rent-seeking and corruption demonstrated by instances of misappropriation involving high ranking officials including president Nazarbayev in infamous Kazakhgate scandal, where he together with PM Balgimbayev allegedly received $78 million in bribes (Olcott 2002, 148).

3.2.2 Boom years, 2000-2006

High world oil prices in 2000 onwards contributed to significant economic growth in Kazakhstan. Country's GDP grew 9% on average (Figure 3.2), throughout 2001 -2006 (Usui 2007, 3), non-oil GDP increase from 2005 is due to credit and construction boom (WB 2005, 38), driven by the oil sector (explained in the next section). Oil exports steadily increased reaching 60% of total exports in 2006 (2007, 3), (Figure 3.3). Correspondingly, export earnings ballooned with record high – $3.1 billion – in September 2006, when oil price hiked to $73.67 per barrel (Makhmutova 2008, 13). Fiscal oil revenues rose together with oil price increase, so did government reliance on oil and gas revenues; if in 1999 they compromised only 5% of state total revenues (Tsalik 2003, 136) then in 2006 they made up 37% and

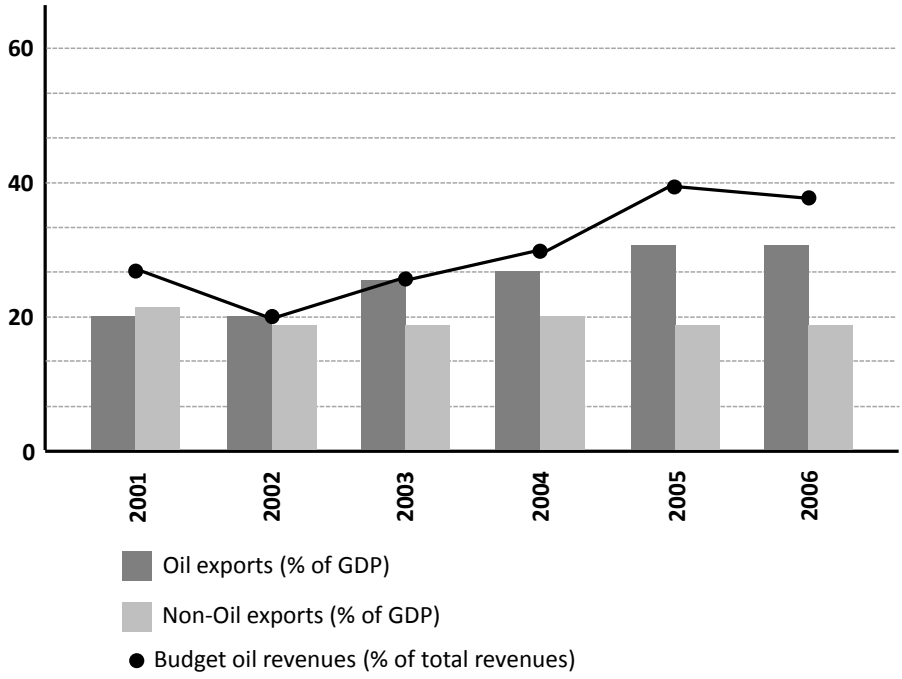
contributed to 30% increase of total fiscal revenues (Usui 2007, 4). Government, however, remained cautious with the use of oil revenues and run surpluses throughout 2000-2006 (2007, 4).

Figure 3.2: Real GDP growth (annual % change)



Source: (Usui 2007, 3)

Figure 3.3: Oil Exports and Budget Oil Revenues, 2001-2006



Source: (Usui 2007, 3)

Growing reliance on oil exports and revenues posed several threats for other sectors of the economy. Labor productivity within the manufacturing sector remained stagnant throughout the first half of 2000's, whereas in agriculture it was declining over several years (WB 2005, 13). Exports of these sectors together with other non-oil sectors remained at the same level of $2 billion from 1997-2005 (2005, 10). Moreover, investment into non-oil tradable sector remained at the same level of three percent of GDP and was driven mainly by the government; non-oil non-tradable sector received almost twice more than infrastructure in 1999-2004 (2005, 9). Currency continued to appreciate in real and nominal terms (Egert and Leonard 2007, 18).

In conclusion, stagnant productivity of manufacturing and declining in agriculture, growth of non-tradable sectors and currency appreciation in this period suggests further vulnerability of the economy to Dutch disease (Egert and Leonard 2007, 10), on contrary, oil revenue volatility effects were mitigated by running continuous budget surpluses.

3.2.3 Economic crisis, 2007-present

Period 2007 onwards set the major economic achievements back. Government efforts now are concentrated on recovery from downturn caused by the world financial crisis. Financial crisis in 2007 brought banking and construction sectors near to collapse. Oil and gas sector indirectly contributed to real estate bubble and banking sector crisis (Jojarth 2008). Kazakhstan gained "investor grade" by Moody's investor service due positive macroeconomic performance during boom years, which has given banking sector opportunities to borrow from abroad at low interest rates and lend at home at much higher (Markus 2009). External borrowing stopped with financial crisis leaving banking sector heavily indebted and property bubble burst (IMF 2009, 3).

Financial crisis together with domestic had substantial impact on the economy. GDP growth turned negative, inflation and unemployment increased, investment halted (Markus 2009). ACP financed by NFRK ran budget and current account into deficit and it is likely to remain so in the near future (IMF 2009). The global and local crises offset previous macroeconomic achievements and Kazakhstan faces a double challenge: economic recovery and continuous efforts on mitigation of resource curse.

3.3 Kazakhstan's policies for oil wealth management

This section analyzes oil and gas revenue management policies of Kazakhstan in pre-, boom- and crisis- periods.

Government has been active in oil revenue management since 1990's, pre-boom period policies, however, were constrained by factors of transition from command to market economy. Boom period policies safeguarded relatively well against common pitfalls of the increase of oil and gas windfalls. Tax regime provides government with considerable amount of oil and gas revenue, NFRK sterilizes large share of revenues by saving and investing into foreign assets, thereby limiting government on spending.

3.3.1 Fiscal policy: revenue side, tax regime

Presence of appropriate tax regime is important for resource abundant country to ensure that country receives adequate amount of rent so it can save for future generations and provide benefits for the current one (Sunley, Baunsgaard and Simard 2003). Tax regime, however, should not put extreme burden on producing sector, otherwise there would be incentives to evade it and perform poorly (Anker and Sonnerby 2008, 7).

3.3.1.1 Pre-boom period

In **pre-boom** years (1991-2000), Kazakhstan experienced collapse in revenues to 16% of GDP (Auty 2001, 264). Introduction of the new tax code in 1995 did not change situation

until late 1990's when oil prices picked up and oil revenues started pouring in, so tax burden was low, IOCs did not pay much in taxes due to prevalence of PSA and bonus payments.

3.3.1.2 Boom period

During boom period, Kazakh authorities introduced changes to tax regime in extractive sector with amendments to the tax code (Akhmadov et al 2009, 22). New rent tax for oil export of 2004 and 2005 increase of royalty payment boosted state's share of fiscal revenues. In 2005 courts allowed fiscal authorities to check transfer pricing of all oil companies which gave the state greater control over oil revenues (Kennedy and Nurmakov 2010, 7-8).

3.3.1.3 Crisis period

Tax regime was modified again in 2009 with the new tax code. Motivation behind this is to generate more revenues from extractive sector while reducing burden for SME (Nurmakov 2009). Tax code introduced new special taxes for extractive sector: bonus payments and windfall levies, while royalties were replaced by natural resource extraction tax (rates vary between 7-20% depends on production volumes and world market oil prices) and crude oil export duty (equals zero due to decrease in oil prices in late 2008), (Akhmadov 2009, 46-59). New taxes are not valid for previous PSA and JV (Tengiz, Karachaganak and Kashagan) due to tax stability clause in their contracts.

Now large portion of tax revenues from oil and gas sector comes from CIT and PSA. New tax code provides for decrease in CIT rate every year, in 2009 it started with 20%, in 2011 planned to decrease to 15% (Akhmadov 2009, 45). PSA was there since 2005 and was abolished in 2009 due to "ineffectiveness of production sharing mechanism, complexity of implementation and insufficient rate of return" (Baitelesov and Bapakova 2009), and replaced by concession agreement. This novelty was met with scepticism by oil producing companies

that consider new tax regime as unfair since they do not take into account specificities of oil fields (Akhmadov et al 2009, 52). KazEnergy considered initiatives of new tax regime as "distortive" and stated that tax burden increased to 51% while official data of ministry of finance claims it equals 35% (Tulegenova 2008).

On the other hand, recent studies of KRW (2008), conclude that it is hard to judge the adequacy of tax regime (i.e. if state receives a fair share of rent), due to low transparency of major PSA and JV contracts. They were concluded in early 1990's for a period of 30-40 years under a veil of secrecy, so it is not clear how rent is shared between the state and IOCs (Makhmutova 2008, 12).

In sum, despite several pointed out inadequacies of tax regime, state's control over the revenues and share of tax revenues from oil and gas sector increased. Since 2006 majority of them go to NFRK.

3.3.2 NFRK

NFRK is the main institution supporting fiscal policy in Kazakhstan. Currently NFRK has $25.2 billion (Gizitdinov 2010). The establishment of the fund became necessary in response to large flows of foreign capital in the beginning of 2000's when oil prices began to increase. According to NFRK Concept (Concept 2005), a special Management Council runs NFRK which is formed by the president and includes president himself, the prime minister, representatives of Senate -upper chamber of Parliament and Mazhilis - lower chamber of the Parliament, minister of finance and chair of the NBK. President issues binding directives on Management Council. NBK manages the fund and responsible for investment strategy for NFRK assets, for that it hires foreign managers, who also train local National Bank staff for prudent investment strategies (Tsalik 2003). Advisory Board chaired by the president overlooks fund's activities. Information on fund's revenues and expenditures is publicly

available on monthly basis. Independent audit is performed annually (Kalyuzhnova 2006, 600).

NFRK is integrated into the budget, meaning that the revenues coming from tax payments (CIT, VAT, royalties, PSA revenues, etc.) of the oil and other natural resources companies in Kazakhstan (number of which changes every year) investment earnings of the fund, revenue from privatization of state assets, proceeds from land sale, etc. go through the budget and then to NFRK (Chapter 5, Budget System Law).

NFRK is relatively effective in sterilization and stabilization of oil and gas revenue (discussed in Chapter 2), by separating them from expenditures and saving substantial part of it in NBK account.

3.3.2.1 Design of NFRK

NFRK is designed to have two objectives:

- Saving - fulfils objective of intergenerational distribution of wealth by investing oil revenue into long-term investment instruments, such as bonds, 75% of NFRK assets are dedicated to savings portfolio (Concept 2005),
- Stabilization - is aimed to shield economy against commodity price volatility, 25% of assets make up stabilization portfolio (Concept 2005).

The **saving** rule is connected to certain price threshold: if oil prices are higher than the reference price ($19 per barrel), NFRK accumulates excess revenue. If prices are lower, NFRK withdraws the assets to cover up the price difference in the budget (Usui 2007, 7). Despite NFRK's quarterly guaranteed transfer to budget assigned only for long-term development projects and NFRK's discretionary provision on transfers to the budget requiring

president's approval not used until 2008, its saving rate has been always higher than the amount of transfers to the budget (2007, 7).

Rigobon (2004), studied **stabilization** objective in detail. His main argument on stabilization is not stabilization of country's output or stabilization of portfolio but stabilization of consumption volatility because of oil price fluctuations. When oil price increases, revenues and income of the country tend also to increase bringing consumption and demand to rise via income effect. Increase in consumption puts pressure on demand, therefore, on prices and inflation. To break up this link, consumption should be stabilized (Rigobon 2004). Kazakhstan's allocation of stabilization portfolio resembles optimal model proposed by Rigobon, where he proposes to invest into fixed income assets of Euro Area, the U.S. and Japan, where assets are the most oil price responsive. Such allocation of NFRK assets stabilizes consumption the most against oil price volatility. Consumption however is not as responsive to changes in oil prices as GDP and "smoothed by the private sector". Therefore, focus of stabilization should be on volatility outside the private sector while other components of aggregate demand, such as government consumption and investment correlate with oil prices even more than GDP. Hence, government should try to stabilize volatility of these sectors, which to greater extent depend on fiscal policy (Rigobon 2004).

3.3.2.2 Pre-boom period

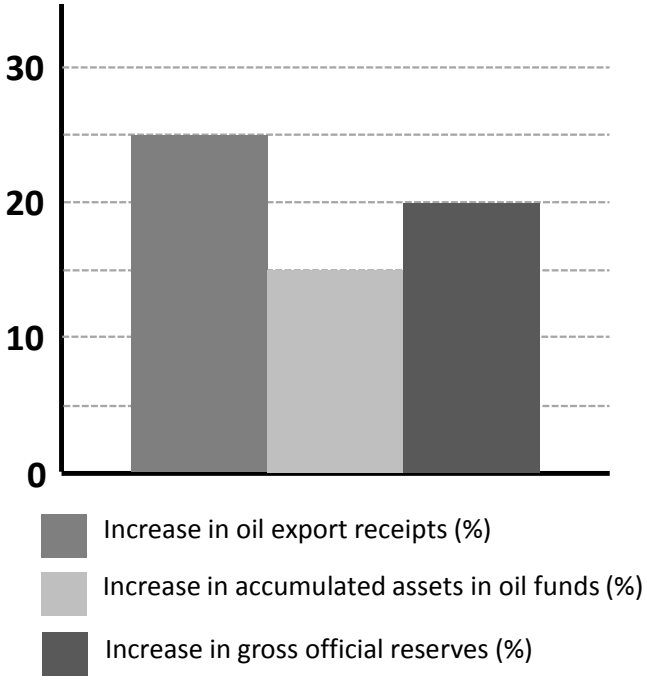
Because of establishing in 2000, at the beginning of boom period, it is not possible to make statements for pre-boom period.

3.3.2.3 Boom period

Overall, stable macroeconomic performance in boom period can be partially explained by presence of the NFRK. Government did not use all the oil export revenue, but it saved

more than 60% (Figure 3.4), of oil revenue in NFRK (Usui 2007, 4). Furthermore, design of NFRK (explained above) contributed to the high rate of oil revenue saving at NFRK.

Figure 3.4: Oil Exports receipts, Oil Fund Assets, Gross Official Reserves (2003-2006, % of 2006 GDP)



Source: (Usui 2007, 4)

Increasing oil export receipts accumulated in NFRK allowed decreasing of the external debt. In 2000, for example, Kazakhstan has paid off IMF debt liabilities seven years ahead of deadline (Markus 2009). It decreased country's fiscal burden and contributed to expenditure stabilization (Usui 2007, 5).

In 2005, new NFRK concept improved fund's stabilization functions. Before 2005, government had discretion on revenue side of NFRK by changing the list of oil companies due to pay taxes. In this way it could increase or decrease revenues accruing to the budget but not to NFRK. Budget and budget expenditures were directly exposed to revenue volatility. Increase in expenditures put upward pressure on inflation and exchange rate. Concept gave parliament authority to approve the expanded list of tax paying oil companies depriving

government of discretion but it lasted only one year. Government got its discretion back in 2007 (Makhmutova 2008, 15).

3.3.2.4 Crisis period

Crisis driven fiscal and current account deficits made government to take stronger stance on NFRK assets. NFRK rules are set to change in 2010 after NFRK's $10 billion were allocated for ACP. Ministry of Economic Development and Trade recently imposed restrictions on loans state development institutions can borrow from NFRK and put a cap on the amount used for service of the government debt, which "must not exceed annual conditional set investment income of 4.5%". Moreover, Ministry imposed a limit of at least 20% of planned GDP for NFRK assets that cannot be used (Gizitdinov 2010). In author's opinion, such strict and explicit rules and liquidity constraint (untouchable 20% of NFRK) present anchor against which government actions can be judged and put indirect constraints on spending by limiting the size of fund outflows.

3.3.2.5 Conclusion

NFRK so far was able to absorb excess oil and gas revenues and prevented them from pouring into the budget. Moreover, NFRK assets cushioned substantially against negative effects of financial crisis, and in author's opinion, saved the country from collapse. New concept in 2005 minimized budget's exposure to oil price fluctuations by allowing parliament to approve the list of tax paying companies. Rules, however, change, NFRK might not shield against excessive spending and ensuing consequences in the future.

3.3.3 Fiscal Policy: expenditure side

Chapter 2 as one of the IMF recommendations indicates "de-linking" revenues from expenditures to stop oil price volatility from spreading into economy. Saving substantial portion of revenues in a special fund helps only to certain extent in this task but does not

guarantee effective budgetary use of revenue. In this context, it is important not to overspend in times of a boom (Barnett and Ossowski 2003). Kazakhstan has taken rather conservative stance on spending by saving most of the oil and gas revenue in NFRK and continuously running budget surpluses. Motivations behind such cautious attitude and consequences are discussed below.

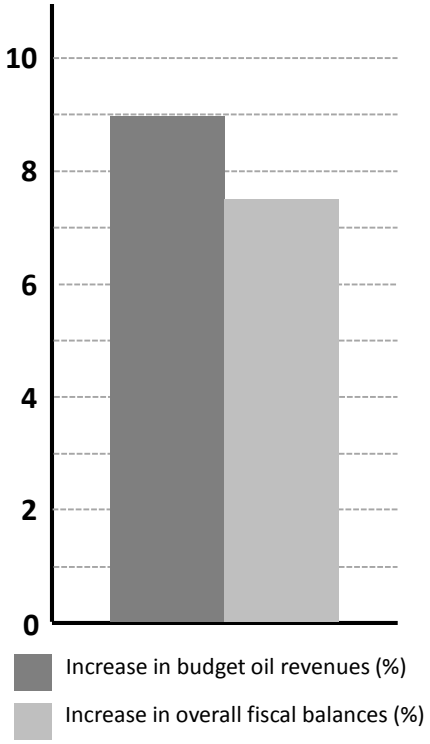
3.3.3.1 Pre-boom period

Pre-boom period did not see much of the oil revenues, therefore, government was not burdened with the task of oil revenue management. Nevertheless, budget crisis of 1998 (oil prices plummeted as a result of Asian crisis), with fiscal and trade deficits showed how vulnerable Kazakhstan became with increasing role of oil sector in its economy (Tsalik 2003, 134)

3.3.3.2 Boom period

In boom period, Kazakhstan improved its fiscal position. According to ADB (Usui, 2007), Kazakhstan pursued exemplary fiscal discipline despite increasing pressure on spending the oil revenue. It kept public spending below the revenue by saving on average 75% of oil revenue in NFRK. Period of 2003-2006 witnessed consistent budget surpluses, in 2006 budget cumulative surplus reached level of 7.5% of GDP (2007, 4), (Figure 3.5).

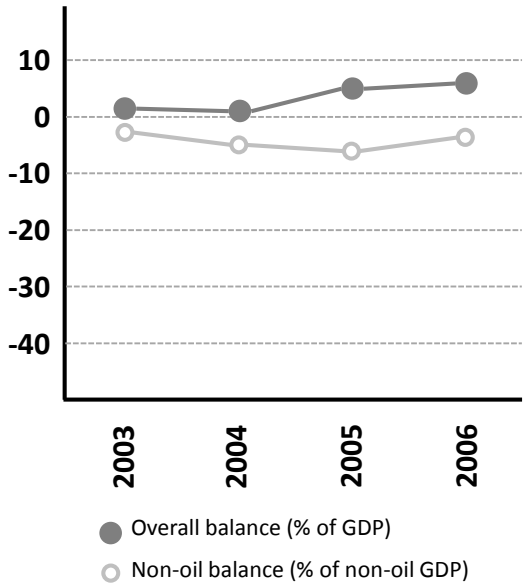
Figure 3.5: Budget Oil Revenues and Overall Fiscal Balances (2003-2006, of 2006 GDP)



Source: (Usui 2007, 5)

As it was mentioned in Chapter 2, non-oil balance is the most important indicator to judge commitment of the government to sustainable use of oil windfalls (Barnett and Ossowski 2002). If non-oil deficit increases at such a pace that oil revenues cannot offset expenditures, it might signal hasty spending and management (Usui 2007, 6). Kazakhstan's non-oil deficit has been decreasing and in 2006, it became 4.3% (Figure 3.6), of non-oil GDP (IMF 2009, 26), meaning that non-oil sectors were growing and even faster than oil GDP, this growth is explained by credit expansion of banking sector and associated growth in construction (WB 2005, 38), both considered to be triggered by increase in oil revenues (Markus 2009).

Figure 3.6: Fiscal Balance



Source: (Usui 2007,7)

History of consistent surpluses in 2000-2006 characterized by IMF and ADB because of "prudent" fiscal management is not so encouraging. KRW indicates poor budget and macroeconomic forecasting as the main reason behind surpluses (Makhmutova 2008, 28-29). Government tends to present pessimistic forecasts that lead to constant budget revisions and adjustments in the middle of the fiscal year, resulting in budget non-execution at the end of the year and budget surpluses. For example, for 2006 deficit forecast was 1.4% of GDP, whereas actually year ended with surplus. Pessimistic forecasts tend to have low crude oil price forecasts, which are on the rise in reality. Such practice might have prevented government from overspending but has negative effects on quality of financed projects because adjustments usually happen in the middle of the year, leaving not enough time to spend surplus money (2008, 28).

Budget spending partially financed by NFRK did not contribute enough to the development of human capital or productivity by spending in infrastructure, education or health (Makhmutova 2008). Budget expenditure for health in 2006 equalled 2.4% of GDP, similar to spending levels of Angola and Uganda and education- 3.4% of GDP, when

sufficient level is 5-6% (IIMP 2008a), whereas Kazakhstan belongs to middle-income countries (Makhmutova 2008, 34). Because of low levels of spending on these items Kazakhstan lost (56th place in 2006, 61st in 2007 out of 131 countries), in competitiveness ranking by the World Economic Forum (IIMP 2008a). Situation on the ground does not change in comparison to pre-boom years. Gap between the rural (40% of population lives in rural areas), and urban population living below the poverty line increased, if in 2001, 1.9% more poor lived in rural areas, then in 2006 it increased to 2.9% (Utebaev 2008, 79-80).

3.3.3.3 Crisis period

Allocation of budget revenues to the state development institutions poses further concerns. As an attempt to diversify the economy, state created several state development institutions aiding implementation of Industrial and Innovation Program 2003-2015, in 2006 these institutions were merged into the sustainable development fund Kazyna. Kazyna was responsible for KZT 4 billion allocated for the support of troubled banking and construction sectors which ended up in plundering of budget means (IIMP 2008b). Furthermore, in 2008 Kazyna was merged with Samruk state asset holding company to Samruk-Kazyna (SK). In 2009, SK received $9 billion of NRFK assets ($5 billion as a debt, $4 as capital injection) as a part of ACP measures (IMF 2009, 8). Reputation of these state *development* institutions raises doubts about effective use of NFRK funds.

In 2009, Kazakhstan adopted new Budget code along with "the result-oriented" MTBF, where budgets are planned three years ahead. Budget of 2010-2012 plans increase of the non-oil deficit to 10.4% of GDP for 2010, with expenditures at 20% of GDP (MEBP 2009, 19). Fiscal expansion is the cost of banking sector crisis with real estate bubble indirectly provoked by oil and gas sector (Jojarth 2008). Such developments imply a threat of overspending. With the history of ineffective spending, it is likely that near future spending

will not improve for education or health – main contributors to productivity - and will be directed at catching with pre-crisis levels.

3.3.4 Monetary and exchange rate policy

Changes in trade balance are compensated by changes in exchange rate, so trade surplus is compensated with the exchange rate appreciation (Devlin and Lewin 2004). Oil and gas revenue "unavoidably" put pressure on exchange rate, where short-term currency appreciation itself is not a problem, rather its "pace, manner and volatility" (WB 2005, 37). Other threat to exchange rate in long term is Dutch disease, where boom of oil and gas sector stimulates real currency appreciation with its devastating effects on real economy either in a form of intersectoral shifts of resources and imbalances, prevalence of non-tradable and public sector, or heavy indebtedness (Frankel 2010, 5). Monetary policy can curb appreciation.

As it was mentioned in Chapter 2, there are three regimes that can help to mitigate effects of Dutch disease (Frankel 2010, 28):

- Floating regime,
- Fixed regime and
- Intermediate regime.

According to Frankel, floating and fixed exchange rate regimes for Kazakhstan are "too constraining" due to small size of the economy to qualify for "optimum currency area" for free float and too large and diversified in trade for fixed (2005, 1). Kazakhstan so far has tried several exchange rate regimes; none of them prevented currency appreciation because of NBK's indecisiveness to maintain commitment to certain regime.

3.3.4.1 Pre-boom period

Kuralbayeva et al. (2001), in their research checked Kazakhstan on presence Dutch disease effects to find out if economy is vulnerable to oil price fluctuations. Their findings indicate presence of Dutch disease. Increase of oil prices have improved TOT in Kazakhstan (ratio of export prices to import prices), these changes appreciated RER in the second half of 1990's – period when oil gained its importance for the Kazakh economy signalling about Dutch disease effects. Their findings got weaker support in robustness tests, so RER appreciation can be explained as productivity gains of transition economy as an attempt to reach equilibrium level (2001, 17). Authors, however, warned about greater potential of RER appreciation in future with greater levels of oil and gas production and exports, thus greater exposure to shocks of TOT which would lead to loss of other sectors' competitiveness (2001, 17).

3.3.4.2 Boom period

Kazakhstan introduced floating exchange rate regime in April 1999, after series of external shocks and unsuccessful attempts to stimulate growth with defensive monetary policy of NBK under fixed exchange rate leading to decrease of international reserves (Kuralbayeva 2001, 10). Floating exchange rate stabilized KZT after some time of depreciation, however, in real terms, KZT strengthened against the U.S. dollar.

Despite floating regime, NBK intervened foreign exchange market to control money supply (Frankel 2010, 28). NBK explicitly indicated in Directions for Monetary policy 2003-2006 inflation targeting as priority measure for exchange rate stability, instead it tried to stabilize nominal exchange rate by buying international reserves and accumulating them in NFRK and issuing debt. Such practice is characterized as "ambiguous" and increased the risk of currency appreciation (WB 2005, 37).

3.3.4.3 Crisis period

Since 2007 due to crisis Kazakhstan had to switch to U.S. dollar peg regime, however, it did not keep exchange rate stable and in February 2009 NBK carried out 20% devaluation that stabilized KZT (IMF 2009, 14).

In sum, monetary and exchange rate policies did not have a pre-determined course announced by NBK. Due to "hesitation" of NBK (WB 2005, 37), in its goals, RER was exposed to appreciation due to large inflows of oil and gas revenue.

3.4 Conclusion

In pre-boom years, oil and gas sector gained its dominance in the economy of Kazakhstan by attracting most of the FDI and contributing large portion of revenues to the budget despite economic recession. Throughout the boom years and crisis years oil and gas sector strengthened its leading position in the economy. Oil and gas sector received most of FDI and made up 30% of budget revenues in 2006 (Makhmutova 2008, 11). Despite its leading position, Kazakhstan's dependence on oil and gas sector is less pronounced than in other oil rich countries like Saudi Arabia or Venezuela (WB 2005, ii). **Governmental policies account for mitigated effects of Dutch disease and oil and gas revenue volatility especially its cautious stance on saving the oil revenue, on contrary, quality of spending is low because of heavy reliance on state development institutions and poor budget forecasting and planning**. Newly introduced MTBF and NFRK rules would make forecasting and planning less complicated as both present explicit constraints and targets.

3.4.1 Fiscal policy

Fiscal policy in relation to oil and gas sector in pre-boom years was constrained by economic downturn. Oil and gas revenues accrued directly into budget and were spent on current expenditures putting pressure on currency and inflation (Makhmutova 2008, 15-16).

Such tendency continued until 2006 when new concept for NFRK was introduced to clarify destinations of NFRK transfers for long-term development projects. In boom years, Kazakhstan seemed to manage its revenues prudently by cautious saving rather than spending, crisis years test government for its previous commitments. Increased role of state development institutions presents threats to the spending effectiveness, which up to now did not meet the goals of diversification or increased productivity. Spending levels on education and health remained low, whereas spending on "breakthrough" (Makhmutova 2008, 31), and "white elephant" (Frankel 2010, 23), projects increased widening the gap between the regions and urban and rural (Makhmutova 2008, 34). Furthermore, stagnating manufacturing and agriculture exports suggest that these sectors are underinvested.

3.4.2 Monetary policy

Kazakhstan had managed float since 1999 but without pre-announced targets. Currency appreciated throughout boom years without NBK efforts to curb this trend. NBK's stance was ambiguous, with contradicting exchange rate and monetary policies. Since 2007, NBK temporarily tightens up monetary policy by pegging against U.S. dollar. Up to now there is no clear empirical evidence about presence of Dutch disease in Kazakhstan but if NBK continues to remain hesitant in its policy, it would expose RER to further oil led appreciation, which might end up with Dutch disease.

3.4.3 NFRK

Creation of NFRK provided Kazakhstan with self-insurance against negative effects of the resource abundance discussed in Chapter 1. Rigobon argues, in relation to Kazakhstan's oil wealth, that market is not able to provide enough insurance against uncertainty of oil and gas prices and hedge the risks of the oil-related assets, state intervention is necessary to present socially optimal outcomes when it comes to resource revenue management, especially if resource sector is a state property and that sector provides significant amount of fiscal

revenue (Rigobon 2004). NFRK helps government of Kazakhstan to stabilize revenues by saving them in NBK account, thereby sterilizing them from pouring in into economy. Up to 2006, Kazakhstan saved more than it spent.

Nevertheless, NFRK alone cannot decrease revenue volatility. Budget is still subject to revenue uncertainty due to government discretion on approval of tax paying oil companies and increased role of state development institution (SK) that get guaranteed transfer as part of their capital for long term development projects. Activities of SK might destabilize Kazakh economy if oil revenue flow halts. As a part of ACP, SK deposited its assets (including NFRK) into local banks (IMF 2009, 9), but if SK withdraws its assets, banking sector might collapse. Besides that, SK acting as state agent might increase government contingent liabilities (IMF 2009, 8) and debt.

Based on this conclusion next chapter provides several recommendations on problems identified here.

Chapter 4: Recommendations and Résumé

Kazakhstan performed relatively well in oil revenue management by saving in boom years and spending in bust. Nevertheless, there are many problems, therefore, it is important that after economy picks up with the next boom government should concentrate on problems identified in previous chapter. Below are several recommendations to start with, the main message is to restrain spending and improve quality of spending.

4.1 Fiscal policy: On revenue side

New tax code provides government with stronger authority over control and collection of oil revenues. However, it is not clear whether the tax burden is too high, therefore, it is recommended **not to amend current tax regime and not to increase tax rates**. There is evidence that in 2006 a third of oil exports was sold under transfer pricing system taking millions of dollars away from taxation (Makhmutova 2008, 12). A further increase in taxes would promote evasive behaviour of oil companies. Moreover, it is important at least for government **to be aware of specificities of every oil and gas** production site. Application of the same rates to all oil companies is not fair and can discourage further investment. A more pressing issue remains the secrecy of major PSA and JV contracts, which give majority of the revenues. Government would benefit more (forecasting and planning become easier, transparency and accountability to people) if it discloses these contracts.

4.2 Fiscal policy: On expenditure side

On expenditure side it would be desirable **to improve macroeconomic and budget forecasting** – as quality of forecasts defines quality of spending. Government repeatedly failed to present realistic forecasts to the budget, so parliament had to readjust budget in the middle of the fiscal year with grave consequences on effectiveness of spending. Government's inability to forecast lies in its possible unwillingness to disclose expected oil

sector revenues during initial budget discussion and adoption stages (Makhmutova 2008, 37). Hence, it is important to unveil the secrecy of oil contracts to finally see what share of rent does the government get. Based on this information it would be easier to forecast.

As next, **prioritize education and health for spending** – Kazakhstan's economic status is characterized as "growth without development" (WB 2005, 5). Education and health – the most important components of human capital are essential for labor productivity. Oil can not buy everything, human capital decides how competitive or diversified can economy be. At the moment there are numerous programs[1]; implementing all of them at the same time would not bring any results (WB 2005, 22).

Retain high rates of saving but encourage non-oil private investment - Saving oil revenue not only insulates it from immediate spending, but also stimulates investment. Saving rates by government are encouraging but the use of saving is not. Investment in non-oil tradable sector was stagnant and facilitated by government. Therefore, encouragement of private investment is essential if country is set to diversify from the oil sector. If government continues to use state institutions, it might end up with bloated public sector exposing economy to inflationary and currency pressures and ineffective spending.

Decrease the role of state development institution - Expanding the role of SK in times of crisis puts fiscal policy under threat. The role and status of SK are broadly defined; it is not even consolidated in fiscal accounts (IMF 2009, 9), although it spends the budget money. SK projects are "ineffective and wasteful" (IIMP 2008b).

[1] Among others: Industrial and Innovation Program, Development o f the City o f Astana, e-Govemment program, Housing Policy, Rural and Agricultural Development Program (WB 2005, 19)

4.3 NFRK

Get back parliament to decision-making process – NFRK concept in 2005 (Concept 2005), guaranteed a role to parliament in process of approving tax paying oil companies. Presence of the parliament assured stable flow of revenues to NFRK on contrary to previous years when government could easily change the list of oil companies, thereby divert revenues to the budget and not to NFRK. Change in revenues affected quality of spending. Now parliament is out of decision-making process. NFRK is completely under control of the president. To assure stable flow of oil revenues, presence of parliament is essential. Parliament would prevent budget process from unnecessary interruptions as did government with budget forecast readjustments, and make sure that revenues are going to NFRK and do not remain to finance current expenditures.

Define the optimal size and investment strategy to avoid excessive expenses. Current losses of NFRK -KZT 13.5 billion in 2005 and annual average investment return of 5.44% being less than inflation rate (Makhmutova 2008, 24). At this point, losses of NFRK might not seem to be significant and maybe justified in terms of greater saving than spending, but it is a loss to public wealth. Government should reconsider investment strategy of NFRK and its size and make sure that it earns on investment.

4.4 Monetary policy

Announce a specific target and stay committed. Currency appreciated throughout boom years without NBK efforts to curb this trend. NBK's stance was ambiguous, with contradicting exchange rate and monetary policies. Since 2007, NBK temporarily tightens up monetary policy by pegging against U.S. dollar. When economic situation improves, NBK has to switch back to a flexible managed float or peg against basket of currencies including oil price (Frankel 2005). This however bears a risk of "disorderly exit" (IMF 2009, 19). In any

case, NBK should announce its policy and stay committed in order to lower inflationary expectations.

Regulate foreign borrowing by the commercial banks. NBK has been lax in relation to commercial banks during boom period and allowed excessive foreign borrowing that triggered real estate bubble. In order to learn the lessons and prevent overborrowing, NBK should influence borrowing of commercial banks through reserve requirement and possibly building in an early-warning mechanism, for example, by expanding the role of the Financial Supervision Agency to include monitoring of banks' offshore activities.

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This thesis identified common economic and political problems of resource curse (Dutch disease, revenue volatility, corruption, etc.) and presented possible ways of solving them based upon recommendations of international institutions. Kazakhstan as oil producing country faces these problems; their presence was stronger in the pre-boom years, in boom years, government economic policies mostly followed recommendations identified in Chapter 2 and mitigated them by pursuing active but cautious oil revenue saving approach in NFRK that prevented from excessive spending and ensuing pressures on inflation and currency. Effects of Dutch disease are unclear but other sectors of economy experience stagnation signalling about underinvestment and low quality of spending. Until now, Kazakhstan has "growth without development" (WB 2005, 5). Oil sector contributed to growth, and government has done relatively well in avoiding the pitfalls of oil-led growth, but now task of the government is to turn growth into development.

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