CAN THE KAZAKHSTAN ECONOMY BECOME RAW-MATERIAL INDEPENDENT

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Kazakhstan's economic development has been rather impressive in recent years, but the country has very justified concerns about how long it can keep these dynamics up. Many experts are inclined to explain the stable growth rates not by the government's intelligent

economic policy, but by the economy's reverse motion after the slump reached its peak, and also by national currency devaluation and increasing oil prices.

The high price of raw material resources in recent years is indeed ensuring high growth rates of Kazakhstan's GDP. But the amount of revenue coming into the country from these sources is extremely unstable and unpredictable and can hardly be viewed as a firm foundation for long-term economic growth. What is more, as many research studies indicate, this revenue may even hinder successful development to a certain extent. The Kazakhstan economy is not unique in this respect. Nearly all resource-rich countries are encountering the same problem—how to diversify industrial production and export so that they depend less on resource factors.[1]

[1] See: N. Volchkova, "Prichiny syrevoi zavisimosti rossiiskoi ekonomiki: "gollandskaia bolezn" ili nedostatochno razvitye instituty?" p. 2, available at [http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Accession/438734-1109706732431/ChapteronNaturalResources_Rus.doc].

The question economists are trying to answer is whether abundant resources are a boon or bane for the economy.[2] At first glace, it seems strange that a country's natural supplies of valuable resources might be a reason for economic failures. But, as often happens in economic systems, various indirect negative effects can outweigh the direct positive effect of supplementary wealth, so in terms of economic development as a whole, the overall effect of possessing natural resources could be negative.[3]

Several mechanisms can be singled out that are responsible for the negative effects of a country's natural resources on its economic development. First, the percussions of the "Dutch disease." Second, the unproductive activity of economic agents, stimulated by the high rent related to natural resources, leads to poor management of economic institutions, which, in turn, slows down economic growth.[4]

[2] Ibidem.
[3] Ibidem.
[4] Ibidem.

Growth without Development

Today, the main source of economic growth is exploitation of the country's raw material potential. Economic growth is generated by an increase in oil production maintained by the high price of raw material, as well as the increase in foreign investments. The oil sector has had a stimulating effect on other key spheres of the economy as well, such as the service, production, and construction sectors, which achieved significant economic indices.

Extensive growth based on rich natural resources is being observed in the country. The oil-producing countries of the Persian Gulf and many other states went through similar development stages in the 1950s-1970s, in so doing demonstrating the highest GDP growth rates. For example, in Mexico, high oil prices stimulated an increase of 8-9% in the GDP in 1978-1981, compared with 3-4% in 1975-1977, and the average annual increase in investments amounted to 16%. But the situation in the Mexican economy began to deteriorate due to a change in the oil price trend at the beginning of the 1980s. The GDP began to decline, the national currency (peso) underwent devaluation of more than 40%, capital began to drain from the country at an accelerated rate, and the foreign debt rose to 97 billion dollars in 1985.[5]

[5] See: V. Mau, "Ekonomicheskaia politika v 2004 godu: poisk modeli konsolidatsii rosta," *Voprosy ekonomiki*, No. 1, 2005.

The Kazakhstan economy began undergoing real growth in 1996, although it backtracked in 1998 when the Asian and Russian financial crises and the drop in world prices for the country's main export items caused a decrease in the GDP of 1.9% compared with the previous year. After the profound crisis at the beginning of the 1990s, economic growth in 1996, 1997, and 1999 was insignificant, averaging 1.6%, while the improved situation on the world market at the beginning of the 21st century gave a boost to economic growth as a whole and to oil production in particular. For example, the average annual growth rates in GDP for 2000-2006 were more than 10%. The volume of GDP increased from 2,016 trillion tenge (or 16.85 billion dollars) in 1999 to 9.74 trillion tenge (or 77.24 billion dollars) in 2006.

Revenue from the raw material sectors largely defined the priorities not only of economic, but also of social policy. For example, the unsuccessful development of the situation on the world hydrocarbon market in 1997-1998, when the price of oil fell at the end of 1998 to 9 dollars a barrel, forced the government to curtail the investment programs and sequester the budget (mainly its social component) several times throughout 1999.

The natural resource sector is playing a very significant role in Kazakhstan's economy. But there are problems with defining the precise structural proportions of the GDP.

According to the results of 2005, the RK Statistics Board assessed the percentage in the GDP of all branches related to the oil and gas sector at 17.5%, or at 1 trillion 334.6 billion tenge (or 10 billion dollars) in absolute figures (at current prices). While the share of the raw material sector in the GDP amounted to 22.2% and to 1 trillion 682.4 billion tenge (12.66 billion dollars) in absolute figures (at current prices).

The official statistics show that the oil and gas sector itself accounts for 14.3% of the GDP. In so doing, the share of crude oil and associated gas production amounted to 12.4% of the GDP, natural gas production to 0.2%, oil and gas production services to 0.8%, and petroleum product production to 0.8%.

In other branches of the economy, the contribution of the oil and gas sector to the GDP is much lower. For example, in construction, the oil and gas sector is represented by the laying of major oil and gas pipelines, whereby in 2005 the volume of this work amounted to 0.3% of the GDP. In trade, car repair, household goods, and personal items, the oil and gas sector is represented by services in wholesale liquid or gaseous fuel trade, which amount to 1.4% of the GDP. In the transportation sphere, the oil and gas sector accounted for 1% of the GDP, in terms of pipeline transport for 0.7% and of rail shipment for 0.3%. With respect to real estate transactions, rental and other services offered customers in the oil and gas sector by means of geological survey accounted for 0.5% of the GDP.

Judging by these statistics, the contribution of the oil industry to the GDP looks artificially low. Many experts are taking note of this fact. In particular, Peter Oppenheimer, economic advisor at Oxford University and expert at the British company Oppenheimer Technical Assistance Consultants, said in Almaty at a conference on the Development of the RK's Energy Strategy on 23 February, 2006 that the official data do not realistically reflect the share of the oil industry in the GDP, since part of what the oil industry actually produces is attributed to other services, trade, and transport." Mr. Oppenheimer believes that the actual share of the oil industry tops 25% of the GDP.

It should also be noted that the Russian Federation State Statistics Board offers a similar picture, according to which the percentage of the oil and gas industries amounted to only 9% of the GDP in 2000. However, the report of the World Bank shows that the assessments of the State Statistics Board are significantly distorted by the transfer pricing that occurs in vertically integrated production and trade companies and branches of the economy related to natural resources. This leads to an underestimation of the share of the resource-intensive production sector and an overestimation of the service (trade) sector in the production structure of the economy. Using the trade markups obtained from the statistics for other countries (Great Britain, Canada, Denmark) and data of the Russian input-output table, researchers of the World Bank recalculated the share of these industries and came to the conclu-

sion that the contribution of the oil and gas industries in the Russian economy could reach 25% of the GDP, while the share of trade could decrease from 30% to 10%.[6]

The change in Kazakhstan's industry and export structure speaks in favor of raw material growth.

As a result of the structural changes at the beginning of the 1990s and the increase in prices for raw materials at the end of the last decade of the 20th century, there was a decrease in the share of machine-building and agriculture with a simultaneous increase in the share of the mining industry.

In 1990, agriculture accounted for 34% of the GDP, the production sphere for 20.5%, transportation for 8.6%, construction for 12%, and trade and distribution for 8.2%. Six years later, the percentage of agriculture in the GDP fell to 12.2%, of construction to 4.4%, while the share of the production sector and transportation changed very little and amounted to 21.2% and 9.7%, respectively. In so doing, the share of trade and the circulation sphere rose to 17.3%.

The major changes in the structure of the economy continued after the price of oil and metals began to increase. The share of agriculture fell to 5.5%, thus showing an annual reduction in the role of this sector in the GDP for the entire time of the country's independence. The share of the production sector in the GDP for this period grew steadily, reaching a peak of 33.3% in 2000, when the price of oil abruptly increased. In 2005 and 2006, this share decreased somewhat, after reaching 29.8% and 29.5%, respectively. After the slump in the mid-1990s, the share of construction began to rise, reaching 8.9% in 2006, and the share of transportation for these years remained at a steady 9%.

As industry's role increased, its share of crude oil and natural gas production increased from 10.8% in 1995 to 50.9% in 2005, thus intensifying the raw material vector of industry, which is largely explained by the export orientation of these branches. In so doing, the percentage of ferrous and non-ferrous metallurgy compared with the beginning of the 1990s remains essentially unchanged, and even fell compared with the middle of the mentioned decade. In so doing, this happened under conditions of an increase in the price of metal on the world market.

Table 1

Structure of Industrial Production for 1990-2005 (%)

	1990	1995	1996	2000	2003	2005
The entire production sector	100	100	100	100	100	100
Oil production	1.8	10	14.2	38	39.6	50.4
Gas production	0.2	0.8	1	0.5	0.4	0.5
Ferrous metallurgy	6.1	13.6	10.7	8.5	7.9	5.3
Non-ferrous metallurgy	9.5	11.5	11.8	11.7	8.1	7.6
Machine-building	15.9	7.4	7.1	2.5	3.3	3.4
Light industry	15.6	2.5	2.4	2.1	1.4	0.83

Source: The Republic of Kazakhstan Statistics Agency.

[6] See: N. Volchkova, op. cit.

The share of industries putting out end products, on the contrary, dropped. For example, in 1990, machine-building accounted for 15.9% of the industrial production, whereas in subsequent years the share of this industry steadily fell, reaching 3.4% in 2005. The share of the light industry (represented by the textile and sewing industry, as well as leather production) fell from 15.6% in 1990 to 0.83% in 2005, and of the food industry from 22.3% in 1991 to 8.8% in 2005 (see Table 1). Several branches, such as the glass, china and porcelain, and microbiological industries ceased their activity entirely.

The deterioration in the export structure also demonstrates an increase in oil dependence. For example, the share of mineral products in export for the past ten years has been steadily increasing. In 1996, the share of mineral production in export amounted to 36.9%, and of oil and gas condensate to 21.3%. In 2006, mineral products occupied 71.9% of export, 61.7% of which was oil and gas condensate.

According to the results of the first nine months of 2006, the export of raw materials and low value-added primary products accounted for more than 90% of the country's export. Against the background of an increase in the export of hydrocarbons and non-ferrous metals, there is a reduction in the share of other goods in the overall export volume. Despite the increase in export in cost terms, in comparison with the first nine months of 2005, the percentage of export of ferrous metals decreased from 8.2% to 6%, of textiles and textile goods from 0.7% to 0.6%, of machinery and equipment from 0.8% to 0.7%.[7]

According to the estimates of the World Bank, since 1997 the export volume of all the other industries has been frozen at a level of approximately 2 billion dollars.

Hypertrophy of the oil and gas industry can be seen even more prominently in the structure of foreign direct investments. Investments in major projects of the oil and gas industry determine the structure of the gross FDI inflow in terms of types of economic activity and investor countries.

In 1993-2005, the share of the production industry, primarily of the oil industry, was approximately 70-80% of the total mass of foreign direct investments coming into the country.

In general, the production industry and geological survey work absorbed more than three quarters of the gross inflow of foreign investments from 1993 to the first nine months of 2006. Ferrous and non-ferrous metallurgy account for a little less than one tenth (approximately 7%). The processing industry, not including metallurgy, accounted for only 5% of the inflow of investments, and agriculture for only one tenth of a percent.

According to the result of the first nine months of 2006, the gross inflow of foreign direct investments topped 7.1 billion dollars, after increasing 1.6-fold compared with the same period in 2005. The percentage of investments in industries related to raw material production, ferrous and non-ferrous metallurgy, and geological exploration for the first nine months of 2006 amounted to 81% (see Fig. 1), while only 1.6% was invested in the production of machinery, 4.3% in construction, 3.66% in transportation and communications, and 0.5% in agriculture (see Table 2).

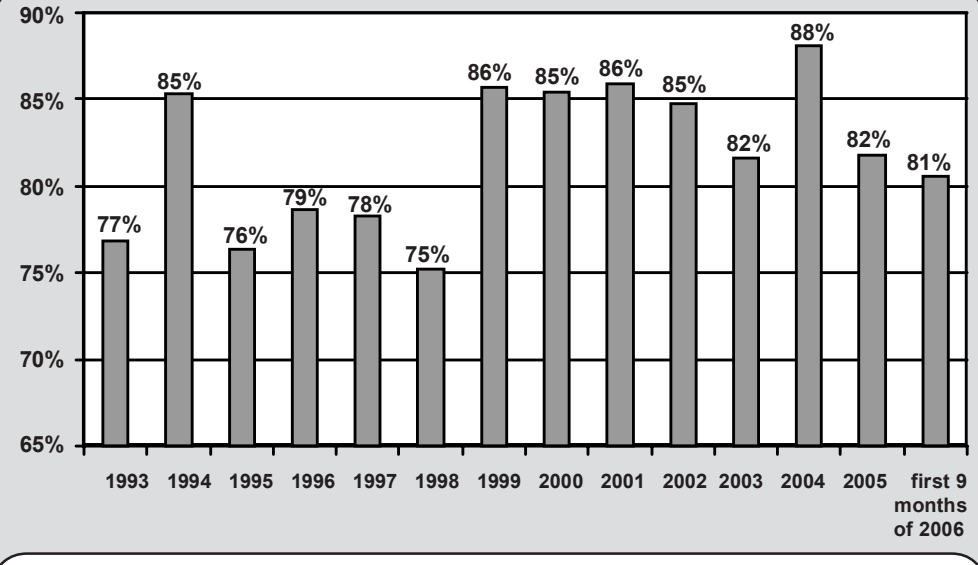
The increase in gross inflow of direct investments was largely ensured by implementing oil and gas projects, in particular with respect to the development of the Kashagan, Tengiz, Korolevskoe, and Karachaganak fields. The increase in geological exploration and survey work to 57.8% was related to the increase in financing for the North Caspian project, and the slight drop in the gross inflow of FDI into oil and natural gas production is explained by the KazMunaiGaz National Joint-Stock Company's purchase of assets of the Kazgermunaigaz Joint Venture from foreign investors.

Summing up the above, we will note that the role of the raw material industries in the country's economy has significantly increased and forms the foundation of the country's development. Whereby the influence of the increase in the oil and gas sector goes way beyond its direct contribution to the GDP through demand on suppliers and related industries, the effect of oil wealth on domestic con-

[7] See: Report of the National Bank "Balance of Payments and Foreign Debt of the Republic of Kazakhstan," January 2007 [http://www.nationalbank.kz/?docid=626&uid=080CABD1-802C-E8FB-3D60D6426DE661FC].

Figure 1

Percentage of Investments in Industries Related to Raw Material Production, Ferrous and Non-Ferrous Metallurgy of the Overall FDI



Source: National Bank.

sumption, the increase in the price of real estate and financial assets, and the increase in the real exchange rate.

At present, construction, trade, commercial activity, transportation, and financial services are undergoing growth, but these trends are the direct or indirect result of demand born by large investments and spending in the oil industry. As we know, the Dutch disease, the symptoms of which are inherent in the Kazakhstan economy, could be manifested in an increase in the relative significance of branches producing non-commercial goods, that is, goods that cannot be imported, primarily services.

Table 2

Gross Inflow of Foreign Direct Investments in Terms of Types of Economic Activity (*million dollars*)

Type of activity	1993	1995	1999	2000	2005	first 9 months of 2006
Agriculture, hunting, forestry, and fishing	—	—	0.3	3.8	1.2	35.7
% of overall FDI	—	—	0.01%	0.14%	0.02%	0.50%
Mining industry	921.5	477.8	1,402.9	2,035.5	1,795.2	1,363.0

Table 2 (continued)

Type of activity	1993	1995	1999	2000	2005	first 9 months of 2006
% of overall FDI	72.5%	48.5%	75.7%	73.2%	27.13%	19.14%
including crude oil and natural gas production	921.5	191.8	1,372.5	2,002.1	1,681.0	1,153.6
% of overall FDI	72.5%	19.5%	74.1%	72%	25.41%	16.20%
Textile, sewing industry, production of leather, leather goods	—	0.8	—	1.0	0.0	1.7
% of overall FDI	—	0.08%	—	0.04%	0.00%	0.02%
Ferrous metallurgy	—	98.0	4.8	71.4	3.2	1.2
% of overall FDI	—	9.96%	0.26%	2.57%	0.05%	0.02%
Non-ferrous metallurgy	—	62.4	29.8	29.8	92.6	258.3
% of overall FDI	—	6.3%	1.6%	1.07%	1.40%	3.63%
Production of machinery, equipment, electric and electronic equipment, transportation equipment	—	16.6	28.0	52.6	49.6	113.3
% of overall FDI	—	1.7%	1.5%	1.9%	0.75%	1.6%
Construction	—	1.3	2.6	12.3	119.0	305.5
% of overall FDI	—	0.1%	0.1%	0.4%	1.8%	4.3%
Transportation and communication	—	18.3	20.4	88.4	110.9	260.6
% of overall FDI	—	1.9%	1.1%	3.2%	1.7%	3.7%
Geological exploration and survey work	55.3	113.0	149.5	238.2	3,521.7	4,116.1
% of overall FDI	4.3%	11.5%	8.1%	8.6%	53.2%	57.8%
TOTAL FDI (foreign direct investments)	1,271.4	984.3	1,852.1	2,781.2	6,616.5	7,120.3

Source: National Bank.

Development Paths

An accelerated oil production strategy does not meet the country's interests and entails risks both for the country's current economic development and for the future. The tempestuous development of the raw material industries primarily generates the problem of extraction and redistribution of rent revenue. It can be appropriated by the field owners, while personal incomes will decrease or remain unchanged, or will increase at slower rates. This is leading to high income differentiation and social inequality. To prevent this from happening, the state should extract natural rent with the help of taxes or fees for use of the subsurface owned by the state. But nowhere has it yet been possible to carry out such regulation painlessly and efficiently.

Second, even with full extraction of natural rent by the state and its fair distribution among citizens, problems may arise of regional imbalance between product demand and supply.

Third, an important aspect of the Dutch disease is its time-domain measurements. A sharp decrease in merchandise production, cutback in the export of the traditional industries, and an increase in raw material export is causing the appearance of unprofitable and bankrupt enterprises in the processing industry, in agriculture, as well as in the high-tech branches of the economy. This is leading to high structural unemployment and a decrease in the wages of many categories of highly qualified employees, particularly in the scientific-intensive industries. After all, the production branches, including oil, are not scientific-intensive and high-tech, their production operations are simple and standard and so do not require special high technologies and complicated techniques, and they are conservative and do not particularly need a highly qualified workforce. At the same time, oil revenue is inevitably slowing down the necessary structural changes by strengthening the tenge exchange rate and thus raising production costs, as well as lowering the competitiveness of the non-raw material sector of the economy.

Fourth, particular price instability is characteristic of the raw material markets. And this is giving rise to strong macroeconomic instability. In so doing, undesirable consequences for Kazakhstan's economy could arise in the event of both low and high oil prices.

In this way, at accelerated oil production growth rates, no structural changes in the economy within the permissible limits will make it possible to bring the share of finished products closer to the share of raw material in the GDP, especially in export. This means that the country will always be on the fringe of the developed countries, and its economy peripheral and backward, despite its oil wealth.

At present, when there is abundant revenue coming in from oil export due to the favorable foreign economic situation, it is difficult to expect the government to reject the impressively high growth rates that oil generates. Particularly since the high growth rates and vast inflow of oil revenue observed over the span of seven years have already created the strong illusion that economic growth is sustainable and have given rise to a false feeling of euphoria that the Kazakhstan economy will continue to grow in the future and that the country is safe as long as it has oil. Nothing discourages the people and the government like an abundance of natural resources, which generates vast surplus revenue when the situation in the world economy is favorable.

Oil ultimately becomes not so much a boon as a bane for structural and institutional reforms, without which there can neither be diversification and an increase in the economy's competitiveness, nor its sustainable growth. But if the state pursues the correct policy, the surplus of resources could augment the welfare and prosperity of the present and future generations.

Today, Kazakhstan's main problem is relieving the economy of its raw material dependence and the volatility of world oil prices, and facilitating a transfer to economic growth accompanied by development. So the most urgent task is to ensure broad diversification of the economy and raise its competitiveness. Whereby not only is diversification necessary, but also radical modernization. The production of new types of finished products must be assimilated, particularly high-tech forms with

high added value, their range renewed and expanded, a qualitative revival of the entire production apparatus of the economy's non-raw material sector achieved, and the economy provided with a highly skilled workforce.

At present, unequal conditions have been created for the processing industry compared with the raw material sector. The raw material sector has enormous earning power, so it stands to reason that investments are being channeled in that direction. On the other hand, profitability of the processing industry is very low. The share of unprofitable enterprises remains high—34% of all the enterprises in the sector—while the earning power of these branches is no higher than 10%, and several branches and many sub-branches are in the red.[8]

So the processing sector cannot compete for investments. This means that capital is not flowing between the raw material and the processing industries.

World experience shows that the economy should be cured of the Dutch disease, like any other medium- or long-term interference of the state in the economy, with the help of fiscal measures (changes in taxation, and so on), and not only monetary policy measures (manipulating the hard-currency exchange rate by means of transactions on the currency market), and by building up the National Fund and gold and currency reserves.

Having understood this situation, the government took several measures to diversify the economy. The government approved the Republic of Kazakhstan Strategy of Industrial-Innovative Development for 2003-2015. The following free economic areas function as a means of state stimulation of real production: Astana-New Town, Information Technology Park, Aktau Sea Port, and Ontustik. Along with creating free economic areas, the government is also promoting another of its ideas regarding sectoral clusters. In order to develop the textile cluster, a special free economic area—Ontustik—has been created. Nine sectoral and inter-sectoral programs have been approved, such as programs for forming and developing a national innovation system, developing the construction industry, items, and structures, an energy-saving program, and others.

The state is also creating development institutions. As of 1 October, 2006, the portfolio of investment projects of the development institutions consists of 144 projects approved for project financing totaling 3.7 billion dollars, and with the participation of development institutions totaling more than 1.0 billion dollars.

Also, in the past two years, a set of tax remissions has been introduced into the legislation aimed at ensuring an overall decrease in the tax load (individual income and social taxes, VAT), and the introduction of benefits and preferences for enterprises operating under special tax conditions and certain sectors of the economy. For example, certain preferential tax conditions have been established for organizations functioning in the petrochemical industry and special economic zones, as well as for organizations selling products they manufacture themselves with high added value. Tax preferences are being introduced separately, which the government determines for enterprises implementing investment projects.

Despite the efforts aimed at diversifying the economy and the relatively high development indices of the non-petroleum sector in recent years, the rapid growth of the oil and gas industry has made it possible to preserve its dominant position in the economy.

The government's efforts to change the current situation in the economy are arousing doubts. For example, the Kazakhstan economy will hardly be able to compete with China by means of its cotton cluster, which M. Porter, one of the authors of the cluster strategy, announced. And the development institutions have still not implemented any kind of serious projects in 2005-2006.

[8] See: A. Esentugelov, "Rekomendatsii po dolgosrochnoi strategii upravleniia dokhodami ot dobyvaiushchei promyshlennosti," in: *Collection of Reports "Kazakhstanskaia neft—shans dlia razvitiia,"* Kazakhstan Revenue Watch, Almaty, 2006, p. 54.

There is criticism of the state's tax policy, which offers individual tax benefits to certain, so-called priority branches and enterprises. This archaic way of stimulating production, which was used by the Asian countries in the 1960s-1970s, is leading only to subsidizing poorly managed inefficient industries at the expense of citizen taxes and efficiently functioning branches, which is reminiscent of the Soviet system of profit redistribution of advanced enterprises. In this way, the government is creating unequal competitive conditions. It is not fair that enterprises and entire industries become competitive not on the merit of their own activity, but with protection from the state by means of competitive industries that are successful through their own efforts. What is more, the priority of certain industries and the establishment of preferences by willful and hidden methods in the quiet of the government's offices are subjective.

So the IMF's criticism is justified, according to which the investment business climate beyond the oil industry remains difficult, in particular for medium and small enterprises and foreign investors.

With respect to the aforesaid, the tax load on the non-raw material sectors of the economy must be significantly decreased while retaining high export duties on raw material, which is called upon to extract part of the natural rent. For example, the corporate tax rate should be drastically lowered from the current 30% for all enterprises of the processing industry, agricultural taxes and VAT rates should be further reduced, and cooperation between business and the government significantly simplified.

The financing and stimulation of R&D and innovations in the economy should also be drastically increased, primarily of fundamental science and innovationally active enterprises. Investments in these spheres mean investments in people, without whom it will be impossible to raise the competitiveness of the country's economy. However, Kazakhstan spends only 3.4% of the GDP on education (according to 2005 data) and 2.5% of the GDP on public health, while in Hungary, Poland, and the Baltic countries from 5.1% to 7.5% of the GDP is spent on education and from 4.0% to 7.4% on public health.[9]

The state should not only increase budget fund investments in the development of human capital and reduce the tax load, but also drastically raise the efficiency of the state bodies with the help of information technology and institutional changes. This in turn is arousing the need for reform of the entire institutional system and the production of services of the state sector in order to raise its efficiency.

Administrative and budget reforms, which define clear and sensible distribution of responsibility and income sources at each level of the government, are capable of significantly reducing additional outlays caused by corruption, the economically unjustified shuffling of resources within the economy, and so on, which will help to raise economic efficiency as a whole, without causing "overheating" of the economy and an increase in inflation.

[9] See: A. Esentugelov, op. cit., p. 59.