

FDI and Its Significance on Economic Development in Kazakhstan: Issues and Prospects

Choong Y. Lee, Professor of Management, Pittsburg State University, USA
Ekaterina Kolesnikova, MBA, Pittsburg State University, USA

ABSTRACT

The purpose of this research is to evaluate economic situation of Kazakhstan's market and its attraction to Foreign Direct Investors, to provide clear view of potential that Kazakhstan economy has and the prospective of further development of the area of the economy and the future of this country. The country of Kazakhstan is one of the largest world energy markets due to its considerable reserves of natural gas and crude oil. With the help of FDI this country can become one of the largest oil producers, but for that the country must grow to be more modern and diversify its economy to help it to get more integrated in to the global economy. Foreign investment can become the main driver of the economic growth of the country. Today, this country has already gotten the highest per capita indicator in the whole former Eastern Block. However, current policy is to support and to strengthen the non-oil sector of the economy, by diversifying of higher-value added industries, therefore in order to do that additional capital flow is required that can be brought in to the country with FDI possibilities.

INTRODUCTION

Kazakhstan is the largest country in Central Asia, and one of the most populated. It has gotten its independence from the Soviet Union in 1991, and since then has been growing on its own. It has also inherited a considerable amount of infrastructure from the USSR. This country is rich in energy and mineral resources, well-educated population, substantial export possibilities in industrial and agricultural products. All through out the Soviet times, Kazakhstan was as agrarian supplier for the USSR, after getting its independence considerable changes had to be made to transfer from command planning economy into the market system. Of course, in the process of those changes the country had to face numerous challenges in economic, social and environmental levels (OrexCA.com).

Kazakhstan had to undergo an active program of economic reforms, and today is one of the most successful in achieving the most advances and results from the process of transformation comparing to other Central Asian countries. It is also one of the first countries that reached investment grade status of BBB/Stable by Standard & Poor in 2004. Gross Domestic Product has been gradually growing over time, and the Economist Intelligent Unit has put Kazakhstan into the Top 10 world fastest-growing economies in 2005(The World Bank). Since 1991, Kazakhstan has been a very promising resource base, supported by well-educated work force available, hence, it was free of the past policies of the USSR, and was headed towards a new transformational way, through implementing a number of reforms to make a smooth transaction from planned to market economy. Such reforms were de-monopolization, privatization, debt and tax restructuring, and price liberalization. This country had reformed its banking system and enhanced investment laws, loosened up the trade processes and established its own currency. The unemployment rate in Kazakhstan is the lowest one in the region of the Central Asia.

The Kazakh government believes that through attracting foreign investment continued growth, diversification of the economy and development of the country will be ensured. For that, however, this country will have to ensure stable economic environment and make improvement in the investment climate market, lower the inflation rate and reduce budget deficit (OrexCA.com).

ECONOMIC OUTLOOK

The country of Kazakhstan is considered to be a lower middle-income country with a slowly raising national income per person from \$2,930 to \$3,700 a year and this trend is still on the incline, and one of the most sparsely populated in Central Asia. It has great deposits of mineral wealth and vast land available for numerous activities and business developments. The economy of Kazakhstan is dependent mostly on a few goods and is about to face a fast coming problem of unavoidable diversification. Oil industry and all industries related to it combine together about 16.6 % of Kazakh GDP. Metals and grains are other two industries that are crucial for the country (The World Bank).

There is still a certain percentage of inequalities among the population. The poverty rate is still high and some of the social indicators are the lowest in Europe and Central Asia, however, this issue is mainly tied up to the problems of safe water and the rise of HIV infection rates and diseases.

Kazakhstan is also in the battle with some of the environmental challenges and industrial pollution, and so far some significant improvements have been made to regulate and restrict the pollution levels. Kazakhstan was one of the first Central Asian countries to accept the World Bank membership and with the help of World Bank a number of financial and private reforms have been performed with attention to making the country's welfare and social protection. At the present times, the World Bank is supporting Kazakhstan in reforms in agricultural, environmental sectors, and upgrading infrastructure to help the country reach continued growth and reduce the poverty. In comparison to other post-Soviet satellites Kazakhstan was one of the bravest ones to liberalize its prices, reduce trade barriers and allow privatization of small and medium size enterprises. Those early reforms had made an improvement in the financial processes of treasury and budgeting, however, in the land reforming and elimination of corruption it did not succeed as good (Economic Cooperation Organization).

There has already been created a basic framework to attract the Foreign Direct Investment (FDI) into the industry that is rich in oil and mineral. That framework was created together with the reformation of banking and pension systems. Recently, public resource management framework has been introduced, which lays the foundation for modern civil services, and the National Fund has been created to save up a certain part of the revenue coming from the oil business. The result of such reforming was very significant for the country, bringing up the value of the Tenge against US dollar, increasing the capital flow into the country and increasing oil exports. However, the government is still looking for ways to improve spending policies, to enable regular people to enjoy the benefits from the recent economy growth.

CURRENT ECONOMIC CHALLENGES

Even though the recent data shows a visible improvement in the economy of Kazakhstan, there are still a few challenges that remain unsolved. Therefore, these are the most important issues that must be addressed (Umurzakov, 2003): (1) The oil flow of the country must be managed wisely and effectively, to avoid any possible inflation and to improve the productivity and competitiveness; (2) Business environment will have to continue to be attractive to investors both domestic and foreign, and the economy must be well diversified to do that, so the investment risk and the cost of doing business is low enough; (3) Building human capital is crucial for the country, there is an acute skill shortage, therefore there is a need for more inviting conditions to attract and retain the human capital; (4) There is a need for a very well prepared agricultural policy, which will define the degree of state regulation and involvement and land restructuring issues; (5) The Government must look for a way to encourage effective projects, to implement targeted social assistance and sectoral development strategies, and develop a good spending policy; and (6) The key infrastructures must be improved and their problems must be addressed to create a better business environment to attract investors (Umurzakov, 2003).

IMPORTANCE OF FDI IN KAZAKHSTAN

The Kazakh Government understands the importance of FDI, and realize that FDI is needed to maintain sustainable growth. The objective is to create an open and liberal regime for FDI with guarantees of national treatment, nonexpropriation, repatriation of funds, stability in the legal regime, access to international arbitration and incentives in certain priority sectors provided. The country's desire is to provide a more attractive investment climate by drawing in as many major transnational and global enterprises as possible (Embassy of Kazakhstan in Israel).

There is a rage of incentives offered for foreign investors in terms of legislation in priority sectors, however, the priority is to attract FDI into the following sectors: (1) Industrial infrastructure; (2) Processing industries; (3) City capital development; (4) Construction and housing; and (5) Agricultural sector. Kazakhstan's strategy is also to protect country's young developing industries by supporting them on the state level, by pushing domestic content in the investment, especially in the areas of oil and mineral sectors. The Kazakh Government has begun to change its policy which has resulted in a draft of some investment law submitted for consideration by Parliament, to eliminate stability clauses for foreign investors who come in Kazakhstan after the enactment of the new law and to limit recourse to international arbitration of investment disputes (Umurzakov, 2003).

As of November 1996, the State Committee on Investments was created to be a one-stop shop to restructure investment procedures in the country, to assess investment policies, developing investment proposals, coordinating the activities of the various government agencies involved, providing incentives and facilitate to qualified investors, determining the terms of operations before the signing of contracts, and monitoring projects. On 30th June 1998 the President of Kazakhstan signed a decree to establish the Foreign Investors' Council that reports directly to him. The new investment law (Law of the Republic of Kazakhstan "On Investments" No. 373-II 3PK), foreign investors have the right to set up their businesses and own property. Land is now available on lease and all foreign investors have the right to invest in any types of activities, except for those, which are exempted by the legislature of Kazakhstan (Embassy of Kazakhstan in Israel). This law also guarantees legal protection of investors' activities in the country, the conditions of contracts between investors and the Government, the use of income and the rights of investors, and provides mechanism for the settlement of disputes (Umurzakov, 2003).

The new law also guarantees the Government support on investment, which includes creating a favorable investment climate, stimulating investment in new production operations, expanding and renovating existing ones. Any investment privileges available to approved projects in priority areas approved by the Government include: deduction of cost of fixed assets brought in as part of the investment project from aggregate annual income; relief from the property tax and land tax; exemption from customs duty; and state grants in kind (not more than 30 percent of the volume of capital investment). Those privileges are predetermined in a contract between an investor and the Government. The law protects against expropriation and guarantee of repatriation of capital, profits, and dividends are provided. Goods like equipment and raw materials, may be qualified for total or partial exemption of duty on condition that the goods are used as an input in designated priority projects. Those companies that are export-oriented enterprises established in special economic zones are entitled to special incentives, including a tax-free and customs-free status. Kazakhstan permits the importation of goods from CIS free-trade partners and certain developing or least-developed countries free of duty or at a reduced rate within the framework of the Generalized System of Preferences. Today there are three special economic zones (SEZ) in Kazakhstan – Lisakovsk, Kyzylorda and Zhairam-Atasu.

Investors are permitted to buy out major industrial firms through long-term management contracts, through fully foreign-owned companies, joint ventures, branches, and representative offices of foreign legal entities. There are production sharing agreements with the Kazakh Government available for the exploitation of natural resources. There is not really a requirement that nationals own equities in foreign. According to the Agency on Statistics of Kazakhstan, there were 1,694 foreign firms operating in the country, employing 17,284 people on 1 September 2003. The International Monetary Fund reported that FDI flows to Kazakhstan, with a breakdown on equity investment, reinvested earnings, and intra-company loans. However, outward flows are registered only as equity investment.

CURRENT FINANCIAL SITUATION OF KAZAKHSTAN: CRISIS OR NOT

Recent studies show that there is a potential financial crisis currently happening in the economy. First of all, crisis of the subprime mortgage in the US caused financial sector of the Kazakhstan to lose its liquidity due to the effect that the sector heavily depends on foreign credit. If the credit is affordable the foreign investment is flowing into the country which would lead to growth and development of various sectors of the economy. Then, an artificial inflation of the Tenge, created by the substantial lending sprees, has increased volatility of the currency, and therefore, it troubles the repayment of foreign debt and makes it more unpredictable. Hence, macroeconomic shocks, created by overexposure to the real estate and retail sectors, make financial lending businesses and banks of Kazakhstan more sensitive to economic changes and movements on international market (Lee, 2008).

National banks have been putting money into financial markets to help stabilize the Tenge, national currency of Kazakhstan, plus, in addition to that, the government has been buying back the shares of Kazakh companies to insure and improve the price of them on the market. However, it is known that Kazakh banks and the credit agencies are being ignorant to the presence and possible consequences of inherent risks in the country, and the priorities of the economic direction are not in the needed order, with a lack of transparent system in banking and government as well (Lee, 2008).

Although, through reprioritizing the economic growth plans, together with timetables, strategies and processes for future development, and rethinking short and long term perspectives socio-economic impacts on national wealth and population distribution, and overall economic development will create a more favorable investment climate and attract more capital flow (Lee, 2008).

DISTRIBUTION OF FDI AND ITS PERFORMANCE IN KAZAKHSTAN

It is not a surprise that the impact of FDI inflows in Kazakhstan on economic growth, improvements in trade balance and balance of payments, as well as all other important macroeconomic indicators has been positive and beneficial for the country. However, it is still too early to evaluate the extent to which the FDI is having an impact on the local economy. The FDI is able to stimulate technology transfer and technological capacity building, as well as human resources development. That is why the Kazakh Government is pursuing a policy of establishing closer linkages between the large foreign investors in the resource sectors and domestic suppliers. That cooperation has resulted in established connections leading to the development of technological capabilities of domestic enterprises.

An example of such enterprise is Karachaganak Integrated Organization (KIO), a consortium of Texaco (United States), British Gas (United Kingdom), Agip/Eni (Italy) and Lukoil (Russian Federation), is implementing a program focusing on increasing the domestic content in the Karashganak project on development of a huge oil and gas field in western Kazakhstan. Nowadays, KIO has concluded contracts on the supply of goods and services with more than 400 local companies. Such contracts with local companies represented about two thirds of all new contracts signed by KIO amounting to about US\$ 150 million. The volume of goods and services supplied by local companies to KIO increased seven times to US\$ 430 million in 2001, constituting 32 per cent in overall volume of supplied goods and services, from US\$ 59 million in 1998 (21 per cent). With strong support from KIO, western companies having long-term contracts with KIO have signed nine agreements with local companies on cooperation in the implementation of those contracts, and other four agreements would be signed in the near future. Today, KIO is starting two new projects on the building of plants for manufacturing of pipes for the oil and gas sector with cooperation of local companies.

STRENGTHS, WEAKNESSES AND OPPORTUNITIES IN KAZAKH FDI MARKET DEVELOPMENT

Strengths

According to foreign investors, Kazakhstan is as an emerging market rather than a developed market, including oil and minerals sectors, and its strengths are viewed from only that standpoints, and in this case this country is viewed as an economically viable and profitable, as well as politically stable environment dominates among the experts familiar with the Central Asian region. The following factors are considered by representatives of foreign investors and independent observers as Kazakhstan's strengths:

- (1) Natural resource endowment of this country has very attractive huge resources of hydrocarbons and minerals and attractive exploration potential for additional discoveries. Together with oil and gas resources which are the key sector attracting foreign investors, Kazakhstan has also world class natural resources as coal, uranium, gold, aluminum, lead, copper, zinc, iron ore, etc. Kazakhstan also has abundant resources of land which can be used for agriculture, although, some of the areas are heavily dependent on irrigated water which may have a high economic cost.
- (2) Kazakhstan is the largest economy in Central Asia, and with a population of nearly 15 million, and GDP and FDI growing at a high rates, Kazakhstan is a sizeable market for investment not only in the extractive sector but also in infrastructure, and consumer goods, and in services, especially in those areas where foreign supply through imports is not profitable because of large distances and/or high transportation costs. This is a transit country with great potential to become a major transit route for the transit of goods between the Russian Federation, Central Asian countries and China, which includes gas volumes transited through existing transit pipelines connecting Turkmenistan and Uzbekistan with the Russian Federation. Kazakhstan's location in close proximity to the emerging markets of the Russian Federation, Central Asia and China presents opportunities for the country to serve as a hub for transport and other services, as well as to serve as an export platform (Umurzakov, 2003)
- (3) Kazakhstan has well educated, skilled and motivated workforce with the needed levels of education and skills of the workforce and their high level of motivation, even though there is a shortage of skilled labor.
- (4) In comparison to other Central Asian countries, Kazakhstan has stable macroeconomic situation, prudent macroeconomic policy, a stable macroeconomic situation in Kazakhstan, and a stable currency are generally viewed as positive factors by prospective investors.

Weaknesses

Location of Kazakhstan is a landlocked country which is not viewed by investors and experts as either a strength or a weakness. On the other hand, the weaknesses in public policy, legislation and its implementation resulting in unfavorable business conditions are identified as significant weaknesses:

- (1) Being a landlocked country could be a significant weakness for the development of any export-oriented industry, especially if the industries are based on the processing of imported commodities for re-export. The Kazakh Government has prudently emphasized the Kazakhstan's position as being at the crossroads between East and West, therefore, implying the ability to supply either markets, and to benefit from being a linkage in trade between the areas. At the same time, Kazakhstan can be perceived as being equally remote from the major markets of both East and West. Kazakhstan's dependence on other countries for overland transportation (road, rail and pipeline) is a significant current weakness for attracting FDI in oil and minerals sector. Kazakhstan's geographic position could be considered as a weakness in attracting inward investment for global markets. However, Kazakhstan is a large country in the Central Asian region neighboring the Russian Federation and China which is a potential strength.
- (2) Infrastructure of Kazakhstan is a immense, thinly populated, landlocked country faces particularly salient needs for infrastructure improvement, such as needs for transportation and telecommunications. Moreover, while the country has extensive energy resources, the energy transportation infrastructure is underdeveloped, both for export and for delivery to domestic markets. In addition to that, significant improvements are needed in the power sector and in municipal utilities.
- (3) Kazakhstan presents a difficult business environment, which is different from investor expectations and international practices that investors are hesitant to commit their capital, with the exception of those in the extractive sectors. The Government of Kazakhstan has made great efforts in improving foreign investment legislation, although, the main concerns remain the same, and that includes the vagueness of laws, contradictory legal provisions and poor implementation. Bureaucracy is another leading competitive disadvantage of the business environment in Kazakhstan. Unfortunately, many investors claim to have encountered excessive delays, which hinder the establishment of new investment, the conduct of ordinary business operations and reinvestment. Transparency of laws remains a major problem in Kazakhstan and an obstacle to expanded trade and investment.

Foreign participation is generally welcomed, however, some foreign investors claim that the Government is not always even-handed and sometimes reneges on its commitments and obligations. Corruption is widespread and encouraged by the lack of transparency in the legal system, the broad discretion given to civil servants and the relatively low wage levels in the public sector (Umurzakov, 2003).

Opportunities

Kazakhstan has two strategic opportunities: the opportunity to develop industry in compliance with national advantages and the opportunity to become the preferred investment location in the region:

- (1) The preferred investment location for a regional market is guaranteed by the opportunity to become a production and services base for the wider regional market of 56 million people in Central Asia. That attracts a large amount of FDI including investments of reputed international investors which could bring with them financial resources, know-how and best international practices. These connections improve the capacity of local companies and managers could be substantially improved. Hence, another advantage is that Kazakhstan is perceived as the strongest and best regulated financial sector of the Central Asia, which could give a head start for Kazakhstan's non-extractive sector in comparison to other countries in the region. For instance, Almaty has a real opportunity to be the regional office for professional and trade service firms, and in the longer term may develop as a key financial centre and capital market for the region.
- (2) Ensuring sustainable economic growth is not easy due to the challenge that the country is facing in terms of increased importance of the oil sector and the volatility of oil prices. In this regard, the economy has to be more diversified to better withstand future commodity price shocks and offer economic opportunities to the population outside the resource sector. The non-oil and non-minerals sectors are currently perceived by international investors as relatively unattractive. Therefore, the investment climate must be improved and all concerns of investors have to be addressed, including a wide range of regulatory issues (Umurzakov, 2003).

KEY ISSUES AND RECOMMENDATIONS

Since 1991, Kazakhstan has attracted more than US\$ 12 billion in foreign investment which is more than all of the former Soviet republics, of course with the exception of the Russian Federation. The United States alone invested over US\$ 2 billion in Kazakhstan during the past ten years, and therefore is this country's largest single source of FDI. However, over 80 percent of all investment today are made in the extractive sectors. Kazakhstan's lesson learned today is that economic performance in the last decade is that the country needs to expand and deepen its economic reforms and diversify away from oil to protect its economy from external demand shocks. To achieve that this country must remove current administrative barriers and offer opportunities for investment in the non-extractive sectors.

Another important issue in creating effective environment is to ensure implementation of structural reforms including transparency and corporate governance, privatization and commercialization of public utilities, and liberalization of trade policy. To guarantee regional competitiveness of Kazakhstan, the Government has to come up with better policies and procedures than its neighbors, and through this way differentiate itself from its neighbors as the best place to do business in Central Asia. Kazakhstan is at the forefront in the region, in reform of the financial system, in pension reform, however, there are still many areas where Kazakhstan is far from being the best and indeed has a poor reputation. This is particularly true in respect of administrative barriers (Umurzakov, 2003).

WTO ACCESSION AND ITS INFLUENCE ON FDI IN KAZAKHSTAN

Since Kazakhstan Government has applied to become a member of WTO in 1996, many analysts believe that it brings several positive benefits for the economy of the country and makes the investment climate better for the foreign investments. Those benefits are known to be stronger economic collaboration, increased competition, development of trade, progress of infrastructure, and faster economic conversion. However, with the accession of WTO this country will be able to collect the benefits of the membership and create more attractive investment climate only if the following

points will be resolved. First of all, Kazakhstan should work to improve its solid foundation and reputation in the financial centers of the world, such as New York, London and Hong Kong. Those are very diverse metropolitan financial centers with developed industrial foundation and financial facilities, and Kazakhstan must try to reach their levels in order for it to have a better investment climate that will promote stability to the investors. Secondly, elements like financial crises, increase of unemployment rates, reduction of domestic production, and going up inflation rates must be resolved and reduced to minimum to insure the prospects of sustainable growth and development. Government should support emerging sectors of Kazakhstan economy with money collected for oil and natural gas sales to promote the development and growth of domestic industries and financial institutions, thus ensuring the future of Kazakhstan economy, diversifying and building those industries that need help and support from the government to encourage their future profitability and success.

RECOMMENDATIONS AND SUGGESTIONS

Modification of existing legislation is needed to ensure clear and unequivocal access to international arbitration. Hence, simplification of the process for obtaining work permits for short-term foreign employees is also needs to be addressed. In addition to that, in order to ensure fair business registration, there must be established a centrally-coordinated business registration procedure and introduce an electronic database accessible to other ministries and the public.

In terms of taxation, the focus should be on particular priority taxation issues that pose serious problems to investors, including: (1) Enforcement of transparency in tax regulations by interpreting critical cases and general terms of laws and regulations, and creating a functioning appeals mechanism; and (2) Strengthening of enforcement of legislation and reduction the number of unnecessary audits and inspections.

Customs should also rearrange their policies and regulations in terms of: (1) The lengths of delays associated with transportation stoppages; (2) Implementation of a comprehensive reorganization of customs to improve reporting and consultative relationships with other government agencies and private sector clients.

Another issues that strongly must be addresses is government bureaucracy, there the following items must be replayed: (1) Clarification of each agency's area of responsibility and removal of overlaps and duplications; (2) Making rules and regulations for conducting inspections and make them available to the public and more transparent for foreign investors.

Structural reform as well needs an improvement in transparency and corporate governance through full disclosure of ownership structures, and therefore, stopping related party transactions and protection of minority shareholder rights. Institutional framework should be improved in the area of the institutional capacities of investment related bodies taking into account the world-best practices, and coordination between national and local agencies in implementing after-care services for investors. Finally, regional cooperation should reduce trade barriers for cross-border trade and transit in the region and enhance cooperation within regional groupings.

The recommendations for sub regional and regional cooperation are to encourage economic cooperation among the five Central Asian countries through cooperation in investment attraction and promotion, through taking into account current requirements of regional countries, as well as the low level of present economic cooperation in the region through the following steps: (1) Synchronization of national investment strategies of host countries; (2) Elimination of administrative barriers, enhancement of business environment; (3) Liberalization of trade policies through removal of tariff and non-tariff barriers in the region, and establishment of free trade area, even if it is going to be over a length of time; and (4) Joint competence building in specific investment promotion policies with the coordination of investment policies of Central Asian countries, assuming that regional technical assistance programs in the area of trade and investment in Central Asia are planned and implemented by different contributor organizations, a strategic partnership would be developed with other technical assistance providers to ensure synergy effects and the understanding gained by other institutions in this area.

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