Session I: Prospects and Challenges of Financial Systems in Transition Economies

DEVELOPMENT, PROSPECTS AND CHALLENGES OF FINANCIAL SYSTEM IN KAZAKHSTAN

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I. 1993-1997: From Stabilization to Growth (General Macroeconomic Survey)

Since its independence in late 1991, Kazakhstan has consistently followed an economic course toward development of a free market economy. The 1991-1993 period may be described in general as a preparatory phase, laying the foundations of reforms of the republic's inherited administrative-command economy. Significant economic reforms started in 1993, following the introduction of Kazakhstan's national currency—the tenge.

An unsuccessful attempt to address the problem of interentreprise arrears by issuing loans led to an inflation surge in April-June 1994, and to devaluation of the tenge. Since June 1994, the National Bank of Kazakhstan has been pursuing a tight monetary policy aimed at lowering inflation and stabilizing the tenge. As a result of coordinated policies implemented in monetary and fiscal areas, monthly inflation measured by the CPI dropped in the period from January to December 1994 from 42.6 percent to 10.2 percent. The annualized inflation for 1994 exceeded 1,160 percent.

By and large, direct lending to economic agents by the National Bank and second-tier banks, the practice of the previous years, did not result in output recovery. The GDP continued to decline, contracting by 11.4 percent in 1993, 17.8 percent in 1994, and 8.9 percent in 1995 relative to the corresponding period of the previous year.

Under these conditions the emphasis was put on achieving macroeconomic and financial stabilization. During subsequent years, the thrust of economic reforms implemented by the Government and the National Bank of the Republic of Kazakhstan has been mainly shaped by the need for creating and developing the institutions of a free market economy. In particular, destatization and privatization proceeded vigorously, the country's financial institutions were strengthened, and the necessary legislative, normative and regulatory framework for development of the Kazakhstan economy's private sector was established.

However, the situation in many sectors of Kazakhstan's economy remained difficult. The industry operated under tight financial constraints due to the shortage of working capital caused by consumers' arrears, and often by its own inability to complete the entire production cycle resulting from shortfall in deliveries of raw materials and components. A low level of domestic savings and sluggish effective end-product demand reduced fixed capital investment.

The situation became especially difficult in the domestic market-oriented and the CIS countries' market-oriented sectors of the economy.

In 1996, for the first time since the start of the reforms, the GDP grew—by 1.1 percent, against the backdrop of continued decline in inflation from 60.3 percent in 1995 to 28.7 percent. This growth was mainly the result of an increase in services output, the share of which in the composition of the GDP increased by 4.8 percent to a level of 57.5 percent. A major factor contributing to this was the completion, for the most part, of the first stage of privatization—the small-scale privatization. The decrease in the share of construction (from 6 percent to 3 percent) and of transportation and communications (from 11 percent to 9 percent) in the composition of the GDP was associated with a shortage of investment into capital construction, with arrears, and with structural and institutional transformations, which did not commence in these sectors until the second stage of denationalization and privatization.

A stabilization trend emerged in industrial production, where the output growth equaled 0.3 percent compared to the 1995 level. Total industrial output increased mainly due to a growth of production volumes in export-oriented sectors, chiefly in oil-producing and refining industry. The situation in machine building and metalworking, in construction materials industry, in food industry and light industry, and in enterprises of the energy complex remained difficult.

The composition of final consumption also underwent some changes. The share of consumption expenditures of the private sector, particularly in households, increased, while the share of general government sector expenditures decreased. However, the level of domestic savings, and correspondingly the volume of capital investment, remained insufficient.

The outcome for 1997 shows the GDP growth of 2 percent with the industrial output at the level of 104.0 percent as compared to 1996. The sectoral composition of the GDP did not undergo significant changes compared to 1996. Growth of industry by 4 percent and that of construction by 10 percent led to an increase in the share of industrial output and construction in the total GDP by 0.4 percent and 0.3 percent respectively for the first time it was observed. The estimated investment in the country's economy amounted to approximately 119 billion tenge, representing a 20.2 percent increase compared to 1996. Sixty percent of fixed capital investment was financed by enterprises and the population (79.4 percent in 1996), 26.2 percent was financed by foreign investment (13 percent in 1996), and 13.8 percent was financed from the budget (7.6 percent in 1996).

A further decline in the average monthly inflation rate to 0.9 percent, compared to 2.1 percent in 1996 and 4 percent in 1995, was typical for 1997. End-1997 inflation was 11.2 percent as opposed to the target of 17.5 percent, which is 175 percentage points below the 1996 level. Prices went up by 6.0 percent for foodstuffs, 2.7 percent for other goods, and 38.8 percent for paid services to the public. The price of electric power paid by the public increased overall by 60.5 percent republic-wide. Implementation of the second stage of housing and public utilities reform was accompanied by a raise in tariffs paid by the public to a level enabling enterprises providing these services to reach an acceptable profitability ratio. State regulation of the pricing of output and services of certain enterprises—natural monopolies, electric power distribution and oil shipment, in particular, as well as freight shipment by rail, significantly contained price increases by industrial producers. In general, during the last year there was no significant difference between the producer price index and the consumer price index.

II. Fiscal Policy

Fiscal policy aimed in recent years at maintaining macroeconomic stability, achieving a sustainable rate of economic growth, reversing the decline in the population's standard of living, improving tax administration, and reforming the existing system of pension benefits. These factors influenced the amount of tax revenues and fee collection of the budget, changed the expenditure composition of the budget, and predetermined its social orientation.

In 1997, revenues and official transfers of the general government comprised 16.8 percent of GDP, expenditures comprised 19 percent of GDP, net lending equaled 1.4 percent of GDP, and the budget deficit was 3.6 percent of GDP. As for the expenditure mix, education accounted for 22.9 percent, public health for 11.0 percent, and social insurance and welfare for 8.3 percent of the total budget expenditures.

According to the preliminary data, the republican budget (the central government budget) revenues and official transfers in 1997 amounted to 166.6 billion tenge (9.9 percent of the GDP). Tax revenues accounted for 62.2 percent of the total revenues of the republican budget, nontax revenues for 2.5 percent, and capital revenues for 35.3 percent.

Notwithstanding improvement in tax collection ratio, the situation remains complex. According to information from the Tax Committee of the Ministry of Finance of the Republic of Kazakhstan, shortfalls in tax and fees collecting amounted to 43.6 billion tenge (2.6 percent of the GDP) by January 1, 1998, out of which 40.7 billion tenge were not collected in state taxes and 2.9 billion tenge in local taxes. Revenues from privatization, which accounted for 32.7 percent of the total budget revenues in 1997, continue to contribute a substantial share to the budget.

Expenditures of the republican budget comprised 201.3 billion tenge (12 percent of the GDP). The deficit of the republican budget for 1997 was 58.3 billion tenge, or 3.4 percent of the GDP. It was financed mainly through external borrowing—46.8 billion tenge, or 80.3 percent of the budget deficit. Direct credits from the National Bank of Kazakhstan fell from 4.9 billion tenge (12.5 percent of the budget deficit) to 2.5 billion tenge (4.3 percent of the budget deficit). Starting from 1998, the National Bank of Kazakhstan will no longer extend credit to finance the budget deficit. Receipts from sales of government securities grew to 9.8

billion tenge (16.8 percent of the budget deficit). The increase in the budget deficit compared to the initially assumed size of the deficit equaling 3.16 percent of the GDP in 1997 resulted from the start of pension reform and larger payments at the first (solidary, i.e., pay-as-you-go) level of the system.

As of January 1, 1998, the consolidated public debt of the Republic of Kazakhstan amounted to 203.4 billion tenge (12.1 percent of the GDP), of which foreign debt accounted for 134.5 billion tenge (8.0 percent of the GDP) and domestic debt accounted for 68.9 billion tenge (4.1 percent of the GDP).

Significant changes occurred in the composition of domestic public debt as a result of development of the government securities market. While in 1996 credits from the NBK [National Bank of Kazakhstan] accounted for 62.4 percent of the total domestic debt, government securities accounted for 17.5 percent, and compensation on household deposits accounted for 18 percent, in 1997 the share of NBK credits decreased to 53.4 percent, the share of government securities grew to 32.7 percent, and interest on household deposits was 13.9 percent of the total domestic official debt. As of 1998, the debt of the Ministry of Finance to the National Bank pursuant to the credits of past years was restructured, and floated in the market in the form of 10-year treasury bonds with fixed coupon.

III. Monetary Policy

In 1996-1997, the focus of monetary policy was to curb inflation and stabilize the tenge. Monetary policy was accordingly structured. Monetary base, chosen as a specific intermediate target, was regulated through interest rate policy (changes in the refinancing rate and other official interest rates of the NBK), reserve requirement policy (setting a required reserves norm), issuance of short-term National Bank notes, and open market operations, including operations in the domestic foreign exchange market. The main targets of monetary policy have been met in 1996 and 1997.

Inflation measured by the end-period CPI fell from 28.7 percent in 1996 to 11.2 percent in 1997 against an indicative target of 17.5 percent as of end year).

Monetary Program Implementation in 1997
(In bln tenge)

Target	1996	1997	Change in 1997	Program for 1997	Deviation From Program
Monetary base	80.9	114.7	+33.8	92.2	+22.5
o/w:					
- currency outside the NBK	65.7	96.5	+30.8		
- deposits with second-tier banks	15.1	18.2	+3.1		
Foreign assets (net)	100.5	137.5	+37.0	110.3	+27.2
o/w:					
- monetary gold	48.9	49.1	+0.2		
- foreign exchange (net)	51.6	88.4	+36.8		
Domestic assets (net)	-19.6	-22.8	+3.2	-18.1	-4.7
o/w:					
- credit to government (net)	30.4	29.7	-0.7		
- credit to banks (net)	0.6	1.4	+0.8		
- other assets (net)	-50.6	-53.8	+3.2		
Money supply	134.0	177.5	+43.5		
Percentage of change over previous year	13.8	32.5	+18.7		
Money multiplier	1.66	1.55	-0.11		

The dynamics of the monetary aggregates is shown in the following table:

Monetary Aggregates
(In bln tenge)

	1996	1997	% Change
Reserve money	80.9	114.7	41.8
Money supply	133.9	177.5	32.5
Currency in circulation	62.8	92.8	47.7
Deposits	71.1	84.7	19.0
Deposits of nonbank legal entities	51.8	57.5	11.0
Household deposits	19.4	27.2	40.3

Interest rates. The National Bank of Kazakhstan sets official interest rates taking into account inflation dynamics and conditions in the domestic financial market. During the year, the real interest rates were positive. The refinancing rate fell from 35 percent to 18.5 percent, the Lombard rate from 39 percent down to 16.5 percent, and the overnight (lending) rate followed, falling from 25 percent down to 15 percent.

Minimum reserve requirements. The required reserve ratio was lowered from 15 percent of banks' total deposit liabilities to 10 percent, while interest payment for alternative form of reserving was eliminated.

Open market operations. The National Bank started operations with government securities in the secondary market in September 1997. So far, the total volume of operations carried out in the open market in government securities amounted to 2.34 billion tenge. Repurchase and reverse repurchase agreement transactions comprised 68.7 percent of the total volume of operations.

It is envisaged that as the financial markets develop and deepen, the National Bank of Kazakhstan will conduct its monetary policy relying mainly on indirect instruments.

An important place in the conduct of monetary policy is reserved for institution building in the national financial system, and in particular, for prudential control and supervision of the banking system.

IV. The Banking System of the Republic of Kazakhstan

The Republic of Kazakhstan has a two-tier banking system where the National Bank of the Republic of Kazakhstan constitutes the upper (first) tier of the banking system and all other banks constitute the lower (second) tier of the banking system.

Reforms in the banking sector started from the introduction of international prudential standards, accounting, capital adequacy, liquidity, and asset diversification standards, and standards on data input and transfer. The system of prudential supervision has been restructured and centralized concurrently.

Within the banking supervision department of the National Bank of Kazakhstan, at present there are banking supervision divisions consisting of two subdivisions each (an inspection subdivision and an analysis subdivision), which are responsible for a certain number of banks divided among the divisions so that each division supervises the homogenous banks. The combination of analysts and inspectors in one division made it possible to improve quality of monitoring the financial position of a bank through both off-site supervision and on-site inspections. In late 1997, the National Bank of Kazakhstan introduced for banks new financial reporting forms based on international standards.

In order to enhance the stability of the banking system and assist the banks in achieving international standards, the National Bank of Kazakhstan adopted the "Program for Transitions to International Standards by Second-Tier Banks." Accordingly, all banks were divided into two tracks. Banks from the first track have to attain international standards by end-1998, while for banks from the second track the deadline has been set at end-2000. Classification is based on the banks' plans for recapitalization and improvement of their portfolio, setting up their individual targets for attaining prudential standards in line with international standards that they must submit to the NBK. The NBK monitors fulfillment of the banks' commitments on a monthly basis and takes action when they do not meet them. Banks which do not attain an adequate level of capital are to be liquidated or transformed into institutions carrying out only certain types of banking operations. By the end of 1997, 30 of the 82 second-tier banks were classified as the first track banks, while 30 banks were placed in the second track.

The NBK also requires that banks set up units for asset/liability management. Pursuant to the Statute on Prudential Standards, second-tier banks must file with the National Bank a table matching/comparing the maturities of their assets and liabilities.

Pursuant to the Statute "On Classification of Bank Assets and Contingent Liabilities and Calculation of Corresponding Provisioning by Second-Tier Banks of the Republic of Kazakhstan," classification of all bank assets and mandatory 100 per cent provisioning recorded as bank expenditures were envisaged starting July 1, 1997.

Overall dynamics of the banking system development in recent years is reflected in the following table:

As of 1/1/95		As of 1/1/96		As of 1/1/97		As of 1/1/98		As of 3/1/98	
Number of banks	Noncomplying with standards	Number of banks	Non-complying with standards	Number of banks	Non-complying with standards	Number of banks	Non-complying with standards	Number of banks	Non-complying with standards
183	119	131	65	101	36	82	34	76	32

The table shows overall strengthening of the banking system followed by its consolidation. By March 1, 1998, five out of the 76 functioning banks were state banks, one was an interstate bank, and 22 were banks with foreign participation (including subsidiary banks/branches). In the past year, 25 banks had their licenses revoked, including 15 banks—for regular non-compliance with prudential standards and other mandatory norms and limits established by the National Bank of Kazakhstan, one—following a decision of the

Government, two—following a court order, one—following voluntary liquidation, and six—in connection with merger.

The government and the National Bank of Kazakhstan are committed to the policy of reducing the state's interest in the charter capital of banks. For example, the state-owned Export-Import Bank of the Republic of Kazakhstan (Eximbank) has been corporatized, the "Program of Phased Privatization of the Joint-Stock People's Savings Bank of Kazakhstan for 1997-2001" was approved and is now implemented, exchange of the state's interest in the Kazagroprombank is completed, and privatization of the Zhilstroybank by tender will occur in the first half of 1998. The TuranAlem Bank was privatized in early 1998 by tender, in which 100 percent of the state's interest offered at a starting price of 20 million tenge was sold for 72 million tenge.

The territorial distribution of the banks remains uneven. Over 50 percent of the registered banks and branches are located in the city of Almaty. Then follow Aktyubinsk, Akmola, Pavlodar, and South Kazakhstan oblasts. Weakening of the financial position of banks, associated primarily with the NBK's strict requirements and failure to recover loans issued by second-tier banks in the past, resulted in decrease of the number of branches by more than a quarter since early 1996. As of January 1, 1998, 27 second-tier banks had 583 branches, with the People's Savings Bank of Kazakhstan (182 branches) and Kazagroprombank (180 branches) accounting for more than a half of them. In 1997, the number of bank branches decreased by 361, and many of them were reorganized into cash settlement offices (RKOs). By end-1997, there were 1,464 RKOs in operation, 1,400 of which belonged to the People's Savings Bank of Kazakhstan, which dominated this area.

The banking sector is perhaps one of the most rapidly developing segments of the financial market in Kazakhstan. By end-1997, tier-one of the banking system amounted to 29.3 billion tenge, (26.9 billion tenge, by end-1996), while the adequacy ratios of the total capital were as follows: ratio of tier-one capital/assets—0.14; ratio of capital/risk-weighted assets—0.21. This broadly meets international standards of capital adequacy. Mean-weighted classified assets comprise 75 percent of tier-one capital. The revaluation share in the banks' own capital was 9.5 percent, having decreased by almost a factor of two compared to the end of 1997.

Assets of the banking system comprised 169.0 billion tenge by the end of 1997 (compared to 141.0 billion tenge by the end of 1996). The largest share in the asset composition belongs to net lending (48 percent), investments into government securities (16 percent), currency and deposits with the NBK (13 percent), and deposits with banks and other assets (6 percent each category). The general analysis of the asset mix shows that financial stabilization has resulted in a decrease of the relative importance of currency and bank deposits, including correspondent accounts balances, relative to the total assets (21 percent in 1997 as opposed to 28 percent in 1996). Concurrently, the amount of funds placed in loans and government securities increased (in absolute and relative terms). Nonetheless, the asset composition reflects the general underdevelopment of the national financial markets and insufficient degree of financial and banking intermediation.

In parallel with the growth of the banks' total loan portfolio, there was an improvement in its quality: the ratio of standard loans with respect to the total increased from 59.3 percent as of early 1997 to 68.7 percent as of early 1998, while the share of loss loans fell from 17.9 percent as of early 1997 to 12.2 percent as of early 1998.

The table below shows the loan portfolio structure of the banks based on their two-year performance.

Second-Tier Banks' Loan Portfolio Structure
(In percent to the total)

Loan category per classification	**1/1/97**	**1/1/98**
Standard	59.3	68.7
Substandard	11.7	13.4
Doubtful	11.1	5.7
Loss	17.9	12.2
Total	**100**	**100**

Note: The loan portfolio composition includes loans of TuranAlem Bank (formed by merger and subsequent recapitalization of two of Kazakhstan's major banks—Alem Bank Kazakhstan and Turan Bank) and the Rehabilitation Bank (set up by the Government to deal with insolvent enterprises). The largest part of nonperforming loans of the banking system is concentrated in these banks.

In their lending policies, banks showed preference for the following sectors of the economy: trade, fuel, chemical and petrochemical industry, food industry, ferrous and nonferrous metallurgy, agriculture, metalworking, and machine building. The combined share of these sectors accounted for 47.3 percent of the total loans, with 16.0 percent and 6.9 percent of the extended loans, respectively, going to trade and fuel industry.

By end-1997, liabilities of the banking system amounted to 139.7 billion tenge, representing a 25.7 billion tenge increase over the year. The bulk of the liability compositions was represented by demand deposits (59 percent), time and savings deposits (18 percent), and debt to second-tier banks (11 percent). Growth of liabilities in money terms was caused by an increase in demand deposits and debt to second-tier banks. Demand deposits increased by 26.6 billion tenge, or by 47 percent relative to the data reported for 1996, while debt to second-tier banks increased by 5.4 billion tenge or 54.8 percent. Household deposits amounted to 28.7 billion tenge as of end-1997, including 15.1 billion tenge in demand deposits and 13.6 billion tenge in time deposits.

Debt to banks consists of indebtedness of banks and institutions of Kazakhstan engaged in certain types of banking operations (the domestic interbank money market), amounting to 2.3 billion tenge or 14.8 percent of the total debt, and debt in the form of borrowing from foreign banks—13.2 billion tenge or 85.2 percent.

Liquid assets comprise 80.3 percent of demand liabilities, assets with a maturity of up to one month comprise 55.8 percent, up to two months—78.1 percent, up to six months—92.3 percent, and up to a year—112.5 percent of the liabilities with corresponding maturities. With the banks engaged more aggressively in their off-balance activities, the potential impact of contingent and potential liabilities on liquidity has increased: the ratio of contingent liabilities to assets was 71 percent in 1997, as opposed to 23 percent in 1996. The banking system liquidity is generally maintained at the acceptable level.

Lower revenues of second-tier banks were one of the results of the monetary policy in 1997. To a significant degree, net revenue contraction from 13.4 billion tenge in 1996 to 11.3 billion tenge in 1997 was associated with generally lower financial risks, and consequently with a generally lower premium. Accordingly, the refinancing rate of the National Bank of Kazakhstan fell sharply last year from 35 percent per annum to 18.5 percent per annum, that is, effectively by a factor of two, in line with inflation dynamics and the conditions of domestic financial markets.

In 1997, return on assets was 13.3 percent, return on lending was 16 percent, yield on securities was 10.4 percent, and return on investments was 1.3 percent. Return on lending to banks was 5.6 percent, lending rate on consumer loans to individuals was 26.4 percent, and rate on other loans was 15.6 percent.

The general trend to lower the price of credit resources has emerged. Thus, in 1997 interest rate for tenge-denominated loans in the banking system dropped from 35.9 percent to 21.6 percent, for loans in convertible currency dropped from 20.7 percent to 17.0 percent. Deposit interest rates fell as well. For tenge deposits, the interest rate decreased from 4.6 percent to 2.3 percent for demand deposits and from 27.4 percent to 10.9 percent for time deposits; in the case of deposits in convertible currency, from 2.3 percent to 0.3 percent for demand deposits and from 9.1 percent to 5.5 percent for time deposits.

In the composition of revenues, interest associated revenues decreased from 67 percent of the total in 1996 to 53 percent of the total in 1997, which is explained to a significant degree by lowering revenues from lending (from 45 percent in 1996 to 37 percent in 1997). Concurrently, the share of revenues from banking services (e.g. service fees, payment transfers, and commission fees) grew from 5 percent in 1996 to 21 percent in 1997.

The volume of resources allocated to cover possible loan losses grew significantly in the context of the NBK's requirement of 100-percent provisioning. In one year the expenditures under this item grew from 7.8 billion tenge to 14.6 billion tenge, increasing by 1.87 times.

V. Development of the Insurance Market in Kazakhstan

The reform of the insurance system in Kazakhstan began with the establishment of an appropriate legal framework based on the decree of the President of the Republic of Kazakhstan having the force of law "On Insurance." In general, development of the insurance market in the republic has been determined by the possibilities of the economy itself. Despite the more than doubling of insurance premiums receipts from 1.3 billion tenge in 1996 to over 3.3 billion tenge in 1997, the total insurance reserves are equal to 2.5 billion tenge, that is, only 3 percent of the total lending by second-tier banks in that same year. The insurance penetration ratio calculated as the ratio of insurance payments total to the GDP, is only 0.2 percent of the GDP, while indemnity payments, which include payments under mandatory, personal, and property insurance, do not exceed 0.03 percent of the GDP. Analysis shows that, at present, mandatory insurance is growing faster than voluntary insurance in Kazakhstan's insurance market. With the introduction of new types of insurance (petroleum operations, private notary offices, industrial accident insurance), in the future the share of mandatory insurance will continue to grow. This represents, undoubtedly, a negative trend, brought about by objective factors (decline in economic activity, low standards of living), and as the economy recovers, the share of voluntary insurance will expand.

By the beginning of 1998, there were 65 insurance companies/organizations registered and operating in the Republic of Kazakhstan, of which 42 were located in the city of Almaty. Forty percent of these insurance companies had authorized capital in the range from 12 million to 20 million tenge, the authorized capital of 52 percent of the insurance companies was in the range from 20 million to 30 million tenge, and only 8 percent of insurance companies had authorized capital exceeding 30 million tenge. The distinctive feature of the market is its uneven development: insurance companies located in the city of Almaty account for 78 percent of the total volume of insurance premiums collected, and for 74 percent of the aggregate volume of insurance reserves of all insurance providers of Kazakhstan. As the insurance reserves are built up on the basis of premiums from insurance payments, the current situation suggests that only a small fraction of insurance providers are active, while the activity level of the overwhelming majority of insurance providers is very low.

The insurance portfolio of Kazakhstan's insurance providers consists mainly of traditional forms of insurance: accident (72.4 percent of premiums are paid under personal insurance policies), freight insurance and other forms of liability insurance (40 percent and 37.7 percent of total property insurance premiums, respectively), and mandatory premiums. The insurance provider's investment portfolio is currently represented by deposits (38.6 percent), transactions in government securities (38.4 percent), and real estate (20.3 percent).

Kazakhstan's insurance market is young, is essentially in its infancy and, therefore, encounters a plethora of problems and difficulties. The latter are related mainly to the lack of the necessary insurance infrastructure, lack of diversified financial instruments, and insufficient level of population insurance awareness.

In the nearest future, a consolidation is expected to take place in insurance sector by way of exit or merger of the weak and noncompetitive insurance providers. The large, multi sector, and financially sound insurance companies will survive in the marketplace. The proportion of companies providing life insurance should grow as the new pension legislation has been adopted. Introduction of new types of insurance should broaden the geography of insurance activities, and reduce the concentration of insurance companies in Almaty.

The efforts of the state aimed at creating a favorable investment climate in the republic and the current political and social stability let us hope that foreign capital inflows into the economy of Kazakhstan, in general, and into the insurance sector, in particular, will increase. As this takes place, the insurance services market will develop as a result of introducing advanced insurance technology, new insurance products, and enhancing the professionalism of Kazakhstan's insurance providers.

VI. The Financial Markets of Kazakhstan

The money market. The interbank money market is one of the venues for the sale of credit resources in Kazakhstan. The transactions carried out in this market are mainly short-term, up to 30 days. The market of interbank tenge denominated loans started to function in June 1995. In 1996, there was a decrease in the number of transactions in the organized interbank money market, and banks started carrying out the bulk of transactions directly, in the informal interbank loan market.

In 1997 as a whole, the volume of "short" money (up to 30 days) lent in tenge in the informal money market amounted to 5.6 billion tenge at an average rate of 11.3 percent. The volume of "short" loans in U.S. dollars for the same period was US$47.9 million at a mean-weighted rate of 8.6 percent.

The deposit market. In 1996, deposits of individuals and nonbanking legal entities with second-tier banks increased by more than 150 percent, while in 1997 they increased by more than 20 percent, to a figure of 86.8 billion tenge at the end of the year. National currency deposits grew by 23.7 percent in the deposit breakdown for 1997, while deposits in convertible currencies decreased by 31.5 percent. This is associated primarily with general recovery of the country's banking and financial system, and increasing stability of the national currency.

The deceleration in inflation and lowering of refinancing rate were followed by a drop in interest rates on tenge-denominated and foreign exchange deposits of individuals and nonbank legal entities, which remained at a positive value as it happened. Weighted average interest rates on deposits of nonbank legal entities went down from 13.9 percent as of early 1997 to 9.8 percent as of early 1998, while interest rates on deposits of individuals went down from 14.2 percent as of early 1997 to 6.2 percent as of early 1998. The price of bank loans also went down. The weighted average rates on lending to nonbank legal entities in tenge decreased during the year from 37.4 percent to 23.9 percent, while interest rates on U.S. dollar loans fell from 17.l percent to 12.0 percent. The corresponding figures for loans to individuals were as follows: from 25.5 percent to 21.7 percent for interest rates on tenge-denominated loans, and from 30 percent to 21.3 percent for U.S. dollar loans.

This past year total bank loans to nonfinancial enterprises and organizations increased by 18.1 percent to a figure of 71.9 billion tenge at the end of the year, of which 41.8 billion tenge (58 percent of the total amount) were tenge loans. Short-term lending increased by 39.9 percent, and medium- and long-term lending increased by 18.6 percent amounting to 51.9 billion tenge and 20 billion tenge respectively. Medium- and long-term loans in national currency accounted for 12 percent of the credit extended, foreign exchange loans accounted for 42 percent, and short-term credits in national currency accounted for 46 percent. Credit to small businesses was 43 percent of the total foreign exchange loans and 57 percent of the total tenge-denominated loans, which by far exceeded the NBK's requirement that 10 percent of the banks' credit should be attracted to small and medium businesses. Meanwhile, the rate of tenge-denominated loans extended by banks to small businesses was 24.4 percent, while the rate of foreign exchange loans was 18.6 percent. The volume of lending to households increased last year by 88.3 percent, of which: short-term loans increased by 94.9 percent and medium- and long-term loans increased by 81.3 percent, reaching 4.18 billion, 2.23 billion, and 1.95 billion tenge, respectively, by year-end.

The government securities market. Starting in 1996, the government securities market began dominating financial markets of Kazakhstan. While issuance of government securities was able to finance 2 percent of the budget deficit in 1994 and 9.5 percent in 1995, in 1996 this indicator was at the level of 17.7 percent, and in 1997 it financed 16.8 percent of the budget deficit.

Ninety-five auctions were held last year to float government securities totaling 53.5 billion tenge, which exceeded the volume of government treasury bonds placed in 1996 by a factor of 1.8 . The annual yield of securities issued by the Ministry of Finance of the Republic of Kazakhstan went down between January and December 1997 from 31.74 percent to 13.15 percent.

In the mix of government securities, the ratio of securities with longer maturities is gradually increasing. Issuance of government securities with a 12-month maturity (MEKAM-12) began in the second half of 1996, and issuance of securities with a two-year maturity

(MEOKAM-24) began in the second half of 1997. The issuance of National Savings Bonds commenced with a goal to attract the disposable cash of the public and of small investors, and their annual yield was determined on the basis of three-month government securities' yield (MEKAM-3). Beginning in January 1998, the Ministry of Finance debt owed to the National Bank of Kazakhstan was converted into long-term obligations and issued in the form of 10-year fixed-yield government securities (MEAKAM-10).

In 1996-1997, the demand for government securities regularly exceeded supply. The investors' share in MEKAM purchases increased from 21.7 percent in 1996 to 26.7 percent in 1997, to the level of 14.3 billion tenge. Despite the relatively low yield and the consequences of the Asian financial crisis in late 1997, the nonresidents' share in the total volume of all issued government securities increased from 2.4 percent in 1996 to 9 percent in 1997. The total volume of MEKAM, MEOKAM (at a discount) and National Savings Bonds in circulation as of the year's end was 22.6 billion tenge. In 1997, the Ministry of Finance issued government securities amounting to 55 billion tenge.

For the purposes of operational management of the money supply, the National Bank of Kazakhstan issues short-term notes with a maturity of 5 to 63 days. In the course of the past year, the notes' yield fell from 21.8 percent in January to 10.9 percent in December. Short-term notes with a 14-day maturity represented the largest share, 31.1 percent, of the total volume, while 28-day notes accounted for 30 percent, and 7-day notes for 21.2 percent. In 1997, the National Bank issued notes in the total amount of 77.6 billion tenge, and the volume of notes in circulation as of the year's end was 6.8 billion tenge.

The exchange market. The foreign exchange market is the most liquid and dynamic of Kazakhstan's financial markets. The structure of Kazakhstan's domestic exchange market is comprised of exchange and interbank over-the-counter segments.

As a rule, the trading volume in the over-the-counter market exceeded the volume of exchange trading. It happened against the backdrop of an overall decline in the volume of foreign exchange trading, which was due mostly to lower returns on foreign exchange operations and to development of other markets, in particular, the government securities market. The tenge depreciated relative to US$ in 1997 by 2.8 percent, as opposed to 15.4 percent in 1996. In the course of the year, the tenge exchange rate fluctuated slightly, ending the year at 75.89 tenge to the US$. In the second half of the year, the monthly changes of the tenge exchange rate did not exceed 0.1 percent.

2. Pension Reform and Its Impact on Development of the Financial System

The underlying principle of the pension reform in Kazakhstan is the gradual transition from a state pension system based on the principle of generational solidarity (pay-as-you-go) to a system of private pension savings funds operating on the basis of personal pension savings' philosophy.

In this context, the Government of the Republic of Kazakhstan approved, in March 1997, the "Concept of the Pension System Reform in the Republic of Kazakhstan", which served as the basis for the formulation and adoption of the Law of the Republic of Kazakhstan "On Pension Support in the Republic of Kazakhstan". From this point on, the efforts began with the view to develop and create the necessary legislative and regulatory base, and to set up the appropriate state regulatory bodies.

Pension system reform is a lengthy and expensive process, in the course of which the state must fully settle its obligations to persons already entitled to pension benefits. Therefore, in addition to a pension savings system, the legislation provides for continued operation of the solidary (PAYG) system during the transition period. The latter is to provide pension benefits to current pension recipients and to workers whose pension entitlement was accumulated under the solidary system and who are unable to accumulate sufficient pension savings under the new system. As this takes place, the size of state pensions paid to citizens retiring after the start of the reform will be reduced in proportion to the number of years they participated in the pension savings system. In the future, the pension received from the pension savings system is to become the main source of pension benefits, and eventually every able-bodied citizen must assume personal responsibility for future pension benefits in old age.

Starting in 1998, social allowances/pensions (disability pensions, survivor/loss of breadwinner, etc.) are transferred to social assistance category, and as state obligations, will be funded from the expenditure side of the budget.

Pension contributions of citizens are recorded and accumulated by pension funds in individual savings accounts, and at the time of retirement they will include all investment income.

In 1998, the rate of mandatory contributions to the solidary (PAYG) system was lowered from 25.5 percent to 15 percent, while the rate of mandatory contributions to the second mandatory savings level is set at 10 percent of the worker's income. In the process, a worker may make extra pension contributions to the third level (voluntary pension savings funds). It is anticipated that, as time goes by, contributions by citizens to the first (solidary) level of the system will decrease.

Starting in 1998, the so-called "privileged" pensions assessed on the basis of lists № 1 and № 2 were abolished. The only category to retain the right to early retirement is military servicemen and persons equated to them. For all other categories of workers the retirement age is set at 63 years for men and 58 years for women.

In the transition period, there are plans to keep the old solidary system and the new savings system operating in parallel for 40 years, which is being done in order to build people's confidence in the new system and to ensure an acceptable level of social equality. An appropriate state supervision and management structure is also being created with the view to achieve these objectives.

The State Center for Pension Payments was set up on the basis of the Pension Fund and is now entrusted with the main task of paying pension benefits to current pension recipients. Pension assets formation and placement at the first (solidary) level of the system, organization of their accounting on an individual basis in the transition period were made the responsibility of the State Pension Savings Fund.

Supervision and regulation of pension savings funds activities will be the job of the National Pension Agency of the Ministry of Labor and Social Security of the Republic of Kazakhstan. The Republic of Kazakhstan National Securities Commission licenses, regulates, and supervises pension asset management companies' activities (management companies), while the National Bank of Kazakhstan supervises the activities of custodian banks.

The implementation of pension reform logically follows from the overall philosophy of economic reform in Kazakhstan: providing for sustainable economic growth on the basis of a developed market economy with a high level of investment within tight fiscal and monetary constraints. In turn, this would be impossible without well-developed deep domestic capital markets. While implementing pension reform, the Government of the state pursues the goal not only of ensuring fair and acceptable pension benefits to its citizens, but also of providing conditions which would build people's confidence in domestic financial institutions, foster domestic investment growth, enhance the quality of financial intermediation, and expand the choice of financial instruments.

3. Stock Market Development

Pursuant to the "Program for Development of the Securities Market in the Republic of Kazakhstan," approved by the Government of the Republic of Kazakhstan, the stock market will be created and will develop initially in two stages.

The main objectives of the first stage were to lay the foundations of a depository-registrar system, to address issues related to the activities of investment funds, and to set up a state regulatory system for the securities market. The key measures of the first stage were stipulated as follows:

- create the legislative framework of the securities market;

- create a system of institutional investors;
- create the securities market infrastructure;
- improve state regulation of the securities market;
- implement a reform of accounting and financial reporting.

In the second stage of the program, the main objective was to develop the system and fine-tune the interactions of all components of the securities market infrastructure, including the depository-registrar system, investment funds and their managers, self-regulated organizations, and a system of broker-dealer offices. The key measures included the following:

- develop the securities market infrastructure;
- self-regulation of the securities market;
- set up a system for training professional players for the securities market;
- set up a system of information support for the securities market development.

The main objectives of the first stage were broadly reached in 1996-1997. The basic legislative, institutional, and technical infrastructure of the nongovernment securities market was completed, the package of measures supporting implementation of the "Blue Chips" program was effectively implemented, and the groundwork for the advent of real institutional investors was laid.

The legislative infrastructure. The legislative infrastructure of the securities market was built practically from scratch in the course of 1997, with the laws of the Republic of Kazakhstan "On the Securities Market", "On Registration of Securities Transactions in the Republic of Kazakhstan", "On Investment Funds in the Republic of Kazakhstan", and "On Pension System in the Republic of Kazakhstan" at its core.

In an effort to implement these laws, the Republic of Kazakhstan National Securities Commission drafted 40 normative legal acts in 1997 (36 in 1996), five of which were approved by resolutions of the Government of the Republic of Kazakhstan and 20 of which were registered with the Ministry of Justice of the Republic of Kazakhstan.

These normative legal acts regulate the activity of professional players of the securities market and operations of the market itself.

Moreover, the Draft Law "On Joint-Stock Companies" was drafted in 1997; its adoption will legally protect the interests of investors (especially portfolio and small nonprofessional investors) and promote improvement of the principles of corporate supervision and governance.

The institutional infrastructure. Introduction of a legislative ban on combining professional activity on the securities market with other forms of entrepreneurial activity, and establishment of differentiated requirements on adequacy of proprietary capital of broker-dealer organizations brought about a decrease in their number from 93 to 60, mostly at the expense of small intermediary organizations and organizations for which professional activity on the securities market was a secondary line of activity.

As it took place, the decrease in the number of broker-dealers was accompanied by improvements in their structure: in the second half of 1997, the share of broker-dealers belonging to the first and most capitalized category relative to the total number of broker-dealers grew from 10.3 percent to 41.9 percent among banks and from 21.4 percent to 51.7 percent among nonbanking institutions.

In 1997, a system of registrars—organizations specializing in maintaining registers of the holders of securities—was set up. While in early 1997 there were only four registrars in Kazakhstan, by the end of the year their number grew to 34, and the number of security holder registers maintained by the registrars grew from 1,606 to 3,289 (more than twofold). At the same time, the year 1997 showed that there is a need to restrict the monopolistic influence of registrars, stemming on one hand from the uneven nature of their territorial distribution (for example, 15 of Almaty's registrars maintain 3,131 registers, that is, 95.2 percent of their total number, while six of the republic's oblasts do have not a single registrar), and on the other hand from investors "captivity," as they do not have the freedom to select registrars (since each register of security holders may be maintained by only one registrar).

Four banks acquired custodian status in 1997. In the immediate future custodian banks are slated to play a key role in ensuring the integrity of funds mobilized by institutional investors (investment and pension funds) from the public. Therefore, the requirements as regards the minimum level of proprietary capital of custodians were raised in 1997 from 110 million to 1 billion tenge.

Unfortunately, not a single organization was able to obtain a license in 1997 to manage security portfolios and to manage investment of the pension assets of nonstate pension savings funds.

Over 1,000 specialists were certified to work in the securities market in 1997, and their total number grew from 1,803 to 2,809—that is, by more than a time and a half. In the process, 59 category three specialists (entitled to manage security portfolios) were certified for the first time in 1997.

Building technical infrastructure. The Kazakhstan stock exchange (KASE) initially founded as the Kazakh Interbank Exchange Market, was effectively recreated anew in 1997. In the course of the year, KASE lowered the face value of its shares, spun off a foreign currency trading entity—the Almaty Financial Instruments Exchange (AFINEX), redistributed its stock from banks to professional participants of the securities market, adopted a new charter that includes the "one shareholder, one vote" rule and meets all legislative requirements, and underwent state reregistration on July 3, 1997. Thus, KASE completely fulfilled the conditions on the basis of which it (together with the International Kazakhstan Stock Exchange) won the government tender called for selection of a model stock exchange on December 31, 1996. On September 19, 1997, KASE held its first auction of nongovernment securities.

KASE makes use of an electronic securities trading system and employs a settlement system through the Central Depository under conditions in line with the recommendations of the "G-30" (conforming with actual international standards governing trading, depository, and settlement operations with securities). Total KASE market capitalization was 101,228.4 million tenge as of the end of 1997, and the nongovernment securities trading volume for 1997 was 175.5 million tenge. Twenty-eight nongovernment securities, including 14 so-called "blue chip" securities were accepted for trading at the exchange.

In 1997, the Central Asian Stock Exchange continued its operations. Notwithstanding the fact that it has more experience than KASE in securities trading, it faces two basic difficulties responsible for its non-compliance with statutory requirements: insufficient authorized capital (4 million tenge) and the current composition of shareholders. For the sake of comparison, the authorized capital of KASE is 46.2 million tenge. Total market capitalization of the Central Asian Stock Exchange was 300.8 million tenge as of the end of 1997, while the nongovernment securities trading volume for 1997 was 166.3 million tenge. Two hundred eighty-seven nongovernment securities, the bulk of which (95.8 percent) represent government-owned blocks of stocks intended for one-time sale, were accepted for trading at the exchange.

The International Kazakhstan Stock Exchange (MKFB) ceased its operations in 1997. Its license was revoked because of its failure to meet the requirements set forth by current legislation. It should be noted that conditions for merger of this exchange with KASE were fully met, as the only shareholder of the MKFB in possession of the status of a professional participant of the securities market, the Kazakhstan International Bank, acquired KASE stock.

The Central Depository was created in 1997 on the technical base provided by the National Bank of the Republic of Kazakhstan and KASE. Its main function is to conduct settlements on transactions in government securities and in nongovernment securities traded on KASE under the conditions of "delivery versus payment."

The "Blue Chips" Program. The following main steps were taken in 1997 within the context of implementing the "Blue Chips" Program (a package of measures aimed at preparing stock market entry for the shares of the largest joint-stock companies in which the state retains an interest):

- The list of joint-stock companies, part of the state interest in which is to be sold in the stock market, was determined, and the size of state interest to be sold was specified;

- In conjunction with the Ministry of Finance, the National Commission took the most insistent measures to see that joint-stock companies included in the list would convert their charts of accounts as quickly as possible to the new accounting standards and undergo a full-scale audit;

- Organizational and technical measures such as selecting the model stock exchange and setting up the depository and settlement system were implemented;

- With a view to maximize proceeds from the sale of shares owned by the state, tenders were conducted with the participation of the largest foreign investment banks, companies, and funds for the selection of lead managers for primary placement of government-owned shares.

Bids for participation in these tenders were received from a total of 11 groups of investment banks, companies, and funds. The winners that received from the Government of the Republic of Kazakhstan a stock issuance mandate were as follows:

1) for the state interest in the “Aktobemunaygaz” Joint-Stock Company — Santander Investment/Global Securities/Kazcommerce Securities;

2) for the state interest in the “Mangistaumunaygaz” Joint-Stock Company — CSFB/Global Securities/Kazcommerce Securities;

3) for the state interest in the “Zhezkazgantsvetmet” Joint-Stock Company — CSFB/Capital Management/Peoples Savings Bank of Kazakhstan;

4) for the state interest in the “Ust-Kamenogorskiy Titano-Magniyevyy Kombinat” Joint-Stock Company — Global Securities/ Kazcommerce Securities.

Notwithstanding certain problems arising in connection with the financial crisis in the Asia-Pacific region, there are strong grounds for believing that the “Blue Chips” Program will be implemented successfully, Kazakhstan will derive maximum income from the sale of state interests, and sale of state interests at the stock exchange will have a positive impact on the development of an active and liquid securities market in the republic.

The advent of institutional investors. In 1997, the preconditions for the appearance of full-fledged institutional investors were created.

Pension funds may be placed in the first group of investors. The State Pension Savings Fund (GNPF) and five nonstate pension savings funds were set up pursuant to the Law “On Pension System in the Republic of Kazakhstan.” The National Bank of the Republic of Kazakhstan duly licensed by the National Commission in early January, 1998, became the custodian and manager of the pension assets of the GNPF.

Adoption of the Law of the Republic of Kazakhstan “On Investment Funds in the Republic of Kazakhstan” launched the process of transforming investment privatization funds (IPFs) into investment funds, and emergence of mutual funds and investment companies. In an effort to accelerate this process, the Government allowed IPFs to conduct their first general meetings of shareholders by correspondence. It is anticipated that first investment funds will appear in Kazakhstan in the first half of 1998, both through transformation of IPFs and through creation of new organizations.

Furthermore, amendments and additions to banking legislation adopted in mid-1997 allowed second-tier banks to acquire nongovernment securities, albeit with certain restrictions, and to participate in the capital of organizations acting as professional players in the securities market and of institutional investors (nonstate pension savings funds, investment funds, and insurance organizations). Taking into account that banks are the most highly developed institutions of the financial market, in 1998 one should anticipate development of their activity as direct and indirect institutional investors.

Unfortunately, as was noted earlier, the fourth possible type of institutional investors—insurance companies was represented in Kazakhstan in early 1998 by 64 organizations whose principal activity in the stock market is limited to purchasing government securities.