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PERFORMANCE AUDIT REPORT

KAZAKHSTAN

**STRUCTURAL ADJUSTMENT LOAN
(LOAN 3900-KZ)**

**FINANCIAL SECTOR ADJUSTMENT LOAN
(LOAN 4051-KZ)**

June 7, 2000

Operations Evaluation Department

Currency Equivalents

(As of May 31, 1998)

Currency Unit	=	**Tenge (T)**
T 1	=	US$ 0.0131
US$ 1	=	T 76.10

Average Exchange Rate

Tenge per US$ 1

1994	1995	1996	1997
36.10	61.37	67.76	75.55

Abbreviations and Acronyms

ADB	Asian Development Bank
ASF	Agricultural Support Fund
CAS	Country Assistance Strategy
CbC	Case by Case Privatization
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EFF	Extended Fund Facility
EU	European Union
FSAL	Financial Sector Adjustment Loan
FSU	Former Soviet Union
FY	Fiscal Year
GDP	Gross Domestic Product
GOK	Government of Kazakhstan
IAS	International Accounting Standards
IBS	International Banking Standards
IFC	International Finance Corporation
IPF	Investment Privatization Funds
JSC	Joint Stock Company
MOF	Ministry of Finance
MPP	Mass Privatization Program
NBK	National Bank of Kazakhstan
NPP	National Privatization program
PIC	Privatization Investment Coupons
RB	Rehabilitation Bank
SAL	Structural Adjustment Loan
TA	Technical Assistance
TAL	Technical Assistance Loan

Fiscal Year of Kazakhstan

January 1-December 31

Director-General, Operations Evaluation Department:	Mr. Robert Picciotto
Director, Operations Evaluation Department:	Mr. Gregory Ingram
Manager, OEDCR:	Mr. Ruben Lamdany
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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

June 7, 2000

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Report on Kazakhstan—Structural Adjustment Loan (Loan 3900 KZ) and Financial Sector Adjustment Loan (Loan 4051 KZ)

This is the Performance Audit Report (PAR) on the Structural Adjustment Loan (SAL) and the Financial Sector Adjustment Loan (FSAL). The Board approved SAL for US$180 million equivalent in June 1995. The loan was closed on time in December 1996. The program was co-financed by the Export-Import Bank of Japan with a loan of US$60 million. The Board approved FSAL for US$180 million equivalent in June 1996. The loan closed in September 1997, six months behind schedule.

The objective of SAL was to achieve decisive progress toward enterprise restructuring in three areas: (i) market development, (ii) strengthening the two agents of enterprise restructuring, the private and financial sectors; and (iii) strengthening social protection. These objectives were to be achieved through three components. The first, the Framework for Enterprise Restructuring, aimed at the development of competitive markets through the liberalization of the export regime, the dismantling of monopolies, the abolition of compulsory delivery of grains, the removal of administrative prices on oil products, and the facilitation of entry and exit of firms. These measures were successfully implemented by the Borrower.

The second component, the Instruments of Enterprise Restructuring, comprised three main privatization programs-- the Small Scale, the Mass Privatization and the Case by Case schemes. In addition, it included measures for the improvement of financial discipline, and the creation of a Rehabilitation Bank to serve as the sole source of banking credit to some problem enterprises. The results obtained for privatization show that most small and medium enterprises have been privatized, but 55% of the large and 60% of the very large enterprises are still state owned. The speed of privatization was generally slower than envisaged initially, but improved in subsequent years. In spite of the Bank's efforts to ensure a fair, equitable, transparent and competitive privatization process, some implementation difficulties did emerge. In the case of Mass Privatization, each citizen was given free coupons that could either be used directly to bid for shares or entrusted to investment privatization funds (IPFs), who would acquire shares on behalf of the coupon holder. The scheme failed because 40% of the enterprises included in mass privatization ceased operations; the number of enterprises included in the program was far below the target of 3000; and in most instances, the IPFs themselves, having acquired the coupons, went out of existence. The coupon holders, therefore, received little or no value for their coupons. Likewise, for case by case privatization and enterprise restructuring, fully transparent procedures were not followed. The Rehabilitation Bank also had problems in the early stages, as it lacked policies, procedural guidelines and finances, but later helped segregate some problem cases.

The third component, strengthening the social safety net, required increases in unemployment benefits and the continued operation of the social assets divested by privatizing enterprises. The unemployment benefits were initially increased, but the Unemployment Fund was eventually abolished. A policy statement was prepared for divesture of enterprise social assets to local governments, and a pilot was implemented, but not replicated.

The PAR rates the attainment of outcome as satisfactory. The SAL was designed at a time when production and trade had been seriously disrupted, most enterprises were in the public sector, and the economy was in a tailspin. The SAL succeeded in extending privatization and in contributing to macro-economic stability, but failed to achieve the intended strengthening of the social safety net.

Because of governance issues, the PAR reduces the rating of sustainability to uncertain. (The ICR had rated it likely.) The use of non-transparent processes has adversely affected the emergence of competitive markets, and the continued ownership of many large firms by the state casts in doubt the sustainability of some of the benefits expected from privatization.

The PAR rates the *institutional development impact* as modest, since many large firms have not been privatized, and weak privatization procedures have led to asset stripping. (The ICR rated ID as substantial). The performance of the Bank is rated satisfactory, which also differs from the ICR rating of highly satisfactory. The Bank made major contributions to the transformation of the Kazakhstan economy under a difficult and challenging environment. The Bank's supervision of the loan was, however, somewhat deficient in several respects, including oversight of the transparency of the privatization process, the provision of benefits to the unemployed, and the operational continuance of the social assets. Moreover, the design of the program was deficient in ameliorating the social costs of privatization. The PAR agrees with the ICR rating for Borrower's performance as satisfactory, based on the political and administrative support provided for privatization.

The lessons from the SAL are: (i) transparency in privatization procedures is essential to the emergence of competitive markets; and (ii) closer supervision might have enabled timely resolution of the IPF problem before the funds disappeared.

The FSAL had two objectives: (a) to improve the sector policy environment, so as to reduce the operating risks and latent liability of all banks, and (b) to deal specifically with problem loans and problem banks. These objectives were to be attained through two components of the program: (i) establishing a conducive environment for sound banking, and (ii) resolving problem loans and problem banks. Both objectives were successfully obtained, although with some delay. The project strengthened the environment for secured lending by adopting appropriate laws, and upgrading accounting standards and practices. Prudential standards have also been strengthened, and progress made in reducing the share of potential and actual non-performing loans from 41 percent at end-1994 to less than 30 percent at end-1997.

The main concerns relate to the privatization of two major banks: Exim Bank and TuranAlem Bank. Failure to privatize Exim Bank impaired its effectiveness and led to mounting net losses. In the case of TuranAlem Bank, the Government bought the shares of the private shareholders under a special law, provided loans and grants for its recapitalization, and then sold the Bank. However, the recovery of the loans provided remains uncertain.

The PAR rates *outcome* as satisfactory. Despite the concerns about the privatization of two banks, the strengthening of prudential standards was a considerable achievement. The *sustainability* of the project results is likely, given that the incentives underpinning the program should permit the continuation of a favorable environment. The adoption of international banking and accounting standards will encourage the more efficient banks to achieve better recognition internationally. The main concern regarding sustainability of financial sector reforms relates to the concentration of loan activities within a small group (ten to twenty) of borrowers.

Institutional *development* is rated as substantial because of (1) the successful transfer of the state's shares in many banks to the private sector, (2) the adoption of procedures and practices that enhance the institutional performance of banks, and (3) the strengthening of the National Bank of Kazakhstan, whose competence and power played a key role in the strengthening of the financial sector. (ICR rated institutional development as partial, but did not explain why.)

The *Borrower's* performance is rated as satisfactory, given that the financial sector was strengthened through the introduction of prudential norms. The Bank's *performance* is rated as satisfactory. The Bank planned and supervised the program in an effective manner, and adopted a pragmatic approach when the Borrower decided to merge Turan and Alem Banks. The various missions had suitable expertise for the tasks and provided a comprehensive view of the situation in their reports. While the ICR rated Bank performance highly satisfactory, the PAR concluded that the Bank performed up to, but not necessarily beyond, the expected standard.

The lessons from FSAL are: (i) the political will to implement reforms is important; (ii) the power and competence of the central bank to enforce discipline are key factors for successful financial sector reforms; and (iii) the separation of the non-performers (loans and banks) from the performers is useful, since it permits differential treatment of good and bad loans.

The Borrower's comments are included as Annex A.

Contents

Tables

The PAR was prepared by Namet Ilahi (consultant), with Anwar Shah as the Task Manager. Agnes Santos provided administrative support.

Annexes

Preface

This is a Performance Audit Report for two loans provided to Kazakhstan-- the Structural Adjustment Loan (Loan 3900-KZ) and the Financial Sector Adjustment Loan (Loan 4051-KZ). The first loan for US$ 180 million was approved on June 8, 1995 and made effective on July 14, 1995. It was closed on December 31, 1996, as originally anticipated. The second loan, also for US $180 million, was approved about a year after the SAL on June 25, 1996, made effective on July 31, 1996, and closed on September 30, 1997, six months after the original closing date March 31, 1997.

The PAR is based on the Implementation Completion Report, the President's Report for the project, the loan document, project files, related economic and sector work, discussion with Bank staff and a two-week mission to Kazakhstan in June-July 1999, during which extensive interviews were arranged. These included meetings with senior officials of the ministries, National Bank of Kazakhstan (NBK) and other banks, officials of privatized companies and research organization and consultants. The cooperation of the Government of Kazakhstan, the Bank staff in Washington and Kazakhstan and the various individuals and organizations who spared the time for interviews is gratefully acknowledged. Special thanks are due to Mr. Yurukoglu, Resident Representative of the World Bank in Kazakhstan, and Lazzat Buranbayeva, whose efforts enabled the completion of a program of interviews and data collection. The PAR benefited from comments by the borrower (see Annex A) and by the regional colleagues. Regional comments have been incorporated in the text of the PAR.

Ratings and Responsibilities

Performance Ratings

	Structural Adjustment Loan (L 3900-KZ)		*Financial Sector Adjustment Loan (L 4051-KZ)*	
	ICR	*PAR*	*ICR*	*PAR*
Outcome	Satisfactory	Satisfactory	Satisfactory	Satisfactory
Sustainability	Likely	Uncertain	Likely	Likely
Inst. Devt. Impact	Substantial	Modest	Partial	Substantial
Borrower Performance	Satisfactory	Satisfactory	Satisfactory	Satisfactory
Bank Performance	Highly Satisfactory	Satisfactory	Highly Satisfactory	Satisfactory

Key Project Responsibilities

	Structural Adjustment Loan (L 3900 KZ)		
	Task Manager	*Division Chief*	*Director*
Appraisal	O'Brien	Kadir Yurukoglu	Yukon Huang
Completion	Bernard Funck	Kadir Yurukoglu	Yukon Huang

	Financial Sector Adjustment Loan (L 4051 KZ)		
	Task Manager	*Division Chief*	*Director*
Appraisal	A.Lorch	M.Gould	Yukon Huang
Completion	Albert Martinez	--	Kiyoshi Kodera

1. BACKGROUND

THE POLITICAL ECONOMY OF KAZAKHSTAN'S TRANSFORMATION

1.1 The two loans provided to Kazakhstan (Structural Adjustment Loan 3900-KZ and the Financial Sector Adjustment Loan 4051-KZ) are part of an adjustment operation designed to support the reform program of the Government of Kazakhstan (GOK). These reforms were meant to radically change the institutions of a socialist political economy, which had acquired deep roots in Kazakhstan in the course of several decades of its recent history.

1.2 When the Soviet Union disintegrated, Kazakhstan's leaders wanted the country to change to a market economy. However it was soon realized that such a transformation would not only require a redefinition of the role of the state, but also involve major changes in the economic, social and political characteristics of Kazakhstan.

1.3 The state had acquired an overwhelming role in the economy of the country, since it controlled almost all segments of economic activity. In 1989, the state owned 90 percent of the physical assets and produced 80 percent of the output. This was compounded by the very close integration and inter-dependence of Kazakhstan with the rest of the Former Soviet Union (FSU). Thus Kazakhstan, one of the world's major producers of oil, had its crude oil production in the western part of the country and its refineries in the eastern part. Crude oil was therefore imported from Russia in the eastern part and refined oil exported to Russia from the western part.[1] The Soviet planners had set up large factories in each republic; these factories distributed their products to and received their inputs from the whole of FSU. Some of the largest factories in Kazakhstan produced steel and tractors for the country and the rest of the FSU. The Karaganda coal mines employed 65,000 workers and the Karaganda Metallurgical Complex, 28,200.[2] In the circumstances in which FSU collapsed, this production system also disintegrated rapidly since the birth of new independent republics meant that inter-enterprise payments now required formal settlement between nations.

1.4 There were substantial budgetary transfers from the Soviet Union which permitted a level of living in Kazakhstan which were comparable or higher than the standards in Europe.[3] Kazakhstan was a net recipient of subsidies from the Soviet Union; the total transfers to the Kazakhstan budget being over 10 percent GDP in 1989 and 1990.[4] Much of the social services was provided by social assets attached to enterprises, and it proved difficult to provide social services at the previous levels after these assets were dissociated from the enterprises.

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[1] Kazakhstan: The Transition to a Market Economy, page 8.
[2] Ibid, page 8.
[3] Ibid, page 10.
[4] Ibid, page 16.

1.5 The link with the Soviet Union had also brought about the political, social and cultural transformation of the society. Politically, the communist party ruled through a complex balancing of ideological, ethnic, personal and party considerations. Culturally, Kazakhstan went through a major social transformation, as its ethnic composition changed because of the massacres, the emigration of Kazakhs and the immigration of other ethnic groups. The proportion of Kazakhs in the population decreased from 57.1 percent of the population in 1926 to 38 percent in 1939.[5] It is only in recent years that the Kazakh and non-Kazakh population achieved near parity, but this has been achieved at the cost of a negative population growth rate in a country that was already very sparsely populated.

DESIGN AND RATIONALE OF THE INITIAL REFORMS (1991-1993)

1.6 In Kazakhstan, the change from a socialist system to a market economy required a strong political will. In practice this meant that reforms flowed from the top downwards but occasional referendums provided the legitimacy for the agenda and to those who enforced the agenda.

1.7 The political scenario developed over time but is still evolving in 1999. In 1989, Nursultan Nazarbayev was appointed Secretary General of the Communist Party when Gorbachev had decided that the economic system needed major reforms. When the Soviet Union disintegrated in 1991, Kazakhstan (and other republics) was given a choice of remaining within the Soviet Union. Political and demographic factors (Kazakhs being a minority in their own country), brought about two referendums; in March 1991, people voted overwhelmingly to remain within the Soviet Union; but in December 1991, they reversed the decision, and Kazakhstan became the last republic to leave the Soviet Union.

1.8 The struggle to control the decision-making apparatus had two dimensions — between Kazakhs and non-Kazakhs and between the Presidency and the Parliament. As nationalism and ethnicity gained momentum, more and more non-Kazakhs left the country, and power is becoming more focused in Kazakhs, especially since the population is now more evenly balanced. The conflict between the President and the Parliament has meant a gradual increase in the power of the President. In 1993, the Kazakhstan parliament dissolved itself and allowed the President to rule by decree. A new parliament was elected in March 1994, but in March 1995, the court held the elections as invalid, and the President again ruled by decree. In April a referendum was held, the Presidential elections due to be held in 1996 were canceled and the incumbent President confirmed in power until 2000. In August 1995, in another referendum, a new constitution providing for concentration of executive powers was passed. Elections were held in December 1995. In 1998, parliament moved the election of the President forward by one year. In January 1999, the incumbent President, Mr. Nazarbayev, was re-elected.[6]

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[5] Ayna, Kazakhstan Annual Country Profile 1999/1, page 28.

[6] Economist Intelligence Unit, Kazakhstan 1998-1999, and 1999-2000.

1.9 The positive aspects of this concentration of power are that in a top-down process, reforms can be pursued vigorously and the achievement of the results will be less time consuming. The offside is that the process becomes deep rooted and narrow so that it serves only a small group of people. Such a process can lead to massive corruption and abuse of power, and there is every indication that such results are being achieved.

1.10 With the gradual consolidation of power, the reform program was implemented forcefully. When Kazakhstan began its transition to a market economy in 1991, its reformers faced the problem of changing the whole system. Apparently, they had many options for selecting an entry point for interventions —price liberalization, privatization, reforming the banking system, and others — but since the entire system was well integrated, each individual intervention had economy-wide repercussions. The challenge was to select the intervention that had the most comprehensive results and involved the minimum hardship to the people. The selection of an option was not easy, as the Kazakh reformers did not know how a market economy worked and their advisers did not have any experience of how the Soviet system worked.

1.11 A beginning was made by tentative measures for privatization and institutional reform in 1991. This was followed by extensive price liberalization, but in January 1992, when most prices were liberalized, this resulted in an increase of prices by 235 percent in that very month. Inflation continued to increase and between December 1991 and December 1992, prices had increased by 1,600 percent. The design of these first economic interventions caused major disruptions in the economy. Between 1990 and 1993, GDP declined by more than 40 percent because of the disintegration of a centralized production system, which had established a high degree of regional specialization, the breakdown of the trade and payments' system and the loss of markets. The current account deficit averaged 10 percent of GDP in 1992-93. Between 1991 and 1993, high inflation continued and prices rose more than 30 times. The main reason for inflation was the impact of contraction in output and the monetization of large budget deficits throughout the FSU. In 1992, the banking system's ruble monetary liabilities increased by 540 percent and authorities became concerned about ways of slowing down the monetary expansion without causing liquidity problems. During this period, the revenues of Kazakhstan were reduced by a factor of four because of the discontinuance of budgetary support from the Soviet Union and the emigration of people of non-Kazakh origins from the country. By August 1992, real wages had fallen to less than 60 percent of the average level in the first quarter of 1991. State employment fell by 12 percent between 1990 and the first quarter of 1992. To add to the problems, there was a severe drought in 1991.

1.12 It was realized that the existing efforts were not yielding the right results for two reasons: state ownership of business enterprises (especially as monopolies) still continued to dominate the economy, and Kazakhstan's membership of the ruble zone left it at the mercy of the monetary policies set by others. In 1993, Kazakhstan left the ruble zone and established its own currency, the tenge. The new effort to speed up privatization and to concentrate on enterprise restructuring became the subject of the World Bank assisted programs.

Reforms and the World Bank Assistance Strategy

1.13 Kazakhstan joined the IMF and the World Bank in July 1992. As a first step, the World Bank carried out an assessment of the economy of Kazakhstan. This assessment confirmed the country assistance strategy, vide Economic Report (No. 12856-KZ).

1.14 The study focused on two critical issues: structural reforms and the stabilization of the economy. For structural reforms, the study highlighted a number of areas for attention: the need for a redefinition of the role of the government, the necessity of a legal framework, the importance of an appropriate institutional framework and the need to implement price liberalization and a trade framework. For stabilization, the main approach was to limit budgetary deficit financing from monetary system, focus monetary policy to reduce inflation, and arrange balance of payments financing to ensure imports to prevent a decline in output and consumption.

1.15 On the basis of these findings, the World Bank selected a cluster of programs: A Technical Assistance Loan to help institutions to carry out the reforms, the Rehabilitation Project to support stabilization and structural reforms, a Finance and Enterprise Development Project to strengthen institutions to carry out reforms in the enterprise and financial sectors, and a Social Protection Project to assist in the divestiture of enterprise social assets and strengthen employment services.

1.16 The choice of the programs and the level of effort for each reflected a strategy that enabled the various programs to support each other and thus to attain synergy through their joint effort.

2. THE STRUCTURAL ADJUSTMENT LOAN

SAL AND ITS OBJECTIVES

2.1 The Structural Adjustment Loan (Loan 3900-KZ), program focused on enterprise restructuring to support macroeconomic stabilization and to achieve a recovery in output. These objectives were to be attained through three components of the program. The first, the Framework for Enterprise Restructuring, provided for the development of competitive markets. This was meant to ensure that domestic prices moved towards international relative prices and thus provide the signals for economic restructuring. To this end, exports were to be liberalized, monopolies were to be demonopolized, and entry and exit procedures for firms were to be streamlined. The second component, the Instruments of Enterprise Restructuring, provided for enterprise reform and restructuring. It was meant to arrest the drain put on economic resources by loss making enterprises. The restructuring was to be achieved by rapid privatization of industrial enterprises through Small Scale Privatization, Mass Privatization and Case by Case Privatization, extension of the existing program to agricultural enterprises, opening up of the economy to new private firms to become the main engines of growth recovery, strengthening payment discipline and banking standards and containing of credit to the largest loss makers. Since such a program would entail substantial labor shedding, the third component envisaged the upgrading of the social safety net. The overall objective of the program was to accelerate the privatization program and to achieve a critical mass as rapidly as feasible.

PROGRAM COMPONENTS AND THEIR RESULTS

Development of Competitive Markets

2.2 The development of competitive markets envisaged a number of steps — liberalization of exports, dismantling monopolies, and establishing a legal framework, especially for facilitating exit and entry of firms. A number of steps were taken to liberalize exports. These included the elimination of export quotas, abolition of export monopolies and reduction in the number of goods needing export licenses. All these steps were taken effectively.

2.3 To develop competitive markets, a substantial dismantling of the existing monopolistic holdings was necessary, mainly through the privatization of subsidiaries so as to hollow out the monopolies. Extensive work was undertaken for this process of demonopolization. Of the 77 holdings, 65 holdings, which had 2,304 subsidiaries, were slated for Mass Privatization Program (MPP). Of these, 900 subsidiaries were offered at MPP auctions at least once, more than 1,200 were subjected to cash auctions and 175 were considered for Case by Case (CbC) Privatization.

2.4 Two monopolies required special attention — Astyk in grain marketing and Munai Onimdeiri for petroleum distribution. The program required that by second tranche, a blueprint to fully privatize Astyk would be implemented and all grain storage facilities (elevators) would be auctioned, except those required for government consumption. By March 1996, state shares in 246 Joint Stock Company (JSCs) out of a total of 366 JSCs had been sold; and by 1998, most of the action had been completed.

2.5 Similar action has been undertaken to break the monopoly of Munai Onimdeiri in petroleum distribution. By February 1996, 1,023 out of 1,376 gas stations and 55 out of 151 bulk terminals had been offered for sale. The energy sector was further reformed by the abolition of the administrative pricing of crude oil and the elimination of prescribed profit margins of crude oil producers.

2.6 For grain procurement, a plan for the competitive procurement of grains by the government was adopted and compulsory delivery of grains for state needs was replaced by voluntary purchases limited to 1,200,000 tons.

2.7 The objective of liberalizing markets also required legislation, which was undertaken as a provision in the new constitution, a Civil Code, and a law on the Freedom of Entrepreneurial Activities.

2.8 In order to facilitate firms' entry and exit, a draft land legislation was adopted and the code established private land tenure, use and transfer rights. A law for establishing a public register of lands and real estate has also been passed and is being implemented.

2.9 The program required the implementation of exit procedures against distressed enterprises. The government is now initiating proceedings against insolvent companies. However creditors are often reluctant to avail themselves of the recourse under the Bankruptcy Law, and creditor led restructuring of firms has therefore not come about.

Enterprise Restructuring

2.10 Three instruments of enterprise restructuring were envisaged by the program — Small Scale Privatization, Mass Privatization and Case by Case Programs.

2.11 In the case of Small Scale Privatization Program, the program required that on an average, 500 objects (firms, small outlets like bakeries etc.) would be auctioned against cash every month. The local administration was reluctant to identify the objects for auctions, as they had no incentive to do so. It was decided that part of the proceeds of sale should go to local administration. This accelerated the implementation of the program but much of the progress was attained after the closure of the loan, as indicated by the following figures showing the number of objects auctioned under this scheme: 2,748 in 1994; 2,477 in 1995; 3,393 in 1996; 5,590 in 1997; 2,535 in 1998; and 523 up to the end of February 1999.[7]

2.12 The Mass Privatization Program was a more complex program since it required the auction of majority shares held by the state in large companies (with more than 200

[7] IMF: Republic of Kazakhstan – Selected Issues and Statistical Appendix, 1999.

employees) to holders of vouchers. Initially, many of the establishments offered for sale were neither large nor did the state have a majority shares in them. For instance, in November 1995, against a target of 900 firms, 210 firms had been offered for sale but the state had a majority share in only 90 of them. The government preferred cash sales but the MPP was meant for auctions against vouchers. The sale of establishments against cash was not in the interest of equity as the voucher holders were thereby deprived of the opportunity to own a share in any enterprise. The Bank and GOK eventually agreed to a procedure for sequencing cash and voucher auctions and for ensuring transparency. In January 1996, when all vouchers were due to lapse, auctions were held to use up the vouchers. More than 40 percent of the enterprises offered for sale had ceased operations. As in the case of Small Scale Privatization, the progress was slow in the early years but improved later on. About 1,700 enterprises were offered for sale against the target of 3,000.[8]

2.13 In the entire process, the voucher holders had an indifferent deal. When the vouchers were first distributed, it was reported that 3 to 10 percent had been lost and had never reached the intended recipients. Further, the expectations of voucher holders for participating in the Mass Privatization Program were curtailed as only a small number of enterprises were offered for such sale initially; it was only when the vouchers were due to expire that more were offered. The Investment Privatization Funds (IPFs) which were to act on behalf of the voucher holders were operating without regulations that would have protected the voucher holder. Some IPFs made promises of very large returns on vouchers. There was also no system for the registration of vouchers or for accountability of IPFs for the vouchers obtained by them. Having received shares in a company on the basis of vouchers, it was possible for the companies to exchange them for cash and then disappear from the scene. During the Field Mission, not a single IPF could be contacted for an interview. Apparently all IPFs, which at one time numbered 170, have ceased to exist.

2.14 The government was to adopt a plan to reduce to less than 30 percent the government's shareholding in firms previously privatized under the MPP. This has also been done and plans have not only been prepared, they have partly been implemented. The plans involve the cash auction of shares first by the English auction method, and if that is not successful, by the Dutch auction method. By February 1996, nearly 320 residual share packages have been sold through cash auctions.

2.15 The development of secondary markets was to be promoted for trading of shares in the IPFs and those held by the IPFs. Owing to the disappearance of the IPFs, this action is no more relevant. However, measures are being undertaken for the development of an open and transparent securities market. Laws relating to securities market were promulgated in 1997 and securities trading is close to meeting international standards.

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[8] Ibid.

2.16 Case by Case Privatization. The progress in the privatization of large enterprises was slow during the pendency of the SAL as shown by the number of CbC privatization finalized: in 1995, 5; 1996, 28; 1997, 47; and 1998, 3.[9] (The number of enterprises increased from the original 44 owing to the transfer of many enterprises from other programs to CbC). Since many of the privatization contracts are confidential, questions can be raised about the governance aspects of the transfers.

2.17 A group of about 100 very large firms had to be given a special treatment since they faced serious problems of mismanagement, large inter-enterprise arrears and large social assets which no private sector enterprise were willing to accept. In such cases, management contracts provided an opportunity for making improvements in the performance of enterprises. The government assigned enterprises to management firms, who were expected to pay a bonus to the government. This was unlike the usual practice where the government pays fees to management firms for their skills. By December 1994, 41 contracts had been signed mostly with Kazakhstan companies for the management of 94 enterprises, sometimes without a proper tender process.

2.18 The program required the inclusion of all agro-enterprises not yet privatized, as well as the remaining state shares in the partially privatized ones, in the SSP or MPP. This has been done.

2.19 A number of activities were required of banks. The Agroprombank's portfolio of non-performing directed credits was to be transferred to an Agricultural Support Fund. This has been done but Agroprom's non-performing loans to Astyk are still on the books of Agroprom as the privatization of Astyk's subsidiaries has created an uncertain condition. The program required an end of direct influence of state enterprises on banks. This has been done as a Presidential Decree of August 1995 has forbidden enterprises that are majority state owned to hold bank shares. The government sold shares in 9 banks and plans to sell shares in the remaining banks. Loan classification and phase-in provisioning was to be introduced. Loan classification was generally not used but the Tax Reform of April 1995 makes losses partly deductible. It is expected that full deduction will be allowed through a change in the tax laws. That would provide the incentive for loan classification. The program required that commercial banks should set up central work-out units. This has been done sometimes through less formal working groups to resolve the question of bad loans. The individual correspondent accounts of banks with their branches with National Bank of Kazakhstan were to be consolidated in a single central account located in their headquarters. This has been done for most of the small banks but not for the large ones.

2.20 The Rehabilitation Bank (RB) was established in 1995 to deal with the most heavily indebted state controlled enterprises. It was to be the sole source of credit for such enterprises, and access to RB's resources was conditional on the presentation and implementation of a restructuring plan either for privatization or liquidation. Such plans

[9] Ibid.

were to be prepared by a consultancy unit, the Restructuring Advisory Unit, but such a unit was not established until 1996. Initially, therefore, the work of RB suffered because it had no guidelines for its work and no expertise in preparing restructuring plans or even evaluating plans prepared by others. RB also had shortage of funds as it was expected to pay the severance pay and other expenses of the enterprises. Despite the problems, RB was able to achieve a number of results. SAL required that legal proceedings for liquidation or other form of debt resolution would be initiated against an initial group of at least four enterprises. This has been done although after some delay. The RB has adopted policies and operational guidelines linking access to Bank's resources to drastic downsizing measures, leading to either liquidation or privatization. By February 1997, out of the 42 insolvent enterprises assigned to RB, 25 had been restructured, privatized or liquidated.

Social Safety Net

2.21 The program required that legislation would be enacted which provides for a scale of three levels of entitlement to unemployment benefits. The basic rate would be increased to the minimum level of compensation currently set up by law and paid to employees in the budgetary sector, and will be subsequently linked to this amount. Low priority programs, which absorbed the bulk of the Fund's resources, were to be terminated. Although these measures were undertaken, the Unemployment Fund was later abolished. The privatized enterprises had divested themselves of social assets, which had provided important social services to the employees. A policy to continue operation of these services through devolution to local governments was prepared but was not implemented.

CONCLUSIONS

2.22 The project was successful in initiating a breakthrough in enterprise structuring. Experience has shown that failure to implement enterprise restructuring has been a dominant source of macroeconomic instability. The project succeeded in difficult circumstances in extending large-scale privatization and in contributing to macro-economic stability. The results obtained for privatization, which was the main thrust of the project, are shown by the following tables, which indicate that the pace of work was slow initially and large and the very large enterprises are still state owned to the extent of 55 percent and 60 percent. However the overall results are satisfactory as the project provided the momentum for continued efforts for privatization.

2.23 An important feature of privatization is that the private sector's share of investment increased substantially, and accounted for nearly three fourth of the total investment in 1998, with a corresponding decrease in the share of the state's investment.

Table 2.1: Kazakhstan: Enterprises by Size and Ownership in 1998 (in percent of total production)

	State	*Private*	*Mixed*
All Firms	1%	96%	3%
Self Employed	0%	99%	1%
Small	5%	80%	15%
Large	55%	32%	13%
Very Large	60%	26%	14%

Source: State Statistical Office.

Table 2.2: Kazakhstan: Financing of Investment 1993-1998 (percent of total resources)

	1994	1995	1996	1997	1998
State enterprises	51.0	45.0	41.2	27.5	26.7
Budget resources	9.1	4.1	7.0	6.4	12.6
Own resources	41.9	40.9	34.2	21.1	14.1
Mainly Private	49.0	55.0	58.8	72.5	73.3

Source: IMF: Selected Issues and Statistical Appendix 1999. (Hereinafter IMF 1999).

2.24 The liberalization of trade helped in increasing and diversifying Kazakhstan's exports. Table 2.3 shows that from 1994 to 1997, Kazakhstan's exports more than doubled but declined in 1998 owing to a downturn in the economy.

Table 2.3: Exports of Kazakhstan (in Millions of US$)

	1994	1995	1996	1997	1998
Exports (f.o.b.)	3,285	5,440	6,292	6,769	5,774

Source: IMF 1999.

2.25 Exports were also diversified, exports to Russia declined from 44.40 percent of the total exports in 1994 to 28.9 percent in 1998.

Table 2.4: Kazakhstan—Geographical Distribution of Exports and Imports (in percent)

	1994	*1995*	*1996*	*1997*	*1998*
Exports:					
To BRO Countries	58.89	58.11	57.13	46.56	42.01
of which Russia	44.40	45.03	42.03	35.21	28.90
Non-BRO countries	41.10	41.89	42.87	42.87	57.96

Source: IMF 1998 and 1999.

2.26 The support for structural adjustment was also associated with positive macro-economic consequences. Kazakhstan had been having a declining rate of GDP growth for many years but there was a progressive improvement from 1995 onwards, until in 1997 a positive rate of 2 per cent growth of real GDP was obtained. The growth of GDP in per capita terms was even more substantial, as it changed from -11.8 percent in 1994 to 3.6 percent in 1997. (In 1998, the growth rate declined to -2.5 per cent owing to lower commodity prices, decreased agricultural production and the Russian crisis.).

Table 2.5: Kazakhstan: Output Growth (in percent)

	1994	*1995*	*1996*	*1997*	*1999*
Real Growth Rate of GDP	-12.6	-8.2	-0.5	2.0	-2.5
Growth of GDP per capita	-11.8	-4.3	-1.2	3.6	NA

Source: IMF. 1999.

2.27 Inflation, which had impoverished people, was brought under control very substantially, as shown next.

Table 2.6: Kazakhstan: Consumer Prices (percentage change over previous year)

Year	*Jan*	*Feb*	*Mar*	*Apr*	*May*	*Jun*	*Jul*	*Aug*	*Sep*	*Oct*	*Nov*	*Dec*
1994	2,330	2,192	1,921	2,095	2,430	3,029	3,121	2,728	2,304	1,990	1,434	1,158
1995	860	726	639	479	345	212	156	131	115	86	70	60
1996	53	47	42	42	41	41	40	38	36	35	32	29
1997	26	25	24	21	19	18	16	15	14	12	11	11
1998	11	10	10	10	10	8	6	6	6	4	3	2
1999	1	-0.3	-1.2									

Source: IMF 1999.

2.28 The effects of restructuring was felt on employment levels, which declined by nearly two million persons in four years. The impact of unemployment was moderated as many non-Kazakhs left the country. However this meant the reduction of population and of some skill levels in a sparsely populated country.

Table 2.7: Kazakhstan: Total Employment (in thousands of people)

	1993	*1994*	*1995*	*1996*	*1997*
Total employment	5,630	5,415	4,994	4,381	3,659

Source: IMF 1998.

2.29 The average real wage increased from T 76 per month in 1994 to T 92 per month in 1997 but declined to T 84 per month in 1998.

Table 2.8: Kazakhstan—Real Wages, 1994-98 (In Tenge per month, figures for January of each year)

	1994	*1995*	*1996*	*1997*	*1998*
Minimum wage	70	49	174	255	267
Average real wage	76	85	87	92	84

Source: IMF 1999.

Ratings

Outcome

2.30 The outcome of the project has to be rated after considering both its achievements and its shortcomings. SAL was designed at a time when production and trade had been seriously disrupted, most enterprises were in the public sector and the economy was in a tailspin. SAL succeeded both in terms of extending privatization and in contributing to macroeconomic stability. A large number of enterprises were privatized, inflation was brought under control and double digit negative rates of growth were brought down to nearly positive results. On the other hand, there were many shortcomings. The social safety net was not strengthened as the Unemployment Fund was abolished and arrangements for the continuance of the operations of social assets divested by the privatized enterprises could not be made. The speed with which privatization was brought about varied with the type of privatization, but was generally slower than that envisaged by the program. The processes by which privatization was attained raise concern about governance issues. In the case of Mass Privatization, the public at large received little or no value for their coupons. For Case by Case privatization, fully transparent procedures were not often used either for the sales or for management contracts. Considering the achievements and the shortcomings, the outcome is rated satisfactory.

Sustainability

2.31 Sustainability of the results of the program is uncertain. The favorable factors are: the vested interests for the protection of property rights are now well entrenched, the legal framework is in place and government policies support privatization.

2.32 There are two threats to sustainability. One may come from the governance issues related to the management of the economy. Non-transparent processes were used for privatization and no measures were taken to protect the voucher holders, who received no value for their coupons. The state continues to own 55 percent of the large enterprises and 60 percent of the very large enterprises. The legal framework may be in place but the laws are not always enforced. Such practices are likely to lead to the emergence of distortions and inequities in the market economy, and the concentration of economic resources in a small class of businessmen. Such a rentier class will seek to extend and deepen its privileges by promoting further distortions in the market.

2.33 The second threat comes from ignoring the social aspects of development. The real wages of people have gone down by 50 to 60 percent and the high level of social services which was available earlier has deteriorated. Unemployment Fund has been abolished. Those who have borne the hardships of the transition for long look forward to some relief. As the top-down approach to reforms inhibits the upward flow of information, the elites are not likely to be sensitive to the hardships of the people. The conspicuous consumption in the public and private sectors reflects that insensitivity, and may result in some turbulence, which may affect the sustainability of the program.

Institutional Development

2.34 Institutional development is rated as modest. Institutional development refers to two different levels of development: (1) at the governance level, when the manner in which state power is acquired and exercised is considered, and (2) at the operational level when the functions of implementing agencies are considered. The program did not attempt institutional development at the governance level although the manner in which power is exercised determines whether or not development will be distorted through corruption, crony capitalism or similar practices.

2.35 Institutional development was undertaken in this program in a number of different ways: (1) by transferring enterprises to the private sector, (2) by requiring management contracts in some cases, and (3) by creating the environment which promotes efficiency, e.g., by establishing rules for entry and exit or by promoting the enactment of laws that set standards for performance. Although these measures were undertaken, the quality of the processes used affected the quality of the institutional development.

2.36 The use of non-transparent processes in privatization is likely to affect the quality of market development. Weak privatization procedures have often led to asset stripping. Privatization has not yet acquired sufficient depth, as many large firms still remain in the public sector. Furthermore, the state continues to have shares in many smaller firms. These factors tend to hinder the development of competitive markets. The neglect of the social sector creates distortions that lead to inequities and weak institutional development.

Bank's Performance

2.37 Bank's performance is rated as satisfactory. The Bank made important contributions in a difficult environment. The Bank oversaw the transfer of a large number of enterprises to the private sector and supervised the adoption of measures to develop competitive markets. The Bank sought to ensure fair, transparent and competitive privatization process. The Bank sought to reduce corruption by insisting on the abolition of export quotas. The experience with this SAL also demonstrates the limits to Bank's best efforts. For example, the privatization process did not achieve its objectives of transparency fully in the case by case privatization. The policy framework for the disposition of enterprise social assets was approved but was not implemented. No arrangements for the devolution of authority to local governments to take up the divested social assets could be made. The unemployment benefits were increased but the Unemployment Fund was later abolished. Of course, there were some design flaws. The design of SAL could have paid more attention to the social aspects of the program. The reduction of poverty was not addressed. Governance issues did not receive the required attention quite possibly for fear of being too demanding in rather difficult times of transition.

Borrower's Performance

2.38 The borrower's performance is rated as satisfactory. The political support provided by the top leadership of the country played a decisive role in the achievement of a degree of privatization. On the other hand, non-transparent processes were often adopted for privatization. The program envisaged even playing grounds to promote competition. Such an objective should also have included protection of the public from unscrupulous Investment Privatization Funds. This was not done and the public at large received little value for the coupons they had been given. On balance, the performance is considered satisfactory.

LESSONS LEARNED

2.39 From the conclusions, it would be seen that the project was by and large successfully planned and implemented as it did contribute significantly to enterprise restructuring. However in the discussion above, a concern has consistently been expressed about not just the results obtained but about the quality of the results as well as the processes used to obtain the results. The lessons from this project therefore pertain to governance issues and the need for flexibility in planning and implementation of projects.

2.40 Governance aspect is important in planning the reform. The transition from a socialist to a market economy is a complex process, especially when the deep-rooted political and social characteristics acquired during socialist rule are considered. A top-down reform process makes it possible to implement the reforms quickly but may make the elites less sensitive to the hardships endured by the people (for example, to the fate of the voucher holders of the privatization scheme). The decision-making process may itself become narrow and self-serving. Since privatization of enterprises is only a part of the process of transformation to a market economy, the quality of privatization especially the governance aspect, is as important as the attainment of a critical mass of privatized enterprises if the transformation is to result in efficiency and equity. Without attention to the governance aspects, privatization may lead to distortions in the competitive process.

2.41 Flexibility and comprehensiveness in the design of programs is important. An inflexible design of a program — the blueprint model — creates problems because activities are not always undertaken according to plans. If the behavior of the IPFs could not have been predicted, the program could have provided sufficient flexibility to enable a resolution of the problem before the IPFs disappeared from the scene.

3. THE FINANCIAL SECTOR ADJUSTMENT LOAN

DESIGN AND RATIONALE OF THE PROJECT

3.1 The financial sector was not functioning well in Kazakhstan in 1995. There were many banks which lacked capital, had bad debts, were overstaffed and inefficient. It was estimated by international auditors in 1994 that 50-55 percent of all commercial loans were either doubtful or loss. The capital of the banking system at the end of 1995 was estimated as negative US $850 million. In these circumstances, a Financial Sector Adjustment Loan was provided which aimed at enabling the financial sector to become sound and efficient.

3.2 The program had two components. The first, Establishing a Conducive Environment for Sound Banking Sector Growth, was meant to reduce the unduly high risks faced by banks in their operations. In Kazakhstan, even the most promising banks faced high risks for many reasons: the turbulence caused by the adjustment process, the inadequacies in the legislative system regarding property rights, poor management, inappropriate accounting and audit practices, an inefficient payments system, the limited range of payments instruments available, and the lack of prudential measures to ensure proper ratios. These weaknesses affected several parties: banks charged high interest margins and fees, depositors had little confidence in banks, and investors were reluctant to commit further capital to banks. The first component of the FSAL was meant to address these issues.

3.3 The second component dealt with Old Problem Loans and Problem Banks. Although most of the bad loans (which formed more than 50 percent of all loans) were directed loans and therefore not the responsibility of the banks, they weakened the banks position, deterred investors and depositors and weakened payment morale of banks and enterprises. A burden sharing arrangement was worked out which relieved banks of their directed bad loans and facilitated their capitalization from earnings and private sources. There were also some problem banks which were also very large and therefore influenced public confidence, complicated inter-bank relations and raised the risk of systemic failure. The second component of FSAL aimed at resolving these problems.

FSAL COMPONENTS AND THEIR RESULTS

Establishing a Conducive Environment

3.4 This component envisaged improvements in property rights legislation. The activities undertaken included provisions in the Constitution to provide for private property and the adoption of the Civil Code to clarify property and contractual rights. In addition, there were the promulgation of a Presidential Decree on Bankruptcy, and the signing of the Decree on Economic Entitlements and Companies.

3.5 The use of proper accounting practices are essential for security in lending. The program required that Kazakhstan adopt new charts of accounts and accounting standards that conform to the International Accounting Standards. This has been done although many banks prepare accounts according to both the previous and the new accounting standards.

3.6 The program required fostering institutional development of banks. The activities included either offering for sale to private sector all state shares in, or withdrawing the banking licences of, all except no more than 10 banks (other than National Bank of Kazakhstan NBK) whose equity included state shares. In 1996, the government had shares in 73 banks; this number was reduced to 5 in 1998.

3.7 Inter-bank payments and liquidity management has been facilitated by new monetary and payment systems. Payment clearing centers have been established in all oblasts and an inter-bank Settlement Center is being established. Banks are maintaining unified accounts nationwide with NBK. An overnight Lombard facility at the NBK, although it is not in much use. A law on bills of exchange and promissory notes which confirms to the Geneva Convention was to be enacted.

3.8 Ensuring Competition on an Even Playing Field required a reorganization of Halyk Bank, which used to have special privileges and the free use of state buildings. This has been discontinued. The number of Halyk's branches were reduced by more than 1,900 or 44 percent of the total. To provide service to remote areas, the postal state enterprises are being considered for undertaking limited banking work. The entry of foreign banks has been eased and 22 out of 82 banks now have some foreign participation.

3.9 Prudential norms were to be enforced by the issuance by NBK of regulations following a Presidential Decree which established norms for capital, liquidity, lending limits, insider transactions, and reserve requirements. In 1996, a three-year transition period was adopted to permit banks to comply with the standards. The Banking Supervision Department of the NBK has been strengthened to enable it to monitor the implementation of the norms.

Dealing with Problem Loans and Problem Banks

3.10 Sharing the burden of problem loans implied that banks were responsible for problem loans given by them but not for those that were directed by the government. The directed loans given to farms were transferred to the Agriculture Support Fund (ASF) and directed loans for other purposes to the Rehabilitation Bank. Non-performing loans made from the Economic Transformation Fund were transferred to the Development Bank and those made under the export credit by Alem Bank to Eximbank and eventually to the Ministry of Finance, with the Eximbank serving only as an agent to service those loans.

3.11 The separation of problem loans from others had the healthy effect of improving the financial profiles of banks and enabling them to improve their capitalization.

Enterprises responsible for problem loans were required to go through severe restructuring under management contracts. During the SAL period, RB had had some initial problems. As some of the problems had been resolved, forty-six very large enterprises that had failed to recover under other arrangement were handed over to the RB, which became the only source of credit to them. RB was made responsible for their liquidation or restructuring and privatization. RB was able to reduce staff of these enterprises by 34.3 percent, started liquidation proceedings against four of them, restructured 14 enterprises and placed 26 of them under management contracts. This work was reinforced by the Ministry of Finance whose Agency on Reorganization and Liquidation of Insolvent Enterprises took strong action against insolvent enterprises. By the first half of 1999, 5,694 enterprises had been considered nonsolvent and were being monitored. 2,470 enterprises were at the liquidation stage and 99 in the rehabilitation process. 820 enterprises were liquidated under orders of the court, and 213 were at the appeal stage against liquidation orders. 1,616 enterprises were potentially bankrupt but were being given a chance to rehabilitate, and 439 had improved their performance.

3.12 The issue of problem banks was to be resolved on two levels; a large number of ordinary problem banks was to be handled through streamlined procedures, and four major banks — Turan, Alem, Agroprom and Eximbank were to be restructured on a case-by-case method.

3.13 As far as the ordinary problem banks were concerned, these were handled with speed and resolution. From mid-1993 to mid-1997, licenses of 126 banks were cancelled. Mergers and exits other than through cancellation accounted for the exit of 25 banks from 1995 to 1997. This work has continued through the strengthening of the Banking Supervision Branch of NBK. In 1995, there were 184 banks at the beginning of the year, and by the end of the year, 42 licenses had been cancelled by NBK; the comparable figures for 1996 and 1997 are: Number of Banks at the beginning 130, and 101, number of licenses cancelled, 27 and 17. The cancellation of fewer licenses despite the improvement in banking standards and in banking supervision reflects an improvement in banking practices.

3.14 Four major banks were to be restructured as part of the plans for Handling Problem Banks. In the case of Agroprombank, the non-performing loans were transferred to the Agricultural Support Fund and the remaining loans were subjected to tighter collections or write offs. These steps helped to improve the bank's financial position. The state's shares in the bank were bought back by the transfer of some property owned by the bank. The bank is now fully privatized.

3.15 To reduce the share of the state in the banks, the Eximbank was converted into an open joint stock company in 1997, and a stage-by-stage privatization of the Halyk Bank was approved.

3.16 The problem loans of Eximbank were transferred to the government and the financial situation of the bank improved. A Malaysian Bank was interested in acquiring the majority shares in this bank but because of the Asian crisis, the deal was not finalized. Since then the bank has been waiting for an investor, and the staff has been continued to be employed on two-month contracts. This leaves the bank in a very weak position and the staff in very poor morale.

3.17 Turan and Alem Banks were to be restructured. A team of senior managers from NBK helped Turan Bank to establish a restructuring plan. An Israeli company showed interest in acquiring 51 percent of Alem Bank's shares but the scheme did not mature. When an audit of the bank revealed that the capitalization of Alem Bank was significantly less than previously assumed, the option available to the government was the liquidation of the bank. However, owing to the size of the bank and the anxiety in the financial markets, such a step would have been too risky, and the government decided to merge the two banks. This was against the provisions of FSAL but the World Bank agreed to waive the condition. Under a new law, the state was authorized under certain circumstances to take over shares of problem banks. Using this law, the government renationalized the bank and provided $90 million for its recapitalization. NBK provided an additional $60 million as loan. The state shares were put on tender and were acquired by a consortium of local investors. It is not known if the loan was repaid.

RATINGS

Project Outcome

3.18 The project outcome is assessed as satisfactory as it was relevant to the reforms envisaged in the Country Assistance Strategy as well as the government strategy, and the results were obtained with substantial efficacy and efficiency. The project provided a reinforcement of the activities undertaken by the Structural Adjustment Loan (Loan 3900) for the enterprise sector.

Table 3.1: Percentage of Banks Meeting Prudential Standards in Kazakhstan

Prudential standard	*Dec 1995*	*Dec 1996*	*Dec 1997*
All standards	50.0	65.3	70.8
Tier 1 Capital Adequacy	n.a.	81.2	83.3
Capital adequacy (Tier1,2)	95.4	96.0	84.4
Single Borrower Limit	82.3	89.1	84.4
Lending to Related Parties	91.5	95.0	96.8
Liquidity	91.5	94.0	88.5

Source: National Bank of Kazakhstan.

3.19 FSAL had two objectives: (1) To improve the sector environment so as to reduce the operating risks and latent liability of all banks, and (2) to resolve old problem loans and problem banks that affected the entire sector. The project strengthened the environment for secured lending by adopting appropriate laws, and establishing accounting standards and practices. Prudential standards have been strengthened, as shown by the following table which indicates a progressive improvement in the situation:.

3.20 Progress has also been made in reducing possible non-performing loans (all loans other than standard loans) as the share of such loans has gone down from 41 percent at end 1996 to 31 percent at end 1997, as shown below.

Table 3.2: Loan Classification in Kazakhstan Banking System (as at end 1996 and 1997)

	1996		*1997*	
	Bln Teng	*Percent*	*Bln Tenge*	*Percent*
Standard	38.7	59.3	59.9	68.7
Substandard	7.7	11.7	11.7	13.4
Unsatisfactory	6.1	9.4	3.7	4.2
High risk	1.4	1.7	1.4	1.5
Loss	11.3	17.9	10.7	12.2
Total loans	65.3	100.0	87.2	100.0

Source: National Bank of Kazakhstan.

3.21 The outcomes were generally achieved efficiently. However the lack of a decision on Exim Bank is affecting the functioning of that organization, whose net loss increased from T 50.868 million in 1997 to T 368.628 million in 1998. In the case of TuranAlem Bank, the government first passed a law enabling the repurchase of shares from private owners; thus enabling nationalization of firms. Having purchased the shares, the Bank was provided with loan by the NBK and funds by the government for its recapitalization. The government's shares were then sold to another private sector party. The recovery of the loan or the funds provided to the Bank could not be ascertained.

Sustainability

3.22 The sustainability of the project results is likely. The incentives underpinning the program should permit the continuation of an environment of effective competition. The adoption of international banking and accounting standards, and the conduct of audit according to internationally accepted practices, will encourage the more efficient banks to achieve better recognition internationally and with the domestic market. The removal of privileges of Halyk Bank should enable other banks to compete more effectively, and the interest shown by foreign banks to establish branches in Kazakhstan should intensify the competition in the market and enable an improvement of banking practices.

3.23 The main concern regarding sustainability of financial sector reforms relates to the concentration of loan activities to a small number of borrowers, as seen from the table below.

Table 3.3: Kazakhstan: Percent Share of Largest Borrowers of Five Banks
(as of December 31, 1997)

	Halyk	Kazkommerz	TuranAlem	CentreCredit	Exim
Top 10 Borrowers	49.6	35.0	31.6	35.7	53.1
Top 20 Borrowers	62.6	49.0	43.4	50.5	74.4

Source: National Bank of Kazakhstan.

Institutional Development

3.24 Institutional development is rated as substantial. It consisted of three types of activities: (1) the transfer of state's shares in some banks to the private sector, on the consideration that this would result in an improvement in governance, (2) adoption of procedures and practices that enhance the institutional performance of banks, and (3) restructuring of Turan Bank under the supervision of NBK.

3.25 The transfer of state's shares in banks is an important part of institution building since banks are thereby permitted to be guided by their own sense of market opportunities. The likelihood of state-directed loans which are often non-performing, is reduced. The adoption of accounting and prudential standards were important steps to improve the financial sector. However the quality of the private sector ownership is also an important factor, as illustrated by the Turan Bank, where the private sector shareholders were considered to have obstructed restructuring.

Bank's Performance

3.26 Bank's performance is rated as satisfactory. The Bank had a well-designed Country Assistance Strategy and an integrated portfolio of projects which together had a synergic effect. The Bank planned and supervised the program in an effective manner. The various missions had suitable expertise for the tasks and provided a comprehensive view of the situation in their reports. The Bank adopted a pragmatic approach to various problems, as illustrated by the merger of Alem and Turan Banks. This merger was a change in the conditions approved by the Board but the Bank adopted a flexible approach and negotiated with the Borrower a new set of conditions for the merger of the two banks. However the Bank's performance was not highly satisfactory, as rated by ICR; it did what it was expected to do.

Borrower's Performance

3.27 The Borrower's performance is rated as satisfactory. Major factors in Borrower's performance were: the political will to back up reforms, the determination of the NBK to implement the reforms, and the professional skills of the NBK to ensure their effective implementation. The various requirements of the program were fulfilled, many of them ahead of time. The conditions of the Loan were met, except the one relating to Alem Bank, which was merged with Turan Bank. The attainment of the program objectives reflects a significant achievement in the streamlining of the financial sector and hence support for the privatization program.

LESSONS LEARNED

3.28 The project was successfully planned and implemented. It succeeded in transforming the financial sector which was dominated by the public sector banks to one in which the private sector banks played the predominant role. The project helped the adoption of prudent banking practices, which enabled some banks to gain international acceptance and recognition. The lessons pertain to the factors that were associated with the satisfactory performance on this project.

3.29 Political will to implement reforms is important for the success of reforms during transition as any weakening of the resolve to continue with the reforms will undermine the situation and prolong the hardships. The large scale closure of problem banks caused hardships in terms of staff layoffs and reduction in the services offered by the banks. The consistency of the political will proved crucial to the success of the program.

3.30 The autonomy, power, integrity and competence of the central bank to enforce discipline are key factors for any financial sector reforms. The central bank plays the most important role in setting standards, establishing procedures, undertaking monitoring of banks and taking action where necessary. These functions can most adequately be performed if the central bank has the independence, the integrity, the competence and the powers to undertake its job.

3.31 Separation of the non-performers (loans and banks) from the performers is useful. Kazakhstan segregated bad loans from good ones, bad banks from good ones, the more advanced from the less advanced. This helped the adoption of separate remedies for different categories of loans.

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ҚАЗАҚСТАН
РЕСПУБЛИКАСЫНЫҢ
ҮКІМЕТІ

GOVERNMENT
OF THE REPUBLIC
OF KAZAKHSTAN

11, [illegible] Str., Astana, 473000
Ref. № 20-21-6/6486

COMMENTS RECEIVED FROM THE BORROWER

Astana
May , 2000

Dear Mr. Vandendries,

The Government of the Republic of Kazakhstan having considered the Audit Report submitted by the World Bank on Structural Adjustment Loan (Loan 3900 KZ) and Financial Sector Adjustment Loan (Loan 4051 KZ) has no objections and proposals therein.

E. Utembayev
Deputy Prime Minister

Жауап қайтарғанда біздің [illegible] № және күні көрсетілуі керек.
При ответе обязательно ссылаться на наш № и дату.

Mr. R. Vandendries
Acting Manager
Country Evaluations and Regional Relations
Operations Evaluations Department
International Bank for Reconstruction and Development

Basic Data Sheet

STRUCTURAL ADJUSTMENT LOAN (LOAN 3900-KZ)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	180	180	100
Loan amount	180	180	100
Cofinancing			
- Export Import Bank of Japan	60	60	100
Cancellation	--	--	--

Cumulative Estimated and Actual Disbursements *(amount in US$ million)*

	FY95	*FY96*
Appraisal estimate	90	180
Actual	0	180
Actual as % of appraisal	0	100
Date of final disbursement: April 5, 1996		

Project Dates

	Original	*Actual*
Identification (Executive Project Summary)	06/94	06/94
Preparation	09/94	09/94
Appraisal	01/95	01/95
Negotiations	04/95	04/95
Letter of Economic Reform	05/95	05/95
Board approval	06/95	06/95
Signing	06/95	06/95
Effectiveness	07/95	07/95
1st Tranche release	07/95	07/95
2nd Tranche release	01/96	03/96
Closing date	12/96	12/96

Staff Inputs (staff weeks)

	Planned		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to appraisal	50	177.7	41.9	270.3	42.2	211.5
Appraisal	37	153.6	29.0	123.7	16.0	72.6
Negotiations	12	28.6	7.0	17.2	10.6	36.6
Supervision	30	136.1	49.1	148.7	48.1	143.2
Completion	13	37.1	12.0	33.4	0.0	0.0
Total	142.	533.1	139.0	533.3	116.9	463.9

Mission Data

	Dates (Month/Year)	*Number of Persons*	*Number of Days In Field*
Through appraisal	07/94	4	13
	07/94	8	18
Appraisal through Board	01/95	7	16
Supervision 1	09/95	4	10
Supervision 2	11/95	4	12
Supervision 3	02/96	4	14
Completion	n/a		

Basic Data Sheet

FINANCIAL SECTOR ADJUSTMENT LOAN (LOAN 4051-KZ)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	180	180	100
Loan amount	180	180	100
Cancellation	--	--	--

Cumulative Estimated and Actual Disbursements *(amount in US$ million)*

	FY96	*FY97*	*FY98*
Appraisal estimate	90	90	--
Actual	0	90	90
Actual as % of appraisal	0	100	--
Date of final disbursement: August 1997			

Project Dates

	Original	*Actual*
Identification	01/96	01/96
Preparation		02/96
Appraisal	02/96	03/96
Negotiations	04/96	05/96
Letter of Economic Reform/Sector Policy		05/96
Board approval	05/96	
Signing		06/96
Effectiveness	07/96	07/96
1st Tranche release	06/96	07/96
2nd Tranche release	12/96	08/97
Closing date	03/97	07/97

Staff Inputs (staff weeks)

	Planned		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to appraisal	27.5	115.8	37.4	163.8	53.8	247.9
Appraisal	34.0	140.2	21.3	95.6	77.0	75.0
Negotiations to Board	22.0	74.6	76.9	60.6	8.6	23.5
Supervision	46.0	179.1	38.3	159.0	45.7	187.8
Completion	0.0	0.0	10.0	27.9	0.4	0.8
Total	129.5	509.7	183.9	506.9	185.5	535.0

Mission Data

	Dates (Month/Year)	*Number of Persons*
Through appraisal	05/95	8
Appraisal to Board	02/96	7
Supervision	10/96	3
Completion	12/96	3

Basic Social, Demographic, and Economic Indicators

Social and Demographic Indicators

Area	2,717,300 sq km
Population	15,672,000
Life expectancy at birth (1996-98)	67.0 years
Infant Mortality Rate (per 1,000 births) (1998)	14.2
Hospital beds (per 10,000 inhabitants) (1998)	99.8

Economic Indicators (*in percent of GDP, unless otherwise indicated*)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
Real GDP (percentage change)	-9.2	-12.6	-8.2	0.5	2.0	-2.5
Nominal GDP (US$ Bln)	15.8	11.0	16.6	20.8	22.5	NA
Year-end inflation (% change)	2169.1	1,160.	60.4	28.6	11.3	1.9
External current account balance	-2.8	-8.6	-3.1	-3.6	-3.6	-5.7
Gross official reserves						
(months of imports)*	1.5	3.2	3.2	3.1	3.2	3.1
Government budget						
Revenue**	23.9	18.5	17.2	13.8	13.4	13.9
Expenditure***	25.2	25.9	19.9	18.6	20.3	21.9
Balance**	-1.3-	7.5	-2.7	-4.7	-7.0	-8.0
of which, financing by						
Banking Sector	1.1	3.4	1.0	-0.3	0.9	0.7
Velocity of broad money	3.5	13.0	10.6	12.5	10.6	12.1

*Goods and nonfactor services
**Excluding privatization receipts
***Includes net surplus of extrabudgetary funds and quasifiscal operations for 1994-97.

Source: IMF. Recent Economic Developments 1998. p 5.

List of Persons Met

World Bank

Lazzat Buranbayeva
Angiezska Grudzinska
Amitabha Mukherjee
Helga Muller
Pervaiz Rashid
Anwar Shah, OED
V.Southworth
Bulat Utkelov
K.Yurukoglu

IMF:

Dominique Desruelle, Senior Economist, European Department II.

Kazakhstan: Almaty

Berik Baishav, First Vice President, Bank Association of Kazakhstan. (Formerly of the State Property Commission).
Dosmukhametov Kanat Muhametkarimovitch, Deputy Director, Department of Banking Supervision.
Leonid A. Ivanaov, Managing Director, Halik Savings Bank, Kazakhstan.
Ruslan N Musaev, Head of the Payments System Division, National Bank of Kazakhstan.
Azat G Nukushev, CEO, Agency Restructuring and Liquidation of Enterprises, Ministry of Internal Revenue.
Anatoli M. Pogorelov, Deputy Chairan of the Board, TuranAlem Bank.
Yuriy K. Shokamanov, First Deputy Chairman, National Statistical Agency of Kazakhstan.
Slava I Sizova, Deputy Director, Legal Department, National Bank of Kazakhstan.
Alexander Trigimov, Director, Strategic Planning Department
Rustam Zholaman, Director Institute for Development of Kazakhstan.

Astana:

Daniar Abulgazim, Vice Minister and Chairman, Committee of State Property and Privatization.
Serik Akhanov, Vice Minister, Ministry of Finance
Erlan Arynov, Deputy Chief of Adminsitration, Agency for Strategic Planning and Reforms
Kanat Bozumbayev, Director of Oil and Gas Department, Ministry of Energy, Industry and Trade.
Mukhametali Kouanysh, Deputy Director, Strategic and Reforms Department.
Serik Sh. Kurmangaliev, Deputy Chairman and Executive Director, Monopoly Control and Competition Protection Agency.
Azhar Kuzutbayeva, Vice Minister, Ministry of Transport, Communications and Tourism, (Formerly of State property Committee and Office of the President).
Kurmanov Marat, Head of Investment Division, Strategic and Reforms Department.
Kynotov Marat, Former Deputy Chairman, Rehabilitation Bank.
Duzbayeva Meizamkul, Acting Deputy Chiarman, Committee of State Property on Privatization.
Komlob Angrei Nukalaivich
Kaisar O. Omarov, Chairman of Board, Fund for Financial Support of Agriculture.
N.Sarsenbay, Deputy Chairman, Agency for Strategic Planning and Reforms.
Roman Solodchenko, Chairman, Committee of Economic Planning.
Nurlan Sh. Trimove, Vice Chairman, Agroprombank.

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Gary Linden
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ILO
James G. Windell, ILO Office. Moscow.