# DEVELOPMENT OF FINANCIAL MARKETS IN THE TRANSITIONAL ECONOMY OF THE REPUBLIC OF KAZAKSTAN

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## INTRODUCTION

### 1. Overview and Significance of the Study

"Central Asia has special significance for informed people everywhere, owing to its extraordinary human and cultural qualities. For centuries before the present one Central Asia stood out as a leading civilization, an Islamic heartland, a nexus for international trade," says Allworth (1989, p. xiii) about the Asian part of the former Soviet Union. Kazakstan is the largest state in Central Asian region. It is also one of the most advanced and promising countries in the region.

After proclaiming independence in December 1991, Kazakstan embarked on a wholesale transformation of its economic system. The reforms aim at the creation of a market economy through the introduction of competition and the development of market infrastructure. Yet every step has been accompanied by serious difficulties resulting from both the indecisiveness of the authorities and the obstacles to such change inherent in the remnants of the socialist system. Moreover, the backdrop to the transformation has been a world-wide recession and a crisis in the domestic economy. Output has plummeted; inflation rate has at times reached the hyperinflation threshold of 50 percent per month.

In this situation, banking reform and the creation of capital markets are one of the most urgent problems. Also, these contribute to the founding of stability. Financial sector serves five major functions in the economy. Specifically, financial systems:

1. facilitate the trading, hedging, diversifying, and pooling of risk;
2. allocate resources;

3. monitor managers and exert corporate control;
4. mobilize savings, and
5. facilitate the exchange of goods and services.

The idea that a liberal policy toward the financial system is favorable to economic growth and development has been argued since Hugo Grotios and Adam Smith. However, some economists still deny the leading role of the financial sector. They do not believe that the relationship between finance and economic growth is important. For example, some economists assert that many scientists over-stress the role of financial factors in economy or argue that financial sector responds passively to economic growth. Despite this, there is an expanding theoretical literature and empirical evidence on the links between financial system development and economic growth.

In Kazakstan, like in most of the socialist countries, there was a financial sector based on the system which included only one institution - the Savings Bank- and its branches all over the country, which were endowed with all banking functions. Stock exchanges did not even exist under this system. During the last two years, Kazakstan has partially succeed in the creation of the private sector though privatization. Many spheres of the social life are undergoing continual liberalization. The old system of planned economy is now completely dismantled; a market infrastructure is being formed to serve the economy. However, the rate of economic development is still low. Banking sector reform and financial markets creation are most important parts of this transformation process.

## 2. Purpose

The purpose of the present study is to examine the ongoing processes of banking reform and financial markets creation in Kazakstan during the transitional period. The analysis covers stock markets, the banking system, and the developing financial instruments and institutions in the Republic. The author argues that the development of financial sector is crucial for the national economy. However, financial markets are still in the early stages of development in terms of institutional maturity and financial depth of markets.

This research may provide some insights on the problem of financial market creation in the Republic of Kazakstan. The recommendations on government policy during the transformation period given by the author also could provide an alternative to the development strategy problems of the Kazakstani financial system.

## 3. Description of the Work

This work consists of Introduction (Chapter I), four main chapters, and Conclusion (Chapter VI) parts. The Chapter II, Literature Review, analyses major trends in Financial Development Theory and empirical studies of relationship between the level of financial sector development and economic growth. The next chapter explains the sources and limitations of data used in the analysis, and the methods of analysis employed in this study. Chapter IV, Kazakstan: Past and Present Financial Systems, describes the financial system of Kazakstan under a planned economy and early reform steps in the Republic after independence. Chapter V gives the analysis of recent development in financial sector in Kazakstan. The first part of this chapter is devoted to the examination of stock market development. The second part analyzes the banking sector as the main provider of investment capital in the economy, and the main financial institution on financial markets. The last part gives a detailed analysis of the development and diversification of the financial institutions and instruments in Kazakstan. Chapter VI concludes the study of the Kazakstani financial sector and provides some recommendation on development strategies for the Republic.

## II

## LITERATURE REVIEW

### 1. The Role of the Financial System In Economy:

### Theoretical Framework

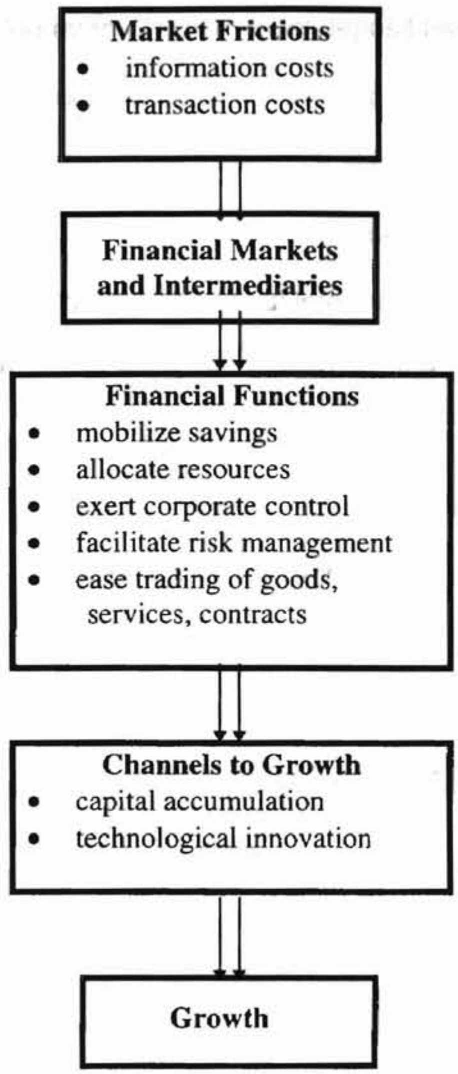
Considerable debate exists on the relationship between the financial system and economic growth. Some economists deny the leading role of the financial sector. Most of the post-war analysis of development has ignored financial indicators as irrelevant or obfuscating. The studies concentrated on real processes - a rise of real capital formation in national expenditure, the expansion of foreign trade, and the diversification of output away from agriculture and primary forms of production. These fundamental economic changes were seen as being supported by dramatic political and social changes. The problem of financing economic development was often restricted to issues of domestic taxation, the self-finance of enterprises, and the negotiation of foreign credits. From this post-Keynesian approach, financial development remains a secondary consideration, viewed from the perspective of a government deciding: which monetary institutions must be built, and which must be destroyed?

Even today, many scientists do not believe that the relationship between finance and economic growth is important. For example, Robert Lucas (1988, p.6) asserts that many scientists "badly over-stress" the role of financial factors in economy, and Joan Robertson (1952, p. 86) argues that financial sector responds passively to economic growth. Moreover, as Ross Levine points out, many leading economists (e.g., Anand Chandavarkar, 1992; Gerald Meir and Dudley Seers, 1984; Nicholas Stern, 1989; and other) very often express their skepticism about the role of the financial system by ignoring it (Levine, 1996, p. 1).

However, some of the earliest works of financial liberalism include seventeenth-century writers such as Hugo Grotios and Adam Smith. In the twentieth century, the importance of banking and finance in economic development has been stressed by Schumpeter (1934), Gurley and Shaw (1955, 1960, 1967), Goldsmith (1969), McKinnon (1973), Shaw (1973). The costs of acquiring information and making transactions create incentives for the emergence of financial markets and institutions. Here, financial systems serve as instruments of the improvement of both the incentives to save and the availability of credit. It is done by means of spreading risks and transforming the maturity structure of debt in ways more attractive to savers and borrowers. It was argued that such activities should produce benefits both from the generation of additional savings and their allocation more efficiently to productive purposes.

Another function of financial system is facilitating risk amelioration. Financial markets and institutions ease the trading, headling, and pooling of risk since they are the holders of information. Financial systems also acquire information about investments and allocate resources more effectively. Hence, this factor leads to faster economic growth. Besides this, financial contracts, markets, and intermediaries may begin to mitigate the information acquisition and enforcement costs of monitoring firms managers and exerting corporate control after financing the activity. Figure 1 summarizes a theoretical approach to finance and growth.

*Figure 1.* **A Theoretical Approach to Finance and Growth**




Another important issue in the financial superstructure function is its influence on the growth of the government sector during economic development. Some governments (e.g. in the former Soviet Union and Eastern Europe, Cuba, Vietnam, and elsewhere) have been fundamentally opposed to the growth of private financial services. Their financial systems have remained rudimentary, dominated by publicly owned deposit banks. Before their independence, many ex-colonial countries also had rudimentary financial systems dominated by currency boards which issued money only to the extent that it was backed by foreign exchange reserves,. These were also notable for a minimal provision even of commercial deposit banking.

When governments do not oppose financial development on principle, or are no longer prevented by colonial powers from pursuing it, they intervene in many different ways. Some of these are beneficial and some are self-defeating. Governments often set up public sector institutions to act as financial intermediaries, catering to categories of borrowers neglected by the private sector institutions, and attracting funds from domestic and foreign savers who find the low risk of government-backed bonds appealing. Governments also often establish central banks with a permit to regulate the mix of public and private credit provisions, and to act as lender of last resort in the event of speculative crises.

The question of whether government interventions to assist financial development are counter-productive has been discussed since Shaw (1973) in terms of the government's responsibility for "financial repression" in developing countries. Financial repression is the constraint on investment caused by the rationing of credit, usually to a few large borrowers. In these financial markets, interest rates and hence the supply of savings are below market-clearing levels.

The administrative setting of interest rates on loans and deposits at very low maximum levels is a wide-spread practice. Also, reserve ratio requirements, imposed on commercial banks both to safeguard depositors and to act as a fulcrum for monetary policy, are often set excessively high, with the aim of forcing these banks to hold the government's own debt at below market rates of interest. The result of both interventions is an inability of banks to offer depositors a market rate of interest; an artificially low level of deposits; a shortage of credit; systems for rationing credit; administrative directions about preferred categories of borrowers; political pressures on credit allocation; accumulating overdue repayments and rising bad debts. The flourishing business of unorganized rural moneylenders and "curb" market lending at extortionate interest rates is then observed.

These theoretical liberalist views are supported by empirical evidence. This paper will discuss various studies of the relationship between financial system and economic development in the next part of this chapter.

## 2. The Level of Financial Development and Economic Growth: Evidence

Various cross-country and country-case studies have evaluated the relationship between the level of financial development and economic growth. The seminal work in this area is *Financial Structure and Development* by Raymond W. Goldsmith (1969). He uses the value of financial intermediary assets divided by GNP to measure financial development under the assumption that the size of the financial system is positively correlated with the provision and quality of financial services. Using data on 35 countries from 1860 to 1963 Goldsmith (1969, p. 48) finds that a rough parallel can be observed between economic and financial development in long-run period. More rapid economic growth in some countries has been accompanied by an above-average rate of financial development.

However, according to Levine (1996, p. 30-31), Goldsmith's research has several weaknesses dealing mostly with the restriction of the analysis to a few indicators and accuracy of the latter. Another problem is that the close association between the size of the financial system and economic growth does not identify the direction of causality. Recently, researches have taken steps to address some of these weaknesses. In 1993 in their various publications, Robert King and Ross Levine study 80 countries over the period 1960-1989. The authors extended the analysis of Goldsmith by employing additional measures of the level of financial development. Also they considered other factors affecting long-run growth such as capital accumulation and productivity.

One of the findings of King and Levine is a statistically significant, and economically large, empirical relationship between the initial level of financial development and future rates of long-run growth, capital accumulation, and productivity improvements. Furthermore, according to the work of Jean-Claude Berthelemy and Aristomene Varoudakis (1996), insufficient financial development has sometimes created a "poverty trap" and thus become a severe obstacle to growth even when a country has established other conditions for sustained economic development - macroeconomic stability, openness to trade, educational attainment, etc.

There are some other works concerned with the direction of causality between financial development and economic growth. For example, Rajan and Luigi Zingales (1996), examining a large sample of countries, find that industries that rely heavily on external funding grow comparatively faster in countries with well-developed intermediaries and stock markets than they do in countries that start with relatively weak financial systems. Similarly, using firm-level data from 30 countries, Asli Demirgus-Kunt and Vojislav Maksimovic (1996) argue that firms with access to more developed stock markets grow at faster rates than they could have grown without this access.

Country-case studies provide a rich complement to cross-country comparisons. For example, the research of Rondo Cameron, Olga Crisp, Hugh Patrick, and Richard Tilly (1967) historically analyze relationships between banking development and the early stages of industrialization for England, Scotland, France, Belgium, Germany, Russia, and Japan. Stephen Haber (1991, 1996) compares industrial and capital market development in Brazil, Mexico, and the United States between 1830 and 1930. He finds that capital market development affected industrial composition and national economic performance. One of the most influential books in financial development literature, *Money and Capital in Economic Development* by Ronald McKinnon (1973), investigates the relationship between the financial system and economic development in Argentina, Brazil, Chile, Germany, Korea, Indonesia, and Taiwan in the post World War II period. McKinnon interprets the mass of evidence from theses country studies as strongly suggesting that better functioning financial systems support faster economic growth.

These empirical studies do not explicitly resolve the issue of causality. Financial development may predict growth simply because financial systems develop in anticipation of future economic growth. Furthermore, differences in political systems, legal traditions, or institutions may be driving both financial development and economic growth. However, as Levine states "while these studies do not prove that finance causes growth, the body of evidence would tend to push many skeptics toward the view that the finance-growth link is a first-order relationship and that difference in financial development can alter economic growth rates over ample time horizons" (Levine, 1996, p. 36). Also, historical country-studies suggest that well-functioning financial systems have, during some periods of time, spurred economic growth.

## III

## METHODOLOGY

### 1. Data

The analysis is based on the data obtained from statistical publications of various Kazakstani and international organizations. The Government Statistical Committee of the Republic of Kazakstan (Goskomstat), and Ministry of Finance are the most important sources of information on economic, political, and social development in Kazakstan. Goskomstat has served as the main provider of statistical information for government planning in the Republic during the Soviet regime. Under the planned economy, every enterprise and organization of any type and ownership were obligated to provide requested information to the Government Statistical Committee. This situation has changed during the last several years. Growth and change in private sector of the economy interfere with the flow of necessary information to government agencies. However, Goskomstat is still the only government agency which has the authority to request the information from economical, social, and political organization. Hence, it remains the main source of statistical information.

Another important source of information is Kazakstani newspapers, journals, and scientific bulletins: Kazahstanskaya Pravda, Panorama, Asiya: Economika i Zhizn, Central Asian Monitor, and so forth. Also significant are analyses of the economic situation in Kazakstan by government officials and leading Kazakstani specialists which may provide insight into the recent trends and direction of economic development.

The main source of information on the West are publications of such international organizations as International Bank for Reconstruction and Development (usually called World Bank), International Monetary Fund (IMF), United Nations Development

Programme, and European Bank for Reconstruction and Development (EBRD). Annual statistical reports, working papers, occasional papers, newsletters, and online publications of these agencies provide the most accurate and detailed information on new independent Republics of the former Soviet Union. For example, The World Development Report by World Bank, Transition Report by EBRD, and Human Development Report by the UN Development Programme include information on main economical and social developments in Kazakstan compared to the rest of the world. Working and occasional papers analyze different aspects of the Republic social life in more detail.

Today, the Internet is a very significant and reliable source of information. Because of the lack of information on Kazakstani economy, the Web site of American Embassy in Almaty is very useful for scientists as well as for those who want to do business in the Republic. The Kazakstan Mass Privatization Project also provides useful on-line information on current economic trends in the Republic and its financial markets. The major sources of information for the web site are the National Securities Commission of the Republic of Kazakstan, the Department for Privatization at the Ministry of Finance of the Republic of Kazakstan, the Department for Managing State Property and Assets at the Ministry of Finance of the Republic of Kazakstan, the Stock Exchanges of Kazakstan, and USAID Mass Privatization Project in the Republic of Kazakstan

Despite these sources, this study remains limited by availability of data. All the data is not available for deep analysis of financial market development in Kazakstan. This is due to the relative lack of interest in the topic, and difficulties of obtaining information from the direct sources. Financial markets in Kazakstan are considered as a part of market infrastructure, but not as an important instrument of domestic saving and internal capital mobilization. Hence, they are not regarded as a primary source of investment capital. Consequently, study of the financial system of the Republic has usually been limited to banking development. However, commercial banks do not represent the whole financial market. They are simply a part of financial institutions which serve those markets. Also, the unsatisfactory development of information systems in financial markets is another source of problems in data collection. The only direct source of information on financial markets (mainly, on stock exchanges) for Western scientists is the Internet web site recently designed by Kazakstan Mass Privatization Project. However, even this single source is followed with the statement: "The organizers of this site cannot attest to or verify the correctness or adequacy of the information provided on this site, and anyone using such information for any reason is doing so at their own risk and should independently verify the accuracy of the information" (USAID, 1997, 1997a).

Second, data obtained by different organizations and scientists are not necessarily consistent with each other. The reason for this is the methods of obtaining and analyzing data by those organizations. This is especially true for Kazakstani statistical agencies who still use the old statistical instruments from the Soviet period for the collection and analysis of statistical data. In many cases these differ from international standards. For example, GDP indicator is calculated in terms of Kazakstani national currency (Tenge), and thus, comparison to other countries' indicators is difficult due to differences in value computation.

Furthermore, the financial system of the planned economy was based on "monobank," a single institution endowed with all the banking functions: it issued money, acted as the Treasury of the state, and as the sole source of credit for the economy. Banks were mere accounting agencies, passively taking in household deposits (which were often the only assets households could hold) and keeping track of the financial transactions that corresponded to allocations made under the plan. Non-bank financing simply did not exist. Soviet statistics reflected this. Therefore, one is not able to find detailed data on banking development or enterprise financing. Even now, the "Finance and Credit" sector of the Statistical Yearbook of Goskomstat consists of only six tables. These tables detail: 1) government budget of the Republic, 2) profits of enterprises and organizations, 3) number of unprofitable enterprises and organizations, and 4) socio-cultural expenses from the government budget of Kazakstan. There is almost no data on financial sector development.

Third, there is a problem of obtaining this data, especially, from Kazakstani sources. Mainly, the reason is the lack of any legislative basis for release of public information in Kazakstan. Government organizations and agencies, which "own" the statistical data, will not release most of the information to the public or scientists. The information available in statistical publications of these agencies does not always provide needed information or this information is not detailed enough for analysis.

## 2. Method of Analysis

As mentioned above, the purpose of this research is to analyze the level of development of financial markets in the Republic of Kazakstan and their role in the economy. My method of analysis is determined by the specifics of the research and by the nature, and availability, of data. Unfortunately, lack of information inevitably will restrict the depth of analysis in many ways.

Financial theorists have employed a wide variety of measurements to assess economic and financial development. The seminal work in financial development theory is *Financial Structure and Development* by Raymond W. Goldsmith (1969). He has used the value of financial intermediary assets divided by GNP to measure financial development. Recent cross-country and country-case studies have employed additional measures of the level of financial development. For example, King and Levine (1993) have used four measures: 1) the size of financial intermediaries relative to GDP; 2) the degree to which the central bank versus commercial banks are allocating credit; 3) the ratio of credit allocated to private enterprises to total domestic credit; 4) credit to private enterprises compared to GDP. However, some of these indicators cannot be employed in this study. They were designed to serve different purposes: to analyze the relationship between economic growth and financial system development. Also previous studies of financial theory miss a very important aspect of financial markets growth. It is the level of financial institutions and instruments sophistication.

This study will employ three main groups of indicators. The first group of indicators measures the development of the stock market. Since stocks and bonds are main instruments of financial markets in Kazakstan, they are critical indicators of financial development. The second category addresses the analysis of banking sector development. These are the main financial institutions within the Republic. And finally, the third group of indicators examines the level of financial institutions and instruments development and their diversification.

**(I).** Stock Market Development Indicators:

1. *Number of Companies Listed* is a simple measure of the market breadth. Listed domestic companies are the main institutions serving financial markets. Hence, the indicator shows the involvement of different types of companies in the financial sector.

2. *Market Capitalization Ratio* measures the size of the stock market compared to Gross Domestic Product (GDP). Large size is not necessarily an indicator of well functioning market. However, the ratio is a good indicator of market development. It reflects the growth of investment capital in the Republic relative to the overall size of the

economy. And the size of the stock market is positively correlated with the ability to mobilize capital and the diversity risk - two main functions of financial sector.

| ***Market Capitalization Ratio*** = Value of Listed Domestic Shares / GDP |
|---|

3. *Value Traded Ratio* is one of two measures of market liquidity which will be employed in this study. It is defined as the total domestic shares traded on the stock market exchange divided by GDP. This measure complements the stock market size since markets may be large but inactive. It is also important for Kazakstan to develop a market of its own equities in order to mobilize domestic savings and internal capital for the development of the economy. Foreign investments can not serve as an sufficient source of capital for Kazakstan. They are not big enough to satisfy the needs of the whole economy. Also, the dependence of the Republic on foreign investments is not desirable for its future economic and political development.

| ***Value Traded Ratio*** = Total Value of Domestic Shares Traded / GDP |
|---|

4. *Turnover Ratio* is my second measure of market liquidity. It measures the volume of domestic equities on the market relative to the size of this market. Hence, it is another relative measure of domestic market volume, and overall size of the equity market. Turnover Ration also complements the first liquidity measure - the total value of equity transactions divided by GDP - since markets may be small (compared with the whole economy) but liquid.

| ***Turnover Ratio*** = Total Value of Domestic Shares Traded / Market Capitalization |
|---|

These indicators give a full picture of financial development by examining three different aspects of stock market performance on macroeconomic level: the size of markets relative to the national economy, the size of domestic markets relative to the whole market, and the size of these markets relative to the size of the whole economy. The indicators also measure the degree of trading in the economy. Liquidity may influence growth by easing investment in large, long-term projects and by promoting the acquisition of information about firms and managers.

**(II).** Banking Development:

1. *Financial Depth* is an indicator of the most important financial institution - banks. It measures the size of the financial system liabilities relative to national output. Liquid liabilities of commercial banks consists of currency held outside the banking system plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries. The assumption behind this measure is that the size of the financial sector is positively correlated with the provision of financial services.

| ***Financial Depth*** = Liquid Liabilities of Banks / GDP |
|---|

However, this indicator does not fully reflect the role of banks in the economy. Thus, to measure banking development and the contribution of banks to the economic growth the indicator of Banking Loans Ratio will be used in this study.

2. *Banking Loans Ratio* equals the value of loans made by banks to private enterprises divided by GDP. It measures credit issued by commercial bank (as opposed to credit issued by the central bank) to enterprises (as opposed to credit issued to the government).

| ***Banking Loans Ratio*** = Value of Loans to Enterprises / GDP |
|---|

**(III).** Diversification of Financial Institutions and Instruments group of indicators measures the change in the structure financial system. There are three major works of financial development theory that show that the more developed country and its financial system, the more diversified its financial market institutions and instruments (Levine, 1996, p. 47).

1. *Financial Institutions Development.* Even though commercial banks are the largest and most important depository institutions that serve financial markets, the development of other depository and nondepository institutions on financial markets is crucial. The level of development of financial institutions such as mutual funds, insurance companies, brokerage firms, pension funds, and other are significant indicators of financial development of economy.

2. *Financial Instruments Development.* The second group measures the level of development of various money market and capital market instruments. Developed financial markets facilitate the exchange of wide variety of financial assets such as corporate stocks and bonds, government securities, municipal bonds, commercial papers, treasury bills, banker's acceptances, and etc. The amount of diversification in financial market instruments is an important indicator of financial development of economy.

In order to examine the level of development of financial markets in Kazakstan, the comparison of its major financial indicators with countries from three different categories will be used. The categories include: 1) developed countries (Netherlands); 2) middle-income countries (Malaysia); and 3) low-income countries (Ghana). Selected countries are standardized by the population size from 15 to 20 million. It is the same as the population of Kazakstan. Domestic population is a main factor of economic growth. It is also the main source of investment capital and also the development of financial markets. The comparison of Kazakstan with three countries that represent three different groups of the world countries will give more clear picture of the financial markets development in the Republic.

**Table 1. Measurements of Financial Sector Development**

| Group of Indicators | Indicators | Phenomenon It Measures | Formula |
|---|---|---|---|
| **I. Stock market Development** | 1. Number of Companies Listed | Breadth of the market | Number of Companies Listed |
| | 2. Market Capitalization Ratio | Size of the market | Value of Listed Domestic Shares / GDP |
| | 3. Value Traded Ratio | Market liquidity relative to the size of the economy | Total Value of Domestic Shares Traded / GDP |
| | 4. Turnover Ratio | Market liquidity relative to the size of the market | Total Value of Domestic Shares Traded / Market Capitalization |
| **II. Banking Development** | 1. Financial Depth | The size of the financial sector relative to national output | Liquid Liabilities of Banks / GDP |
| | 2. Banking Loans Ratio | Role of the banking system in enterprise financing | Value of Loans to Enterprises / GDP |
| **III. Development of Financial Institutions and Instruments** | 1. Number of Commercial Banks | Level of development and diversification of financial institutions | Number of Commercial Banks |
| | 2. Number of Pension Funds | | Number of Pension Funds |
| | 3. Number of Insurance Companies | | Number of Insurance Companies |
| | 4. Number of Brokerage Firms | | Number of Brokerage Firms |
| | 5. Number of Individual Brokers | | Number of Individual Brokers |
| | 6. Types of Stock Market Instruments | Level of development and diversification of financial instruments | Types of Stock Market Instruments |
| | 7. Value of different financial instruments | | Value of different financial instruments |

# IV

# KAZAKSTAN: PAST AND PRESENT FINANCIAL SYSTEMS

## 1. The Financial System of Planned Economies

In order to examine the present situation with financial markets in Kazakstan, one should start with the analysis of the previous, planned, system of economy. In Kazakstan, like in most socialist countries, there was a system based on a single institution serving all the banking functions in the Republic. These saving banks were mere accounting agencies, passively taking in household deposits and allocating resources under the plan. Other functions of these government-based saving banks were to provide insurance services and finance housing and other households loans. Banks did not - as in market systems - allocate resources to the highest rate of return.

Furthermore, the other components of the financial system were rudimentary; in most countries non-bank financing simply did not exist. There were no such institutions as commercial banks, brokerage firms, mutual funds, insurance companies, and pension funds. Almost all of these services were provided by government saving banks. Financial system of planned economies was also instrumentally poor. It was limited to government securities distributed among households by the same saving banks.

Since the former socialist countries started transformation to market economy, the financial system inherited from the system of central planning is in a poor state. The banking system are plagued by low capital and large stocks of non-performing loans to state enterprises. Other problems were loan portfolios that are concentrated both geographically and sectorally and small branch networks for other that the savings banks. Also managers had little experience in appraising loan applications and in measuring and managing risks. Equity and bond markets are either nonexistent or extremely small and illiquid. Both the small- and large-value payment systems are incomplete and inefficient. In this environment, payments are frequently made on a cash or barter basis and firms have created extensive networks of interenterprise credits. Yet the process of transformation from central planning to a market system will place tremendous demands on the financial system.

## 2. Early Reform Steps

The first task in financial sector reform was to create a two-tier banking system, with a Central Bank and independent commercial banks. Competition was introduced in this sector by allowing enterprises, local administration, individuals, and foreigners to set up new banks, under various provisions. The large state-owned banks were split and acquired a new regional or functional specialization, while in many countries a number of new, often private banks emerged. This was not enough, however. Building a banking system on market principles required either transforming the state banks into market-based institutions by rehabilitating them, or creating a new banking system through the entry of new banks. Transition economies adopted different combinations of the rehabilitation and the new entry approach. In Hungary and Poland, recapitalization of state banks was chosen, and extensive programs were adopted to develop such banks institutionally and to privatize them as soon as possible.

Several roles were conceivable for this new banking system: to support the stabilization program; to provide finance to the economy; and to facilitate privatization and enterprise control. However, in all countries, the development of the financial system coincided with a decline in the performance of enterprises. As a result, banks accumulated significant amounts of nonperforming loans. The role of banks in financing enterprises also declined. Many banks in Central and Eastern Europe currently limit their role to financing trade and some working capital, making small contributions to enterprises investment.

The first elements of the emerging financial markets in Kazakstan came into existence in 1991, when the Kazak SSR Decree "On Securities and Stock Exchanges," and other legislative documents were ratified. Commercial stocks and other securities were issued; fund exchanges and brokerage firms emerged. The legislative acts began the creation of financial markets in the Republic.

However, the level of financial markets development at the early stages of economic transformation in Kazakstan was not sufficient. The reason is that the development of the financial system in all transition countries started from a very weak base. At that time, such institutions were certainly useful in helping people to become familiar with the notion of a capital market, but they played a very small role and did not assist the economical transition process in the way capital markets do in the Western economies.

# V

## RECENT DEVELOPMENT OF FINANCIAL MARKETS

The main results of the study are presented in the Table 2. It shows that the present level of financial markets development in Kazakstan is not sufficient for the economy. Compared to the low-income countries' markets, such as Ghana, the Kazakstani financial system is much more sophisticated even thought it was actually created and started functioning during the last 2-3 years. However, for an economy with a population of 15-20 million, Kazakstan is far behind other middle- and high-income countries. Fast transformation of developing countries to a developed market economy requires much more investments and hence more active financial markets than of developed countries. The financial sector plays a very small role in promoting the economic development of the Republic.

**Number of Listed Domestic Companies** participating in markets is very low in Kazakstan compared to Netherlands and Malaysia. It is due to the underdevelopment of non-bank institutions in the Republic. Privatization Investment Funds, pension funds, and insurance companies are in the very early stages of their development and do not participate or play a very small role on financial markets. This issue will be discussed in more details in the last part of this chapter.

**Market Capitalization Ratio** reflects the size of financial markets in four countries. Malaysia has the largest market due to the need of large investment for the fast economic development. Kazakstani markets are more than 7 times smaller than that of Netherlands and almost 21 times smaller than Malaysian markets! It is due first of all to the late creation of the market-based financial system in the Republic and its slow development.

**Table 2. Comparison of Main Financial Market Indicators: Kazakstan, Netherlands, Malaysia, Ghana (1995 and 1996-1997)**

| *Indicator* | *Kazakstan (1996-1997)* | *Netherlands (1995)* | *Malaysia (1995)* | *Ghana (1995)* |
|---|---|---|---|---|
| **Population (million)** | 16.6 | 15.5 | 20.0 | 17.1 |
| **Listed Domestic Companies** | 95 | 387 | 529 | 19 |
| **Market Capitalization Ratio (% of GDP)** | 12.5 | 90.0 | 261.1 | 1.1 |
| **Value Traded Ratio (% of GDP)** | 17.1* | 62.8 | 90.0 | 0.3 |
| **Turnover Ratio (% of capitalization)** | 70.2* | 77.7 | 36.4 | 1.2 |
| **Financial Depth (% of GDP)** | 19.0 | 6.6 | 6.1 | 9.1 |
| **Banking Loans Ratio (% of GDP)** | 7.1 | 98.6 | 129.5 | 5.2 |

* Includes value of domestic shares traded on KSE and CASE only. Data on IKSE is not available.

*Source:* National Statistics Agency, 1997a; Centre for Economic Reform, 1997; International Financial Corporation, 1997; World Bank, 1997, 1997a

**Value Traded Ratio** and **Turnover Ratio** measure liquidity of markets. These indicators also complement the market size measurer - Market Capitalization Ratio - since markets may be small (compared with the whole economy) but liquid. However, it is not the case with the Kazakstani financial sector. Financial markets in the Republic are illiquid. They are far behind Netherlands' and Malaysia's markets.

In contrast, the indicator of **Financial Depth** in Kazakstan is relatively high compared to Netherlands and Malaysia: 19.0 percent versus 6.6 percent in Netherlands and 6.1 percent in Malaysia. Since Financial Depth includes one of the broadest definitions of money, M2, the possible explanation is the higher inflation rate in the Republic. The indicator measures potential resources of the whole economy. However, it does not fully reflect the role of the financial sector in the economy. Banking Loans Ratio is more accurate indicator of the financial system's role in the economy.

**Banking Loans Ratio** shows that the financial sector, particularly the banking system, in Kazakstan is sufficient. Credit issued by commercial banks (as opposed to credit issued by the central bank) to enterprises (as opposed to credit issued to the government) is very small compared to the economy's size. Even the banking system, which is the main part of the financial sector in the Republic, is unable to provide the developing economy with sufficient capital investments. The Banking Loan Ratio for Kazakstan is a little bit greater than that of Ghana, and in 14 and 18 times smaller than that of Netherlands and Malaysia respectively.

The following parts of this chapter will give a more detailed examination of stock market development, banking sector development, and development of financial institutions and instruments in Kazakstan.

## 1. Stock Markets Development

Today, Kazakstan's financial markets are represented by the Central Asian Stock Exchange, the Kazakstan Stock Exchange, the International Kazakstan Stock Exchange, and their branches over the Republic. The central organ of the government regulation of financial markets in Kazakstan is the National Commission of the Republic of Kazakstan on Securities. The main functions of the National Commission are: Control of financial markets participants' law- abidance, legislative regulation of financial markets, preparation of professionals on financial markets, and information services. The National Bank, the Ministry of Finance, the Ministry of Economy, the State Committee for Management of State Property, and the State Committee for Privatization of the Republic of Kazakstan are also connected with regulating the securities market in the Republic.

**Central Asian Stock Exchange (CASE)** was created as a closed Joint Stock Company with charter capital of 4 million Tenge equal to 200 shares with a book value of 20,000 Tenge per share. The CASE was established by two organizations: C. A. Securities (former Almaty Stock Exchange) and Central Asian Depository System "Altyn-Kazna" (former Kazakstan Stock Exchange), in December 14, 1995. The operational model of the Central Asian Stock Exchange has been chosen to use modern securities trade mechanisms taking into account current economic conditions in the Republic. The CASE uses the method of direct contact of buyers and sellers or the so called "voice method" when all purchase and sale offers are announced and written down on the blackboard. This is the most simple, effective and adequate method for the Exchange at this level of development.

There were 35 registered brokerage firms working on the Central Asian Stock Exchange in 1995. As of July 30, 1996, the shares of CASE are distributed among 44 companies. Of them, 16 members are permitted to participate in the bidding that have CASE licenses. Members of CASE are presented by banks and companies which actively function in the securities market. The list of members also includes foreign companies from Australia, Germany, USA, Turkey, and Russia.

In 1995, everyday exchange turnover was 4.416 billion Tenge or 70,668 U.S. dollars. The Central Asian Stock Exchange is a member of International Federation of Eurasian Stock Exchanges (FEAS) which has been established to cooperate and to exchange experience of its members in the Eurasian region. The CASE also has constant contacts with such foreign stock exchanges of New-York, Istanbul, Bombay, Budapest, Moscow, Tashkent, and Kyrgyzstan. There are strong business relationships with the investors of the Central Asian Stock Exchange, for example with Global Securities, Pictet, Framlington, Fleming, Lucky Gold, and Star.

CASE has developed internal legal documents "Rules of Exchange Bidding", "Regulation on Listing of Securities at the Central Asian Stock Exchange", "Interim Regulation on Bidding for Shares of Pre-listing Companies at the Central Asian Stock Exchange", "Code of Standard of the Stock Exchange" approved by the NSC. By now, CASE has developed "Exchange Regulations" which gathers together all legal stock exchange documents.

The second largest equity market in the Republic, the **International Kazakstan Stock Exchange (IKSE)**, was also created as a closed Joint Stock Company with charter capital of 3,800,000 Tenge. IKSE received license of the National Securities Commission (NSC) to carry out exchange activity in the securities market on August 1, 1996. A general shareholders' meeting is the main governing body of IKSE, the Exchange Council is the supervisory body, the Revision Commission - the monitoring body, and the Management - the executive body. In this activity, IKSE is based on the

Foundation Agreement and Charter of the Stock Exchange. Members of IKSE are individuals (dealer) and legal entities (brokerage firm) which (who):

- are owners of broker place at IKSE (broker place at IKSE costs 200,000 Tenge);
- have license of the NSC to conduct broker / dealer activity in the securities market according to the Law;
- recognize and observe the Charter, Rules of exchange bidding, Code of exchange standards, and other provisions of IKSE;
- are permitted to participate in the bidding process of IKSE

Overall, by early 1997, 95 companies had a formal broker-dealer license granted by National Securities Commission (NSC) - 21 of these were banks whose activities are limited to government securities and have a possibility to act as corporate securities custodians for their clients, provided that they have a special license to do so given by the NSC. Capital requirements used to be very low - the equivalent of only 15,000 U.S. dollars - and were raised drastically to 130,000 U.S. dollars in December 1996. Broker-dealers had until April 15, 1997 either to raise their capital, merge with others or have their license revoked. In May 4, licenses were revoked and 52 firms were suspended for one month, so a major consolidation of the broker-dealer community has already taken place. Currently, there are only 14 non-banking broker-dealers with a valid license, and only 4 of them have a first category license which allows them to act as a nominee owner for their clients. The NSC has also repeatedly stated that minimum capital requirements for broker-dealers would be increased in the near future. On June 27, 1997 the Commission defined minimum requirements to be the equivalent of 250,000 U.S. dollars.

## 2. Banking Development

The banking system of the Republic of Kazakstan consists of two levels: the National Bank of the Republic of Kazakstan, which carries out functions of the central bank of the country, and as of 995, 130 second-tier commercial banks. Only 48 of these institutions received licenses for foreign currency banking transactions, and only 37 have general licenses. The actual charter capital amounts to 133.3 million U.S. dollars, i.e. average of 1 million per bank, which is a very small amount under international standards. The smallest banks possess charter capital of Tenge 1 million (16.6 thousand U.S. dollars), the largest -over Tenge 150 million (2 million U.S. dollars). In the late 1995, only three banks in the Republic (Exin Bank, KRAMDS Bank, and ABN AMRO Bank) had charter capital of over 10 million U.S. dollars, and 2 banks (Alem Bank and Turan Bank) had charter capital between 5 and 10 million U.S. dollars. In September 1997, the Board of the National Bank has issued a resolution on the revocation of licenses of 7 banks for non-compliance with the NBK regulations. These are Interinvest Bank, Turkestanbank, Akzholbank, Alaubank, Altynbank, Erminbank and BSB Bank. This year only 2-3 larger banks would qualify for listing A status and in the spring of 1998 they could be joined by another 10-15 companies and banks.

During the 1995-1996, the process of reduction of the number of banks has become evident. The number of banks was reduced by 32 percent - from 191 to 130 between 1995-96. This reduction is more evident with regard to private banks (their number reduced by 42 percent from 56 to 32), and commercial banks (their number reduced from 16 in September 1994 to 1 in November 1995). The number of joint-stock banks reduced by 21 percent.

The process of banks reduction continues. As of September 1, 1997, there are 98 commercial banks in the Republic. Some of them will be closed down and the rest will be transferred into crediting partnerships by the end of the current year. National Bank precut the policy of the banking system consolidation. Kazakstani small banks would be merged with the larger ones by the middle of 1998. The number of the national level banks which have affiliates and work in international financial markets are expected to total approximately 8 in 1998. Only about 60 commercial banks will be operating in Kazakstan next year.

As of the same date, the individual deposits and contributions of legal entities in the second-level banks grew by 5.6 percent against July and reached a total of T83.50b. As of September 12, 1997, twelve representative offices of international financial organizations and foreign banks were opened in Kazakstan.

Despite this complex process within the banking system of the Republic, the role of banks as major financial institutions in Kazakstani financial markets is increasing. Kazakstan has adopted new wording for the law "On Banks and Banking Activities". From now on, Kazakstani banks will, apart from their "major responsibilities", be allowed to contribute to the authorized capital of other banks, non-state pension funds, fund management companies, investment funds, insurance companies, leasing organizations, and legal entities which have shares listed on stock exchanges. They will also be allowed to contribute to the authorized capital of professional players in securities markets and to the authorized capital of legal entities when pledged securities thereof become assets of the banks in accordance with relevant agreements. Plus, Kazakstani banks will be permitted to take over trust management share packages and shares in the authorized capital of legal entities. Lastly, the banks will be allowed to effectuate activities for managing assets of insolvent debtors in bankruptcy procedures.

As of September 15, 1997, the National Bank's Board regulation established a required reserve of the National Bank of Kazakstan at the annual level of 19 percent. In addition in its regulation the National Bank of Kazakstan set a lombard commission rate at the annual level of 17.5 percent and an overnight commission rate - at the annual level of 16 percent both of which took effect from September 16, 1997.

## Development of Financial Institutions and Instruments

Overall, there are over 2000 persons who have passed a qualification test and were licensed by the NSC to work in these financial intermediaries. Additionally, the NSC is now demanding that broker-dealer activities be the exclusive type of operations of a licensed company and could not be combined with any other types of business activities as was the case in the past. There are also several applications from foreign brokers to establish subsidiaries in Kazakstan and to buy seats at the stock exchange. It is realistic to assume that in the near future there will be three major groups of broker-dealers: those that are owned or affiliated with local banks; foreign-owned subsidiaries or joint ventures; and independent brokers not affiliated with banks or foreigners. Competition among these groups would be beneficial for market development and would drive costs to their clients down.

As for mass privatization - all the population received coupons (or vouchers, which were not a security under the law and could be invested only in PIFs), 170 privatization investment funds (PIFs) were created, 67 percent of population invested their coupons in PIFs of their choice, 21 coupon auctions were held, and shares of more than 1,700 enterprises were acquired by these funds. No PIF, though, managed to register its prospectus of emission mainly due to the fact that none of them could convene a general shareholders meeting, as proxy voting rights were not properly specified in the legislation and the presence of some legal inconsistencies. Hence, the initial idea of the privatization program will be that PIFs should register as joint-stock companies and issue their own shares to distribute them among the population in exchange for previously collected coupons, so people could receive regular securities which could be freely and legally disposed of. However, this has not yet come to pass.

In order to speed up the PIF transformation process, several legislative acts were prepared. Among them are draft amendments into the Presidential Decree "On reform Business Entities." This simplified procedures for a general shareholders meeting for PIFs, and a Law "On Investment Funds" adopted in early March which envisages open-end (mutual funds) and closed-end investment funds (called in that law investment companies) to be established. The idea is to turn PIFs into investment companies and allow them to hold a majority stock in enterprises they invest in (previously they were allowed to possess only up to 31 percent of any enterprise) so a restructure of these enterprises can be made. Mutual funds would be portfolio investors oriented and allowed to hold not more than 15 percent of stock of any enterprise. It is difficult to assume, that any PIF would turn itself into a mutual fund as they do not have enough liquidity to redeem the shares if most of their shareholders would prefer to exit. Most of the experts believe that more than 70 percent of shareholders would prefer to liquidate their holdings and get cash as soon as possible. This is because people could not sell their coupons as they are not considered a security; besides, they were not getting any dividends from PIFs in the past few years. When they get shares in investments funds which would be liquid even at very low prices most of the low- and medium income earners would sell them.

After the population receives shares from properly registered investment companies in exchange for their coupons invested into PIFs that would provide for proper connection between mass privatization and corporate securities market development. That would also bring more confidence and, eventually, money of the population to the stock market. Now there is a widespread distrust because of uncertainty with PIFs for the last three years, and because of several pyramid schemes which were developed and subsequently failed in 1994.

Another major development which could greatly influence the stock and bond markets' development is a proposed pension system reform. A concept of this reform was published in March 1997 and contains a plan to start a multi-pillar system in January 1998. The plan is based on a 1994 World Bank proposal which drew heavily from the Chilean pension system reform started in 1981. A revised concept was published in May and by early June, Parliament adopted a package of laws developed to implement the reform.

The existing state-run "pay-as-you-go", or solidarity system continued to experience serious difficulties as non-compliance grew along with privatization. As in other countries, compliance of the informal sector of the economy in Kazakstan is extremely low. So, by the end of 1996 debts of employers (who pay 25.5 percent of wages to the state pension fund) accumulated to KZT 40 billion and the state pension fund was delaying payments for about KZT 9 billion. In spring 1997, appears of the state pension fund rose to KZT 30 billion.

In June 1996, the Parliament passed the Decree "On Voluntary Non-State Pension Funds" which created a legal basis for private pension fund operations, with the National Bank of the Republic of Kazakstan being the regulatory body. In October, the NBRK adopted several regulations on licensing and regulating private pension funds and their investments. In these documents two types of pension funds are anticipated - corporate (for employees of corporations only) and open (which would be catering to other companies). So far, their investments are limited to government securities, bank deposits and bonds of international financial institutions. However, upon the proper establishment of the corporate securities market, the funds would be allowed to invest in corporate shares and bonds of Kazakstan's "blue chip" companies. Eventually, this purely voluntary system was considered inadequate and a new concept was developed.

According to the new legislation which has already been adopted by Parliament, private pension funds will receive mandatory contributions. At the same time, they will act as accumulation vehicles only, and they are required to invest through professional asset managers, whose activities are to be licensed and regulated by the National Securities Commission. Some estimates show that within three years private pension funds could be able to invest up to 500 million U.S. dollars annually into corporate securities. This could provide for both investments, which are needed by enterprises, and create a group of local institutional investors which the market is lacking now. It is anticipated by the NSC that pension assets in corporate shares of listing A companies and up to 10 percent - in corporate bonds of listing B companies. But the bulk of their assets - a minimum 50 percent - in the initial period would be invested in government securities. Along with the development of other segments of financial system - municipal bonds, mortgage-backed securities, and etc. These investment regulations will be amended to accommodate more diversification.

# VIII

## CONCLUSIONS AND RECOMMENDATIONS

Kazakstani financial markets were found to be underdeveloped in the present time. The financial sector does not meet the requirements of the economy for large capital investments. It does not serve its main functions as financial systems in market-based developed and middle-income developing countries do.

There are several reasons for this major underdevelopment of financial markets in Kazakstan, most important being lack of proper legal and institutional infrastructure and of a well established connection between mass and case-by-case privatization, pension and insurance reform, on one hand, and securities market development, on the other. Hence, implementing projects of privatization, pension reform, and creation of an insurance system in Kazakstan, the government and the central bank should take into account both social consequences (how the reform would affect the population, especially the poor and middle class) and economic aspects. Economic aspects include such considerations as if new institutions serve their functions and do they have positive impact on financial market development.

A serious problem in attracting investments to Kazakstani capital markets is the lack of positive interaction between stock exchanges, depositories, registrars, and other capital market structural junctions. In order to resolve the problem, Kazakstani capital markets need, first, to introduce modern computer technologies and telecommunication systems, and second, to create a wide network of capital market affiliates throughout the whole Republic.

A very important issue is the public participation in financial sector reform. Households are the main source of capital investments in a market-based economy.

However, Kazakstanis are very inactive in investing their money in securities and even holding this money in banking institutions. Two of the reasons why Kazakstani citizens do not hurry to invest their money in capital markets, is a lack of reliable information about suggested stock values and the population's mistrust of Kazakstani financial institutions. Hence, the population's participation is another sphere in which the government should place some efforts.

Today, many financial institutions such as pension funds, insurance companies, and Privatization Investment Funds (PIFs) are on their first stages of development. At later stages, local private pension funds and insurance companies could start playing a major role as institutional investors. There should also be much more attention to the development of various financial instruments such as corporate securities, municipal bonds, futures contracts, and etc. Wider diversity of financial instruments and institutions would provide capital investment to different spheres of the Republic including the social sphere, and also secure household investments.

The author believes that greater attention to the development of the financial sector, specifically to the issues discussed above, would promote faster transformation of the Kazakstani national economy to a market economy and sustainable economic growth.

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