

Creating Markets in Kazakhstan

Country Private Sector Diagnostic



November 2017



This report was prepared in consultation with government officials and the private sector in Kazakhstan. Further consultations will be held with the private sector and government officials before the finalization of the report.

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Abbreviations

| | |
|------|---|
| CPSD | Country Private Sector Diagnostic |
| EU | European Union |
| IBRD | International Bank for Reconstruction and Development |
| IFC | International Finance Corporation |
| PEP | politically exposed persons |
| PPP | public-private partnership |
| SCD | Systematic Country Diagnostic |
| SOE | state-owned enterprise |
| TEU | twenty-foot equivalent unit |
| WBG | World Bank Group |
| WTO | World Trade Organization |

| | |
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Executive Summary

This report—one of two pilot assessments—presents the results of a joint International Finance Corporation (IFC)-World Bank diagnostic of the private sector in Kazakhstan. The objective is to identify those sectors where there is potential to create markets and have a development impact.

Objectives and structure of the report

The diagnostic report has four sections: basic approach, sector selection, sector analysis, and operational implications.

Basic approach. The first section identifies the overlaps between Kazakhstan's development objectives and the goals of IFC's new strategy of creating markets for the private sector. Kazakhstan's development objectives are to increase diversification, employment, and productivity. These are based on the government's 2030 Strategy and 2020 Plan, as well as World Bank Group (WBG) country assessments. Operationalizing the IFC 3.0 strategy requires identifying the markets with the greatest potential to help meet these objectives. The approach amounts to: (a) identifying those sectors with the greatest market potential which, if realized, would have the greatest impact on development objectives; (b) providing an assessment of what is preventing the realization of market potential; and (c) indicating the IFC and WB activities that should be the top priorities to help meet this double bottom-line of development impact and market creation.

Sector selection. The assessment in the second section indicates that the sectors with the greatest unrealized development and market potential are food-grains, meat and poultry, and cross-Kazakhstan transport and logistics. The market potential assessment relies on quantitative tools (multiplier models, product space and competitiveness benchmarking), expert interviews and a survey of policy reports.

Sector analysis. For each of these three sectors, the third section identifies the market potential, critical investments and policy reforms, and key market players. "Deep dives" for grains, meat, and transport provide estimates of current and potential market size by subsector (for example, beef, sheep, and chicken for the meat sector). Based on analysis by industry experts, they provide the key elements of a sector strategy for each of these three priority sectors. Finally, the sector analysis includes a cataloguing of the key players that could be interested in investing, and identification of institutional reforms and infrastructure gaps that affect the private sector.

Operational implications: The last section summarizes the priority horizontal reforms, sector-specific policies, and promising sectors with the potential for expansion and greater firm entry. The first part of this section is intended to inform the high-level dialogue between WBG management and Kazakhstani authorities. The second part is essentially the sector-wide measures without which private sector investments will not be forthcoming, recognizing that the aim is to create markets and expand private sector development. The third part identifies promising areas where private sector actors could play a catalytic role, recognizing the ease of playing such roles differs by sector: it is greatest for grains, somewhat less for meat, and least for transport and logistics.

The center of the New Silk Road

Kazakhstan is at the center of the New Silk Road linking Asia to Europe. Three economic blocks will shape the global economy in the foreseeable future: North America, Asia, and Europe. Of the global GDP of US\$75 trillion, Europe's GDP is about US\$20 trillion and Asia's is close to US\$30 trillion. Kazakhstan sits

between Europe and Asia; indeed, Khorgos, the China-Kazakhstan border post, where containers are reloaded to continue their journey to Western Europe, is the symbolic transit point between Asia and Europe. The middle classes of East and South Asia are also expanding, and the demand for consumer goods is rising. Suddenly, Kazakhstan finds itself at the center of a part of the world that commands close to two-thirds of global GDP. It can become a key part of the New Silk Road that will facilitate economic relations between Asia and Europe, and within Asia itself. The big question now is how best to realize this potential.

Reaching high-income status will require a robust private sector to exploit this opportunity. Kazakhstan, an upper-middle-income economy, can reach high-income levels soon if it leverages its geo-economic position and rebalances its economy. With a GDP per capita of just over US\$7,500 (2016, nominal), Kazakhstan can reach high-income status within six years if it gets back to previous growth rates of 7 percent. However, the past development strategy based simply on exploiting natural resources will not be sufficient. Kazakhstan needs to find new sources of economic growth and reform the fundamental pillars of its current economic model. One of the major reform areas is Kazakhstan's financial sector, which is a source both of growth and vulnerability. Based on the experience of successful countries, Kazakhstan will only reach high-income status if it both unleashes and leverages foreign and domestic private sector resources.

Private financing of development increases magnitudes from millions to billions. Traditional government-led development finance will not have the capacity to provide the resources for Kazakhstan to reach advanced levels of development. As in other parts of Asia, it will need to be the private sector—aided by smart government policies and selective public investments—that leads Kazakhstan to high-income status. Development financing, however, can be helpful in supporting the creation of markets through the combination of knowledge, lending and selected private sector investments. If this is done well, millions of dollars of development financing could be used to mobilize billions of dollars of private sector investment.

China's rebalancing is an opportunity for Kazakhstan to rebalance its own economy. China's economy has been powered by manufactured exports, while domestic consumption has been weak. In Kazakhstan, it is just the opposite. As the Chinese economy is gradually reoriented towards domestic demand and its rapidly growing middle class (estimated to reach 1.0 billion by 2025), Kazakhstan could become an important part of China's breadbasket—in ways similar to Canada's economic position vis-à-vis the United States. Instead of one-way trade from China to and through Kazakhstan, the economic rebalancing in both Europe and Asia will create great opportunities for two-way trade. But to benefit most from trade with China and other economies, Kazakhstan will need to fundamentally reform key non-extractive sectors, especially agriculture, husbandry, and transport. The government recognizes this imperative. Kazakhstan's strategic plan emphasizes a diversified and competitive economy, powered by an educated and engaged citizenry. This will require a rapid increase in productivity, a vibrant labor market that generates jobs, and rapid growth in non-primary activities.

A revival in land transport will make Kazakhstan the natural transit corridor of the New Silk Road. The future of economic progress will depend on both efficiency and speed. Therefore, sea transport will likely see more moderate growth than other faster modes of transport, while air transport will remain too expensive for most goods. Kazakhstan can benefit because the greatest efficiency gains will be made in road and rail transport, where the average transport time for one container is still 14 days from China to Western Europe. There is considerable scope to cut costs and reduce the time for both rail and road transport to below one week. New technologies, including driverless trucks, will transform transport and

logistics in a coming transportation revolution, as it becomes easier to consolidate and deliver goods, and to operate vehicles 24 hours a day. Kazakhstan's success in taking advantage of its position will depend on its success in attracting foreign direct investment to develop modern transport and logistics.

Selecting target sectors – Where is the greatest potential?

This report identifies private sector activities in Kazakhstan that have the greatest development potential. For this diagnostic, we looked at several datasets and conducted a wide range of interviews inside and outside the WBG. There are three main data sources:

- **Macroeconomic and demographic trends.** This analysis includes a review of Kazakhstan's economic position, especially vis-à-vis its neighbors, and a review of its economic vulnerabilities, including the financial sector. For this diagnostic, the team has also been able to produce a forecast of China's rising middle class and simulated the impact of a shift of containerized shipments to overland transport.
- **Microeconomic assessment.** Building on an input-output multiplier model and a constraint benchmarking tool, this diagnostic maps Kazakhstan's sectors in terms of their growth and employment impact.
- **Interviews with key stakeholders** (IFC industry team, government, investors, and firms). These interviews include a structured questionnaire with IFC staff to validate the quantitative assessments and provide additional insights into the constraints preventing the opening of some of the key sectors.

In each of these assessments, tradable sectors came out on top, especially agriprocessing, and transport and logistics. In addition, service sectors, especially ICT, health and education could warrant additional deep dives. Building on IFC industry advice and given Kazakhstan's vast agricultural potential, the team chose to separate wheat (which dominates the grain sector) and livestock. While connected, and sharing common traits, these two subsectors are also in different positions in terms of investment readiness and development impact.

The reasons for selecting wheat. Kazakhstan is one of the major wheat producers in the world, but productivity levels are extremely low. Wheat is a staple consumed by all segments of society, rich and poor alike. Growing middle-class consumption across Asia, especially in China, will drive up demand for wheat. To tap into these new markets Kazakhstan will need to improve its export competitiveness to boost exports. There is scope to increase productivity by over 100 percent. Given that wheat is already one of the leading non-oil and gas exports, expanding wheat exports into new markets such as China would also substantially diversify the economy. Furthermore, Kazakhstan also has the option of using its more competitive wheat produce to provide feed for the domestic livestock sector.

The reasons for selecting livestock. As the size of the middle class in China and South Asia continues to grow rapidly, demand for more expensive meat products will expand. With vast expanses of rangeland, availability of feed (including wheat), low production costs and close proximity to potential markets, Kazakhstan is well-positioned to expand its livestock exports and livestock food-processing industry. This provides Kazakhstan with an opportunity to diversify its exports and create employment by feeding into national or regional value chains and tapping into higher-quality value chains. However, making the most of regional value chains will require reforms if the full potential of transport and logistics is to be unleashed.

The reasons for selecting transport and logistics. Kazakhstan is a natural transit corridor for the New Silk Road, and rail and road transport will see a revival due to the westward shift of production in China away

from the more expensive east of the country. Currently, Kazakhstan is only scratching the surface of the potential in China-EU containerized trade, with just 1 percent of the total transiting the country. With reform of the sector, technological innovations (for example, semi-autonomous vehicles) could dramatically reduce transport time and costs, making the option of transiting through Kazakhstan far more attractive. Reform will also open new opportunities for increased trade with The Islamic Republic of Iran and the Middle East, and the rapidly growing countries of South Asia. Greater speed in logistics will unlock opportunities for Kazakhstan's agriculture sector—including wheat and perishable livestock—to grow rapidly. More efficient trade will translate into greater competitiveness in wheat and livestock, while scale economies will create new demand for more sophisticated transport and logistics services, and related professional services such as financial, legal and accounting services.

Why have these sectors not developed enough?

There are three levels of issues that will need to be addressed in order to create new markets in the three “deep-dive” sectors. First, there are countrywide issues, principally the poor business climate for the private sector as a result of the stifling dominance of state-owned enterprises (SOEs). These deter investment, undermine corporate governance and render cross-border trade inefficient and costly.

Second, Kazakhstan faces a number of sector-specific constraints to successful market expansion. In the wheat sector, large financially distressed incumbents, often SOEs, and the involvement of a high number of politically exposed persons (PEP), deter investment and result in extremely low productivity. There has also been an over-reliance on a few markets, at the expense of diversifying into far larger potential markets, such as China and India. In the livestock sector there are thousands of small-scale family producers and, as a result of lack of technology transfer and investment, large uncaptured economies of scale. In addition, there are major gaps in upstream value chains, making it hard to meet quality standards. Inefficient transport and logistics infrastructure limits access to regional markets. In addition to poor infrastructure, transport and logistics suffer from insufficient economies of scale partly due to low demand. The high number of procedures required for cross-border trade keeps Kazakhstan from becoming the transit route of preference.

Third, the difficulties of tapping into economies of scale affect all three sectors. The constraints and disincentives to growth and investment hinder the achievement of a necessary minimum size to drive further efficiencies and improve competitiveness.




What would it take to realize the development potential of these sectors?

In addition to the economy-wide or horizontal reforms that will be needed, sector-specific or vertical reforms are necessary. In the wheat sector, corporate restructuring and subsidy reform will be necessary to attract private investment and usher in badly needed efficiencies and productivity improvements. Improved transport and logistics, and market access through trade facilitation measures will be required to increase the competitiveness of Kazakhstan's enterprises in order to penetrate these new markets and value chains.

In the livestock sector, for Kazakhstan to become a successful regional player the country will need to invest in quality improvements, such as testing and monitoring, to meet international quality and phytosanitary standards. As with wheat, the livestock sector will require improved market access, through better transport and logistics, streamlined procedures and other measures to facilitate trade.

In the transport and logistics sector, investment in state-of-the-art risk management systems and an integrated IT backbone will be essential to reduce costs and speed up the movement of goods. The upgrading of rail and road networks, and the introduction of seamless multimodal connectivity will also be necessary if Kazakhstan is to compete not only in the two sectors above, but more generally position itself as a viable and logical transit route between China and Western Europe. This will require liberalization of market access for advanced players in intermodal logistics operations.

Table ES. 1: Kazakhstan Private Sector Diagnostics – Opportunities, Constraints, Reforms

| | What is the opportunity? | Why hasn't the sector developed? | What would it take? |
|--|--|---|---|
|  Transport & Logistics | <ul style="list-style-type: none"> • OROB initiative with major investments in transport • Superiority of land-transport: faster than sea, lower cost than air (even more so with driverless advances) | <ul style="list-style-type: none"> • Insufficient scale, partly due to weak sectoral performance (low demand) • High number of formalities for trade across borders | <ul style="list-style-type: none"> • State-of-the-art risk management and an integrated IT backbone • Upgrading of rail and road networks, and multimodal connectivity • Liberalization of the market access for intermodal operations |
|  Wheat | <ul style="list-style-type: none"> • Capture growing regional demand (South Asia, China, Iran) • Drive a more competitive meat sector | <ul style="list-style-type: none"> • Distressed incumbents and PEP issues • Low productivity • Weak position in major markets | <ul style="list-style-type: none"> • Corporate restructuring and subsidy reform • Improved transport logistics and market access |
|  Livestock | <ul style="list-style-type: none"> • Rapidly growing demand in China with links to Xinjiang • Low cost of production in land, labor, feed • Growing processing, retail, <u>distr</u> industries | <ul style="list-style-type: none"> • Lots of small-scale production serving local markets; limited aggregators to drive investment and quality • Cold climate and high transport & logistics increase costs | <ul style="list-style-type: none"> • Invest in quality standards, testing, infra, etc. • Improved transport logistics and market access • FDI for tech transfer at critical VC steps |

The three target sectors are interlinked and offer significant synergies with each other. Opening the wheat sector will boost total exports and provide feed for the livestock sector, making it more competitive. A more competitive livestock sector will boost primary exports to China, as well as driving downstream agriprocessing development, with strong potential to develop high-value regional value chains. Transport and logistics has great potential both as a sector in itself offering fast and cheap transit services, but it can also drive improvements in competitiveness in all other sectors, particularly in wheat and livestock, supporting both these sectors to develop strong value chains.

Kazakhstan can rekindle high economic growth rates and achieve its development ambitions. The assessment of this report is that this can be achieved most effectively by unleashing and aiding market forces in three sectors—wheat, livestock, and transport and logistics. Given its central and strategic position between China and Western Europe, and the untapped potential of several of its sectors, Kazakhstan is ideally placed to rebalance and grow its economy as global growth starts to pick up. Investments in these three sectors promise both private profits and the highest development dividends—more jobs, productivity gains and economic stability.

1. Context and Objectives

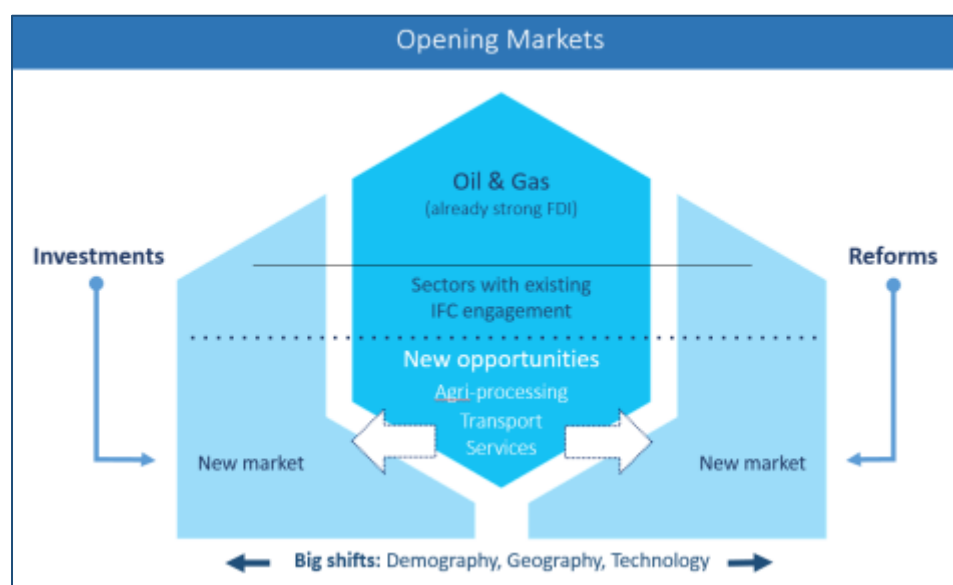
A Private Sector Diagnostic

Developing countries will only grow wealthy and prosperous if their private sectors are allowed to thrive. New opportunities are now arising to **create markets** that are being reshaped by major demographic, technological and economic shifts. IFC 3.0 responds to this new global context by investing in private sector solutions with the aim of creating markets and achieving greater development impact. This **Private Sector Diagnostic** represents a first pilot study to analyze the main opportunities in creating new markets, and the constraints to doing so, in the context of Kazakhstan.

The diagnostic starts with a brief assessment of private sector performance in Kazakhstan, viewed through the lens of economy-wide and factor-market constraints. Building on this country-wide assessment, a sector scan identifies opportunities for IFC to open key sectors, setting the stage for more targeted and in-depth analysis of selected subsectors. These sector “deep dives” are structured towards specific and actionable recommendations to further the market creation agenda by resolving key binding constraints.

Ultimately, the diagnostic aims to identify sector-specific strategies through which IFC interventions can have the greatest development impact—recognizing that crowding in finance and supporting reforms to help open these sectors will require complementary interventions from WBG sister institutions to help remove market and/or government failures standing in the way (figure 1.1).

Figure 1.1: Opening new markets in Kazakhstan through WBG interventions

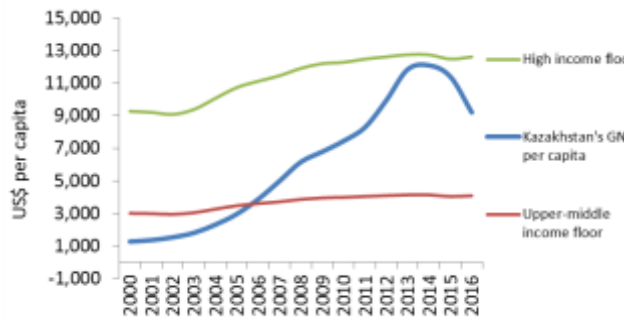


Kazakhstan: a success story, but an economy out of balance

Kazakhstan has been a development success story over the past 20 years. Since independence from the Soviet Union, its economy has grown to US\$135 billion, with a per-capita income of US\$11,000—similar

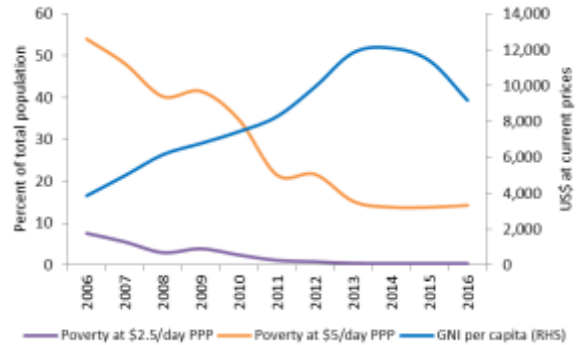
to Romania and higher than Brazil. Meanwhile, poverty incidence has fallen to a level where below 1.0 percent of the population lives on less than US\$2.50 per day in 2005 purchasing power parity (figure 1.2). Economic momentum has also led to the creation of a large middle class, which is set to rise to 18 million people by 2030 (figure 1.3).

Figure 1.2: Almost reaching high-income...



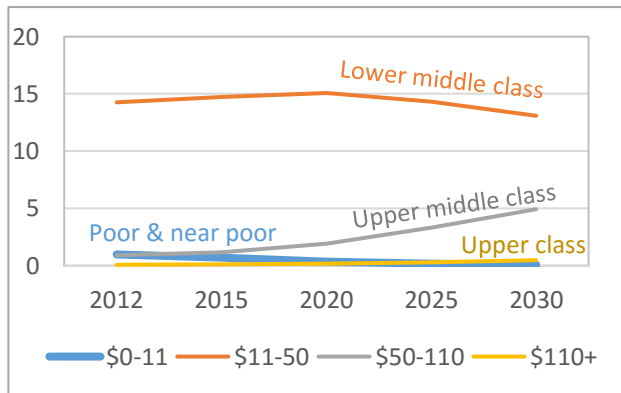
Source: World Bank staff calculations based on official data published and provided by the authorities.

Figure 1.3: ...with declining poverty...



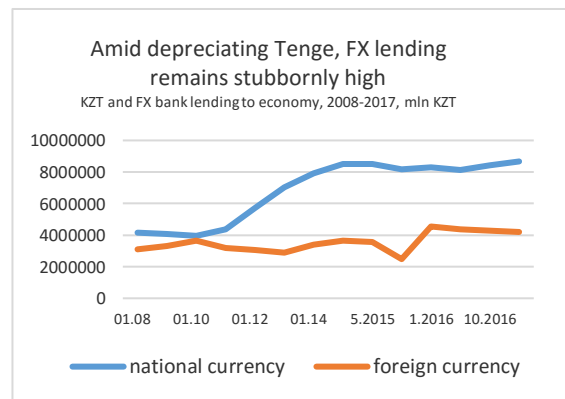
Source: World Bank staff calculations based on official data published and provided by the authorities.

Figure 1.4: ... and an expanding middle class ...



Source: Projections by the World Data Lab. World Bank, Financial Sector team.

Figure 1.5: ... but challenges in the financial sector



Source: Projections by the World Data Lab. World Bank, Financial Sector team.

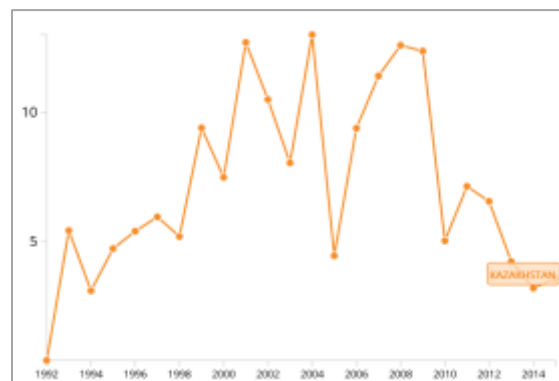
However, these achievements have been called into question because of the sharp decline in oil prices since 2015. This reversal has placed Kazakhstan’s development model under pressure. Kazakhstan’s financial sector is particularly vulnerable due to rising nonperforming loans and weak governance (see appendix B). Although Kazakhstan boasts a largely private-sector banking system, in reality the state, through fully- and quasi-state entities, is the largest depositor and borrower, and owners of the largest banks are closely related to the country’s political leadership. As a result, the problems of banking sector risk governance, ownership and the safety of bank deposits are intertwined. Since 2016, the banking sector has shown no new lending outside the government’s stimulus program and there has been a general deterioration in banking portfolio quality.

Because of the recent external shocks, the goal of reaching high-income status within the next decade is no longer a realistic option for Kazakhstan. Instead, the country risks finding itself stuck in a “middle-income trap”: too rich to compete in low-cost manufacturing and services, but not innovative enough to compete with high-income economies. Economic growth and social progress to date have been largely driven by the extractive sectors, with public investment stemming from revenues derived from high commodity prices. The economy is highly oil-dependent, with oil and gas proceeds accounting for two-thirds of total exports and one-third of fiscal revenues.

The consequences of this over-dependence on the extractive industry are as follows:

- **Vulnerability to commodity price fluctuations.** To a large extent Kazakhstan’s per-capita income gains over the past 15 years have stemmed from US dollar price effects (higher commodity prices and local currency appreciation). Similarly, FDI inflows which are critical to technology transfer and productivity gains have been highly concentrated in the oil and gas sector and as a result, inflows have fallen sharply with lower commodity prices (figure 1.6)

Figure 1.6: FDI, net inflows as a share of GDP follows commodity prices



Source: Data derived from the International Monetary Fund and the World Bank, data accessed through T&C Data 360

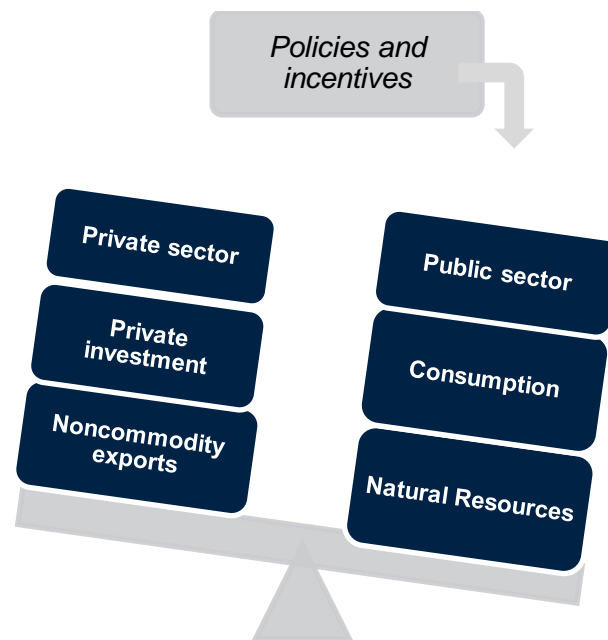
- **Little investment and low productivity outside the extractive sector** (Dutch Disease). As predicted by economic theory, local currency appreciation has skewed growth and employment generation towards the nontradable sectors, especially construction and services (exposed to pro-cyclical shocks), and dis-incentivized tradable production (that could provide counter-cyclical protection). Agriculture is a case in point: although the country has the fifth-largest area of arable land in the world, agriprocessing is currently underexploited.
- **A large state role in the economy.** The state manages most of the formal economy. The assets of the largest state conglomerate, Samruk Kazyna (SK), are estimated to be equivalent to 50 percent of GDP (even more based on some sources), while SK and its subsidiaries account for 30 percent of total employment. This has created powerful vested interests, most critically in the financial sector. As a result, financial relationships between the state budget and the state sector are opaque.
- **GDP growth is reliant on sectors that are not prone to high productivity and employment gains.** Job creation outside the state sector and in the informal economy is weak and this is an issue that is growing in importance given current demographic dynamics.

In summary, Kazakhstan's economy is out of balance and heavily tilted towards:

- **The public sector**, with large SOEs directly involved in production activities, a comprehensive welfare state and, conversely, a limited role for truly private enterprise.
- **Natural resources**, which account for a large share of GDP and exports and, conversely, an under-developed and fledgling tradable sector.
- **Domestic consumption**, with limited success in leveraging foreign demand or investment beyond natural/mineral resources exploitation.

Rebalancing the economy by growing the private sector is central to creating more sustainable growth, diversification and job creation.

Figure 1.7: An economy out of balance



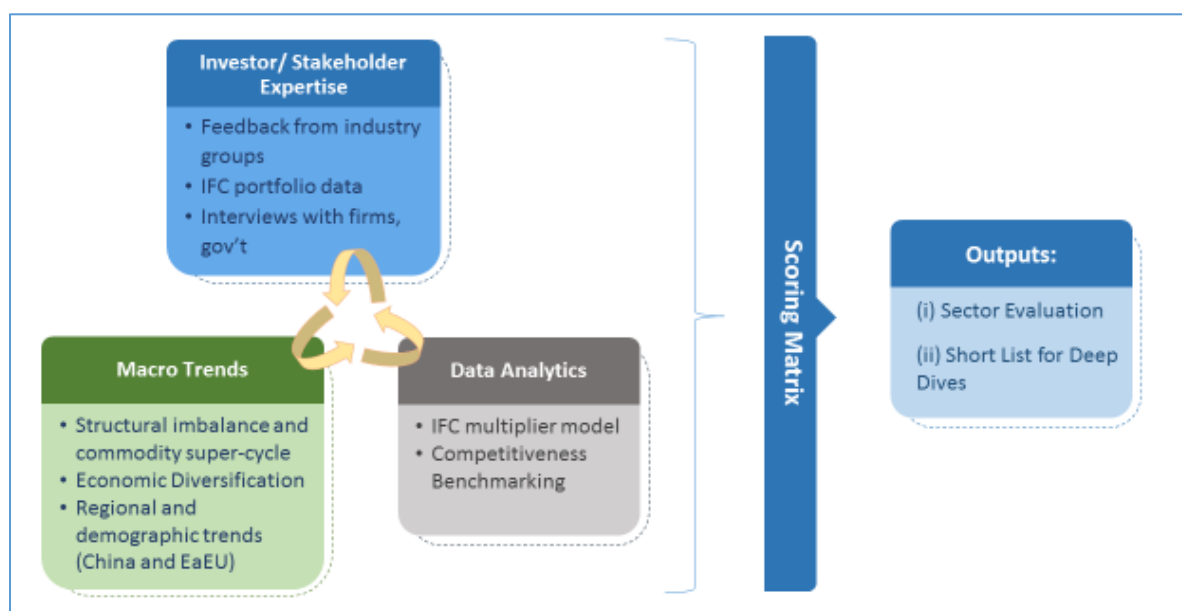
2. Sector Evaluation

Overview: how the “deep dives” were selected

In keeping with the International Finance Corporation (IFC) 3.0 agenda of creating markets, the World Bank Group’s (WBG) twin goals of eliminating extreme poverty by 2030 and boosting shared prosperity, and Kazakhstan’s development strategy, the sector scan sought to identify those sectors and subsectors that would: (i) make substantial contributions to development impact; and (ii) have the greatest potential to open markets and create opportunities for private sector solutions to emerge. The diagnostic followed a holistic and structured approach to sector selection, aggregating three different dimensions or sources of data to produce a “long list” and then arriving at the top-three sector “deep dives.”¹

Using a combination of macro trend analysis, expert consultations and quantitative tools the Kazakhstan Country Private Sector Diagnostics (CPSD) identified the following three sectors for further in-depth analysis: (i) grains—focusing on wheat as this comprises the majority of production in the grain sector, (ii) meat and poultry, and (iii) transport and logistics. These three sectors reflect those with sizeable development impact and market creation potential.

Figure 2.1: Sector scan methodology



Macro conditions and trends

The sector scan takes into consideration major shifts and trends that will influence private sector development in Kazakhstan. The issues of economic rebalancing and the emergence of China’s Belt and Road Initiative are well documented in World Bank, Organisation for Economic Co-operation and Development reports, and will shape Kazakhstan’s growth trajectory over the medium- to longer-term.

¹ Note that these sector “deep dives” are illustrative, and not necessarily an exhaustive inventory of high growth potential.

Economic diversification is a core policy and strategic objective of the government, implying strong client buy-in for pursuing sectoral reforms and policies that create opportunities for the private sector. In addition, a new trade corridor under the Belt and Road Initiative has the potential to make Central Asia truly “central” again. Kazakhstan can leverage this initiative by connecting East Asia to Europe and the Middle East overland, which would be substantially cheaper than air and far faster than sea transport. However, this will require a strong focus on transport and logistics, including trade facilitation.

China’s expected rebalancing, from investment to consumption, will have a direct and significant impact on Kazakhstan, possibly depressing the value of Kazakhstan’s natural commodities but also creating new opportunities to produce consumer goods and agricultural products. Chinese initiatives to revive a New Silk Road will generate opportunities to attract foreign direct investment and foster much deeper integration between East and West, and within the sub-region.

In view of the long-term trends in the region and new innovations, Kazakhstan will be able to benefit from, and should therefore focus on the following areas: (i) transport and logistics; and (ii) agribusiness, to meet the needs of China’s growing middle class and a rising middle class in Kazakhstan, by targeting non-oil tradable goods in general, services, and capturing spillovers from transport and logistics.

Quantitative tools

The diagnostic draws on two sets of analytical tools combined to feed into sector scores: a multiplier model and constraints benchmarking. For Kazakhstan, the team drew on these tools to underpin and refine the eventual “long list” of potential sectors. The two tools provide an evidence-based rationale for the selection of sectors for “deep dives,” help to quantify elements of market potential or development impact, and also inform the constraints analysis.

While no single model is capable of fully capturing all the nuances and complexities associated with sector selection (and sector transformation), these tools do provide a very useful ex ante filter to help in evaluating baseline assumptions in terms of which sectors might lead to better development outcomes, and how feasible these sectors would be to develop in practice. They serve a critical function in this regard.

Multiplier model

As a complement to the development impact criteria outlined above, an input-output multiplier model was used to gauge and inform the potential development impact of individual sectors in Kazakhstan. A social-accounting, matrix-based model, which feeds into the ex ante analysis of the impact of IFC investment operations, provides a static, linear picture of backward or forward links and transactions between sectors (assuming no price movements and no substitution in the factors of production). Resulting multipliers provide the structure of the economy, reflecting:

- How much a sector is buying from domestic sources;
- Profitability, an important driver that can be computed from these data, reflecting value-added per unit of output;
- The desirability side of our sectors, feeding into inclusion, jobs, and economic growth criteria; and Estimates of how changes in output for a given sector translate into GDP growth and job growth, which in turn inform the potential development impact.

In Kazakhstan, the sector with the highest employment-to-output ratio (number of jobs per US\$1 million of revenue) is the agricultural sector, comprising crops (259 jobs per US\$1 million) and animal products (169 jobs per US\$1 million). In contrast, capital-intensive industries such as textiles, oil and gas, and coal have significantly lower jobs-to-output ratios of 2.9, 1.72, and 0.63, respectively. This large difference could be partially indicative of inefficiencies in the agricultural sector and points to opportunities to shift to higher productivity and higher value-added activities in agriculture.

Note that the transport and logistics sector in Kazakhstan has one of the highest GDP multipliers, at 1.4, and compares favorably with other high value-added sectors such as health and education (59 percent of total revenue). At the lower end of the spectrum, textiles, automotive parts, and apparel have the lowest multipliers and are also among the sectors in Kazakhstan with the highest constraints (see constraints benchmarking). As a result, these sectors are not included in the long list of sectors below.

It is important to note that the current data are not indicative of the quality of jobs created, nor do they capture differences in formality, informality, and wages. However, they do give a directional sense of the differences across sectors in terms of job links and GDP links.

Constraints benchmarking

The benchmarking tool helps to identify the main factors constraining productive private investments. The tool matches horizontal indicators of potential constraints to private sector investment to country-level data on the financial success of previous IFC investment projects. This generates a heat map to help identify feasibility and reform priorities by sector. Thus, for a given sector, such as the agriculture sector, Kazakhstan is benchmarked against all countries in the world where IFC has had a positive experience in agricultural sector investment projects.

In the benchmarking charts (see the IFC's CPSD Methodology Guide) a positive number indicates that Kazakhstan is generally performing on par with other countries in which IFC has invested successfully in that sector. The size of the number indicates where Kazakhstan is positioned relative to these other countries in a sector. A negative number indicates that Kazakhstan is underperforming other countries in a sector where IFC has had successful investment projects. The number also suggests how far away Kazakhstan is from the minimum performance threshold of these other countries. Thus, a score of minus one indicates that Kazakhstan is far away from a performance level that would enable IFC to be successful in that sector. The main dimensions or indicators include:

- Market demand – domestic and/or international market potential.
- Production factors – labor and skills, geographic and natural resource endowments, existing capabilities.
- Key inputs – energy, transport, finance (that is, cost and availability).
- Institutions – regulatory barriers, rule-of-law and property rights, market contestability, macro and political stability.

For the Kazakhstan diagnostic, we weighed the feasibility indicators in favor of market demand to reflect the core selection criteria outlined above.

Expert interviews

- The CPSD team met with representatives of the private sector, business associations, and IFC investment staff based in Kazakhstan to seek input on the initial sector scan, and identify high potential subsectors suitable for following up with deep dives.
- Initial consultations were conducted between IFC investment officers, firms, development partners, and investors in the agriprocessing and the transport and logistics sectors to assess the long-term opportunities for the private sector in these areas, as well as the key constraints to investment.
- Presentations and discussions were given by the WBG and IFC offices in Kazakhstan concerning the long list of sectors, as well as potential deep-dive focus areas.

The outcome of these consultations was a consensus view on the sectors and subsectors to be considered and scored, thus providing important qualitative insights that cannot be gleaned from the data or desk reviews.

Scoring feasibility and desirability: meso sector scan results

Taken together, the data sources enable us to filter from the universe of sectors to those that hold the greatest potential for development impact and market creation in Kazakhstan, within a feasible timeframe. By aggregating the relevant macro trends, using the benchmarking and multiplier tools, distilling the insights gleaned from expert interviews, and taking stock of the key constraints in the sectors, a picture begins to emerge of the long list of 10 to 12 sectors and subsectors that warrant closer review. It is from this long list or basket of sectors or subsectors that we apply a structured-scoring methodology based on desirability (development impact) and feasibility to organize the analytical process and finally point us towards the three eventual “deep-dive” sectors that might be selected.

The team used the matrix of desirability and feasibility described in the methodology, but then customized this approach by attaching weights to the different categories of desirability (current and development impact) and feasibility. For Kazakhstan, we linked this to the client’s policy objectives as outlined in the Kazakhstan 2020 Strategic Plan, making economic diversification, employment generation, and productivity the main drivers of development impact. We assigned 65 percent weighting to the desirability indicators (inclusion and jobs, economic growth, competitiveness, and productivity) that align most closely with Kazakhstan’s strategic priorities.

The WBG’s twin goals are also encapsulated in the scoring methodology and given appropriate consideration in the scoring as well. Similarly, on the feasibility or constraints dimension, we attached 50 percent weighting to the indicator for market creation potential, and distributed the other half to the remaining 10 indicators of feasibility, reflecting the importance attached to IFC’s creating-markets agenda to underpin our review of sectors and opportunities for the private sector in Kazakhstan.

A summary of the sector scoring (figure 2.2) shows that agribusiness and transport and logistics have relatively high desirability and greater feasibility to unlock constraints to private sector investment over a three-year timeframe. Energy and ICT follow with high feasibility but slightly lower desirability. However, in these two sectors the potential to unlock constraints through short to mid-term policy reform is viewed as higher than in either transport and logistics or agribusiness making these sectors also good potentials for deep dives. Table 2.1 below provides more in-depth justification for the selection of deep dives.

Figure 2.2: Summary table of sector review results

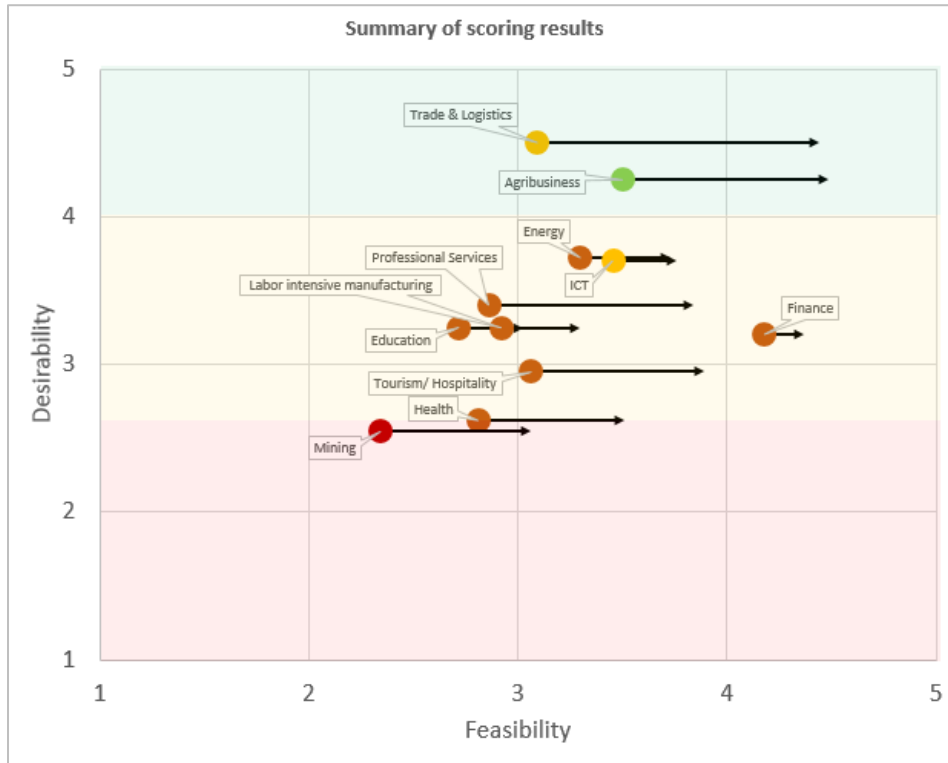


Table 2.1: Sector selection rationale

| Sector | Market potential | Development Impact |
|----------------------------------|---|---|
| Transport and Logistics | <p>Kazakhstan is the natural transit corridor for the new Silk Road; rail and road will see a revival due to westward shift of production in China. Currently, Kazakhstan underachieves: only 1 percent of total China-EU containerized trade;</p> <p>Technological breakthroughs (for example., semi-autonomous vehicles) will dramatically reduce transport time and costs; and</p> <p>New opportunities: Iran, Islamic Rep., growing South Asia.</p> | <p>Reduction in transit and transport generates new opportunities for trade, especially in agriculture (see other sector assessments); and</p> <p>Scale economies in logistics create demand for new services, especially in sectors such as finance and other professional services (legal, accounting, and so on). This is also how economic development in Singapore and Dubai started.</p> |
| Wheat | <p>Kazakhstan is one of the world’s top wheat producers but productivity is extremely low.</p> <p>Wheat is a staple for rich and poor so demand growth is elastic to demographics.</p> <p>Kazakhstan has significant upside potential for export competitiveness or to supply a competitive meat industry.</p> | <p>Diversification. Wheat is already one of the leading non oil and gas exports. Expanding in new markets (for example, China) would substantially diversify the economy.</p> <p>Productivity. Scope to increase productivity by at least 100percent.</p> |
| Livestock (beef, poultry, sheep) | <p>Demand for meat is growing rapidly as the middle class expands domestically and in regional markets, particularly western China.</p> <p>Kazakhstan has low production costs driven by large rangeland, availability of feed, and proximity to markets.</p> | <p>Diversification. Meat is currently a very small contributor to exports with significant scale to increase.</p> <p>Employment. 80 percent of production done at the household level. Potential to feed these into national or regional value chains and to increase employment throughout a higher-quality value chain.</p> |

Overview of sectors not short-listed for deep dives

Financial Sector

The economic slowdown in 2015/16, coupled with the Kazakhstani tenge’s devaluation a year ago, has put Kazakhstani banks under renewed pressure, with credit to the private sector contracting significantly. With the government’s continuous initiatives to stabilize the sector, nonperforming loans were reduced from 24 percent in 2015 to an average of 8 percent at the start of 2016, although the figure varies greatly by institution. Weak business confidence, uncertainty about the exchange rate and inflation will affect lending and profitability in 2016/17. The banking sector remains fragile and further state support may be required. The financial sector remains dominated by domestic commercial banks. The banking sector is largely domestically owned, private and relatively concentrated, with the largest five banks accounting for more than 75 percent of total banking assets. Microfinance plays an important role in addressing the needs of the small business sector, especially firms in rural areas that are in dire need of affordable loans, with demand for microfinance services considerably exceeding supply.

Main constraints and opportunities: The failure to resolve problem loans in the banks influences lending and business growth. Further state support may allow the banking sector to gradually consolidate and repair its financial strength. Nevertheless, it does not seem there is much progress in addressing the key factors that exacerbated the banking crisis in 2009, such as nontransparent lending practices and lack of

corporate governance. Cleaning up the problem banks is just beginning, and as a result, opportunities at the level of individual financial institutions may be limited. Conversely, there may be an opportunity and the political will to address broader capital markets reforms, the resolution of nonperforming loans, financial markets infrastructure, and related fintech opportunities.

Information and communications technology

Overall, 143 percent mobile penetration presents very limited growth opportunities. However, 3G and 4G and broadband penetration levels (40 and 31 percent, respectively) remain low. Increasing both penetration and service affordability requires investment in passive infrastructure (new tower sites and fiber networks) to facilitate better coverage. The most cost-effective way of achieving this is to support independent shared infrastructure providers (independent tower operators and fiber companies). Therefore, IFC might have a role to play in providing long-term financing to these types of providers. Furthermore, being one of the largest Central Asian markets, any country development would have a wider regional impact.

As a landlocked country and one of the least energy efficient economies in the world, there is tremendous need to increase investment in infrastructure, coupled with a shrinking fiscal space to make such investments. For most infrastructure sectors, including road, rail, power, water, border and trade, and ICT, the existing infrastructure largely dates from Soviet-era projects that have deteriorated over time and are badly in need of rehabilitation or replacement. At the same time, increasing demands on air, trade and ICT infrastructure is central to the country's continuing growth and will require largely new investment.

Energy

The Central Asian Power System was designed as an integrated system with seasonal exchange (hydro in summer versus thermal in winter). Its disintegration after the collapse of the Soviet Union resulted in inefficient use of resources and an inability to satisfy energy demand throughout the year. Large investments are required to adequately meet energy demand, especially in the winter. Energy supply gaps are exacerbated by high losses throughout the supply chain: from highly inefficient power or heat generation through distribution to end use. Winter energy shortages are estimated at 3 terawatt hours.

Diversification of the energy mix, freeing up of fossil energy for export and a reduction of greenhouse gas emissions are also important challenges. Kazakhstan ranks among the world's most energy and carbon intensive economies. The ratio of carbon dioxide emissions from fuel combustion per unit of GDP at purchasing power parity is 1.3, compared with a world average 0.44kg carbon dioxide per U.S. dollar (IEA, 2012). The potential for energy savings is large, both in the energy and industry sectors. Despite government efforts, Kazakhstan remains among the countries with high rates of flaring associated petroleum gas, which significantly contributes to greenhouse gas emissions. Apart from major efficiency opportunities, Kazakhstan has renewable energy generation potential in wind and hydro.

Health and Education

The health and education sectors remain largely state dominated, but with greater willingness among officials to bring private service providers into the sectors. The continuing fiscal stress on the national budget may accelerate privatizations, public-private partnerships (PPPs) and support for private investment in these sectors. Both healthcare provision and education services are very fragmented and small in size on the private sector side. This is due to significant state participation (the Kazakhstani

population is entitled to free education and healthcare). The government is considering PPPs in healthcare, although it has been doing so for the past 3–5 years and has still not moved to concrete action. Cheap (subsidized) financing is available in the market: effective interest rates of 4–6 percent in Kazakhstani tenge, at 7–8 year maturities

Dairy

Kazakhstan’s dairy sector has attracted considerable attention recently, with greater investment into the sector in the past few years. However, despite recent economic gains that have served to add strength to the industry, many of the country’s food processors continue to operate inefficiently and often well below capacity. Two decades of underinvestment in dairy farm infrastructure: milk production facilities, collection, and storage facilities; transport; breeding and disease prevention, have been very costly to the efficient development of the sector. According to the national “100 Concrete Steps” plan, the share of imported milk in Kazakhstan is to be reduced from 28 percent to 18 percent by 2020. It is planned to increase milk production by 500,000 tons by 2020 and to increase processing capacity from 40 to 70 percent.

3. Sector Assessments

Transport and Logistics

Market potential

Kazakhstan is a natural transit corridor for the new Silk Road—a project in which China is heavily invested. Kazakhstan’s strategic geographic position will become even better placed in the future because of major geo-economic shifts, together with innovations in the transport industry. Five major trends are driving these new opportunities:

Rising manufacturing in China’s hinterland. As coastal China becomes wealthier, so manufacturing is moving inland, including towards the western provinces bordering Central Asia. For manufactured goods produced in these provinces, land transport to Europe, the Middle East and other parts of Asia will become more attractive than sending goods to China’s coast and then transporting them by ship.

New markets in South and West Asia. South Asia is growing fast, with a rapidly growing middle class. India will become one of the world’s preeminent middle-class markets with a total population of 1.3 billion people by 2030. The opening-up of the Islamic Republic of Iran will also provide new opportunities for China-Islamic Republic of Iran trade through Central Asia.

China’s expanding middle class. The rebalancing of China’s economy will further fuel the consumption of the country’s rising middle class, which is expected to grow from about 550 million (2015) to 1.1 billion (2030). This will create new opportunities for Kazakhstan to export to China, especially agricultural products, and provide a gateway for products from Western Europe and the Middle East to China.

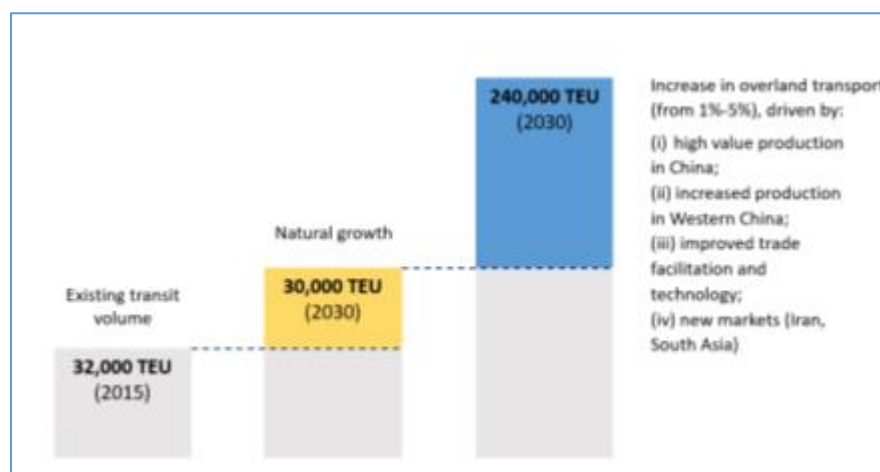
Opportunity costs of higher-value goods. As China and the world in general move towards producing higher-value goods—think computers instead of t-shirts—the opportunity costs of delivering such goods will also rise. For these new goods, land transport is the most viable option because it is cheaper than air and substantially faster than sea. Today, a container transported from a Chinese port to Germany takes around 40 days by ship, compared with 16 days by train, but it is possible that overland transport will soon take as little as 10 days. Shipments by sea are still around half the price of land transport, but rising opportunity costs will increasingly outweigh higher transport costs.

Technological change. There is considerable scope to cut costs and time for both rail and road transport using new technologies. These new technologies will transform transport and logistics in a coming revolution, as it becomes easier to consolidate and deliver goods and to operate vehicles 24 hours a day (that is, driverless trucks). Technology will also support trade management improvements at border crossings, including through the use of preshipment certifications and the smooth entry and exit of people (using mobile passports). It is likely that within the next decade it will take less than one week to transport goods from East Asia to Western Europe.

Kazakhstan can take advantage of the major opportunity to benefit from developments in the transport and logistics sector. China-European Union (EU) trade is a good proxy of the current trends. Today, China ships about 13 million twenty-foot equivalent units (TEUs) to the EU. Only 0.2 percent of this trade—an

estimated 32,000 TEUs²—is currently transshipped through Kazakhstan (figure 3.1). These transit freight volumes via Kazakhstan could increase by a factor of 10, to perhaps 300,000 TEUs by 2025, if the country can provide reliable rail services and improved logistics operations. Future transit growth could come from natural growth in containerized trade estimated at 5 percent per year and a modest shift towards land transport of about 4 percent of total China-EU trade.

Figure 3.1: Market potential: Transport and Logistics



Source: Background assessment on Transport and Logistics for the Kazakhstan PSD, April 2017.

Why has the sector not developed?

The logistics market in Kazakhstan is fragmented and has low capacity. The main players are the traditional freight forwarders that offer only a limited range of services and lack experience in providing complex logistics services and international supply chain management. International logistics companies often hesitate to enter the market in Kazakhstan because of its small size and cumbersome, nontransparent customs and clearance procedures.

The principal challenges facing the logistics industry in its efforts to improve quality and competitiveness are as follows:

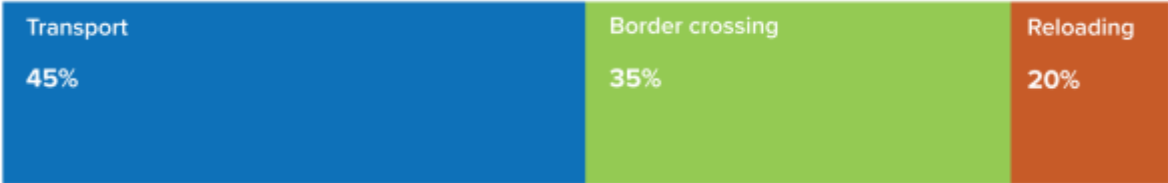
- (i) high transport and logistics costs, resulting from poor operations and underdeveloped logistics services;
- (ii) lack of knowledge of modern logistics and supply chain management, as well as low adoption of supply chain management practices;
- (iii) lack of regional financial guarantee schemes, preventing logistics firms from operating regionally; and
- (iv) lack of automation and checkered recognition of international regimes, such as the Transports Internationaux Routiers system.

² The twenty-foot equivalent unit (TEU) is an inexact unit of cargo capacity often used to describe the capacity of container ships and container terminals. It is based on the volume of a 20-foot-long (6.1 m) intermodal container, a standard-sized metal box which can be easily transferred between different modes of transportation, such as ships, trains and trucks.

Kazakhstan’s transport and logistics sector has not developed into a major economic sector yet for two fundamental reasons. First, market size remains small because most of the China-Europe trade continues to be transported by sea and because other high-potential sectors (for example, agriprocessing) have not yet fully taken off (see parts 4 and 5). Second, despite improvements in the overall business environment, Kazakhstan’s performance in “trading across borders” remains suboptimal. The lack of reliability about the duration and complexity of clearance procedures on border crossing points and inland terminals is holding the sector back. The country will only reap the benefits of the New Silk Road if it can establish seamless border crossings, efficient transport networks and modern logistics systems, including most crucially at Khorgos, the main China-Kazakhstan border post.

Kazakhstan faces challenges both in rail and road transport. Rail transport is not competitive compared with road transport for distances of under 1,000 km, but road transport to western China also remains too expensive. For example, from Almaty to Urumqi (860 km), the cost of delivering one TEU container is US\$2,000 and thus 40 percent more than in the EU and 60 percent more than in the EAEC for a similar distance. More than half the cost comprises border-crossing and reloading costs.

Figure 3.2: Case study: Cost of doing business in the Almaty-Urumqi corridor



Source: Background assessment on Transport and Logistics for the Kazakhstan PSD, April 2017.

What would it take to develop the sector?

The current economic environment, especially given low oil prices, is creating new opportunities to rebalance Kazakhstan’s economy as other tradable goods such as agricultural products also become cheaper in international markets. However, for Kazakhstan to create new sources of growth based on these opportunities it needs to become a world-class player in transport and logistics, so that goods can flow across the border speedily and buyers, for instance, supermarket chains, can then resell goods on to their customers.

Important elements in creating such a state-of-the-art logistics system are risk management and an integrated information technology backbone. Successful trading economies have replaced the need for 100 percent inspections with a smart risk-based system that includes pre-arrival processing of import documentation and establishing a “green channel” for low-risk goods. This would also be a first step towards a single window for trade operations,³⁴ an online, one-stop shop for traders connecting all agencies involved in international trade, where permits and declarations can be requested, uploaded, processed, and received.

³ Kazakhstan is currently working on the National Single Window with support from the Republic of Korea.

⁴ Kazakhstan is currently working on the National Single Window with support from the Republic of Korea.

Inadequate infrastructure is another challenge facing the country's transport and logistics sector. Outdated rolling-stock and rail equipment impede efficient rail operations. Improving the interconnections between the road and rail transport is another important area in improving the efficiency of logistics networks. Improvements in logistics will lead to further improvements in general economic performance, which in turn will allow Kazakhstan to increase its competitiveness as a transit corridor. The increasing use of logistics outsourcing and international third-party logistics providers could serve as a catalyst for Kazakhstan's transformation into a country with a modern logistics services industry.

The clustering of transport and logistics operations creates synergies and increases efficiency in the transactions between manufacturers, traders, logistics service providers and freight forwarders. The development of intermodal logistics centers would help to increase productivity and enhance Kazakhstan's competitiveness as a regional transport and logistics hub. Integration of value-added services is an important factor in the concept of logistics centers and would support local economies in moving raw materials to the producers of intermediate or final products in the value chain. The development of value-added services will be important for Kazakhstan to capture significant value addition from transit freight.

Liberalization of market access to intermodal operations will be a crucial first step in raising competitiveness, improving the quality of intermodal services, and reducing costs of transportation and handling rates. Private intermodal operators play a crucial role in organizing block container trains and the development of intermodal terminals. To attract the private sector, it will be necessary to have not only reasonably strong potential demand but also a reliable supply of rolling-stock and track access.

The impact of opening the sector

Improved efficiency in transportation and logistics will create a number of benefits that will help to raise the trade and transit competitiveness of Kazakhstan. The main benefits are as follows:

- Reductions in transit and transport costs generate new opportunities for trade, especially in agriculture (see other sector assessments); buyers of agricultural products can access products at cheaper prices through a reduction of transportation costs. In particular, prices of perishables and fresh products can be reduced by cutting time-to-market. Wholesalers and retailers can be expected to offer better conditions to agricultural producers, allowing them to sell their agricultural products at higher margins.
- Economies of scale in logistics create demand for new services, especially in sectors such as finance and other professional services (legal, accounting, and so on). This is how economic development in Singapore and Dubai first started, for example.
- Development of advanced logistics infrastructure and the establishment of logistics centers will create multifunctional operations and increase productivity and competitiveness of Kazakhstan as a regional logistics hub. Efficient consolidation and distribution freight operations will result in a significant decrease in transportation and logistics costs, directly raising the competitiveness of local companies and driving GDP growth.
- The greatest potential for creating economic impact from increased transit traffic lies in value-added services (for example, packaging), a trend that can also be observed in other transport service providers such as airports and fueling stations. Once Kazakhstan attracts sufficient scale, it can become a major regional transport and logistics hub. Integration of value-added services will increase

the economic benefits from transit and create opportunities for introducing the assembly of consumer products into the existing transportation and distribution process. This will allow suppliers to customize products moving through Kazakhstan, improving product flows by reducing inventory opportunity costs, while enabling customization to fit the needs of customers.

Agriculture

Kazakhstan has a major agricultural sector thanks to its favorable climate and vast area of arable land. As the world's ninth-largest (and largest landlocked) country, with 74 percent of its surface area suitable for farming, the agricultural sector is a key pillar for both social and economic development of Kazakhstan. Agriculture employs around one-fifth of the economically active population and around 49 percent of the population lives in rural areas. Key agricultural sectors are animal husbandry and plant growing (grain and feed crops).

According to official statistics, the share of capital investment in agriculture increased almost 4 times from around T 44 billion (US\$291 million) in 2004 to around T 166 billion (around US\$1 billion) in 2014, while its share in total capital investment in the country remains small compared with other sectors of the economy. Kazakhstan's gross agricultural output was over T 3 trillion (around US\$13 billion), which is almost five times more than in 2004 (T 696 million, or around US\$4.6 billion).

The Kazakhstani state is by far the largest stakeholder in agriculture. It acts as regulator, policymaker, landowner, and the main financier. It is also the owner of a network of state agencies, quasi-commercial enterprises, and academic institutions involved in agricultural production, certification, licensing and research. In contrast, there are few large-scale private agribusinesses in Kazakhstan. These firms mainly operate in grain production and distribution, and milk production. Much of the private sector is small scale and fragmented, consisting of local cooperatives and individual part-time farmers. Small holdings and households are the main agricultural producers, accounting for more 56 percent of total agricultural output. Large agricultural enterprises account for 20 percent of output and collective farms for about 24 percent.

The following two deep dives present greater detail on leading production subsectors in Kazakhstani agriculture—wheat and livestock.

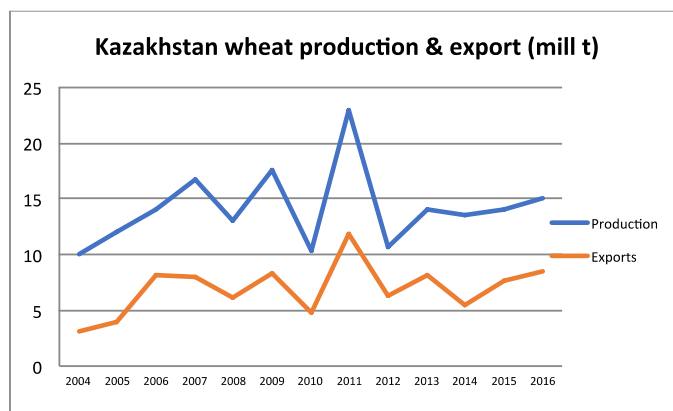
Wheat

There is a strong rationale for including wheat as one of the deep-dive sectors in the diagnostic, both from its market potential and its development impact potential. Wheat dominates the grain sector and is Kazakhstan's largest non-extractive export product, in addition to being an important input into the livestock sector. Kazakhstan is one of the world's leading wheat producers, capitalizing on the country's large stock of rain-fed land, as well as the relatively low cost of labor. However, the sector has struggled to modernize and improve productivity, and it currently faces an uncertain future with the majority of leading producers in financial distress. Attracting new investment and improving management, while restructuring incentives to promote productivity, could have a major impact on the competitiveness of the sector and help Kazakhstan to more than double its exports.

Market potential: A comparative advantage not being catalyzed

Kazakhstan has several sources of comparative advantage in the wheat sector, beginning with the country's large stock of arable land, the majority of which is planted with wheat. This puts Kazakhstan on par with the other major global producers that have even larger land areas but are more diversified in their production. Rainfall conditions are sufficient for wheat production, particularly in northern Kazakhstan, but not as good as in comparator countries in the immediate region, including the Russian Federation and Ukraine. Kazakhstani producers also benefit from relatively low production costs due to low land costs, inexpensive labor, and lower prices for some chemicals and fertilizers (particularly where these are linked to the country's upstream oil industry).

Figure 3.3: Kazakhstan's wheat production and export, 2004–16



Source: Derived from Kazakhstan Ministry of Agriculture.

The wheat sector currently produces about US\$2.36 billion in annual production, with just over one-third of this being exported and the remainder going to domestic consumption. The sector is prone to high volatility in production levels due to climactic factors, usually correlated with the same weather events that affect Russia other Eurasian economies. As a staple food commodity, demand for wheat in the country and region is expected to track long-term growth rates without being significantly affected by growing incomes (for example, the way in which demand for meat and processed foods is expected to grow more rapidly with rising incomes). Absent any external shocks or shifts in production patterns, the baseline scenario should remain steady with gradual production growth, little shift into value-added processing, and a continuation of exports in the range of 30 to 40 percent of total production, largely to markets in Central Asia and Russia.

A more competitive wheat sector would be characterized by greater productivity among leading producers, a smaller and more strategic focus of state support and subsidies so that nonviable producers exit the market and remaining producers invest in productivity, and some diversification away from grains into legumes. Under such a scenario, Kazakhstan could see a reduction in land planted with wheat by up to 25 percent (immediately increasing productivity from the exit of low-productivity producers). This figure of 25 percent is a government target for crop diversification based on the share of land that may be more productive for legumes than wheat. Shifting or rotating to legumes will bring soil quality improvements, diversification benefits, and, most importantly, provide an input into the livestock sector, where Kazakhstan has a strong competitive opportunity vis-à-vis growing demand in western China. At the same time, Kazakhstan could target a productivity level near to or at Russia's productivity level, itself

well below the productivity of other major producers. Improved productivity would allow Kazakhstan to significantly expand its market share among major buyers including China, the Islamic Republic of Iran, and the Caucasus. Under such a scenario, Kazakhstan could nearly double the size of its wheat sector, and more than double exports, on a mid-term time horizon.

Kazakhstan is also active in processing, with exports of wheat flour of more than US\$500 million to Central and South Asia, making Kazakhstan the second-largest global exporter of flour. Given that increasing productivity in the sector will be largely driven by mechanization, greater levels of post-production processing will play an increasingly important role in employment outcomes in the sector.

Why has the sector not developed?

Low productivity. Despite its inherent advantages, the wheat sector remains characterized by very low levels of productivity. Kazakhstani yields for wheat average at just 1.09 tons per hectares relative to 2.5 in Russia, 4.01 in Ukraine, 2.94 in the United States, and 3.09 in Canada (table 3.1). However, it should be noted that there is a high variability in productivity, and additional data should be analyzed to better understand how larger firms or exports compare to other countries in productivity.

Table 3.1: Wheat production productivity among major producers

| | Hectares (thousands) | Production (thousand tons) | Yield (tons per hectare) |
|-------------------|----------------------|----------------------------|--------------------------|
| Kazakhstan | 11,923 | 12,996 | 1.09 |
| Ukraine | 6,010 | 24,100 | 4.01 |
| Russia Federation | 23,908 | 59,770 | 2.5 |
| China | 2,068 | 11,002 | 5.32 |
| Canada | 9,462 | 29,238 | 3.09 |
| United States | 18,771 | 55,187 | 2.94 |

Source: Derived from FAO data.

Key constraints to productivity include poorly structured state support mechanisms that incentivize production over productivity, outdated management practices at the firm level, poor quality of inputs, and challenges in both the availability and timing of finance. In addition, the sector is dominated by a small number of large firms and a few SOEs that are engaged in the value chain in areas such as input supply, offtake, and financing. Anecdotal evidence suggests that these larger firms enjoy preferential access to inputs or public good resources, and this may be crowding out new investment.

Weak position in major markets. Kazakhstan is geographically situated close to large markets for wheat and currently exports to over a dozen countries. However, only four countries account for the majority of its wheat exports—Kyrgyzstan, Tajikistan, Uzbekistan, and Russia. In each of these markets Kazakhstan is the only significant source of imported wheat, supplying more than 90 percent of Russia’s imports and nearly 100 percent of imports in Central Asian markets. Outside these markets, Kazakhstan exports between US\$30 million and US\$40 million to China, the Islamic Republic of Iran, Azerbaijan, and Italy, representing a very small share of total imports in these markets.

This contrast between export markets saturated by Kazakhstani producers and those with a small Kazakhstani presence has numerous implications for growth of the sector. First, even in a commodity market, Kazakhstani producers do not face much competition in exports to Central Asia. This is due both

to the poor level of transportation infrastructure in these landlocked economies, as well as the strong business links between the larger exporters and importers. However, the largest market in the region is in China, which has sufficient transport infrastructure and demand such that the cost of transportation plays a minor role in wheat competitiveness, undermining any benefits Kazakhstani producers might have gained from proximity. As a result, Kazakhstani producers face little competitive pressure to improve productivity because they have access to a largely captured market in Central Asia.

What would it take to develop the sector?

Achieving a significant increase in productivity would require large-scale reforms to the state support mechanisms in the wheat sector, the exit of low-productivity producers that are dependent upon state support, improvements in the quality of transport and logistics, restructuring of large farms to bring in new private capital, and improvements in the quality of management practices in the sector. Bringing in new private investment to enable technology and skills transfer will be essential.

Growing nontraditional export markets will drive productivity improvements

As previously highlighted, Kazakhstani producers have a semi-captured market in Central Asia, thus reducing the need to invest in productivity. Going forward, Kazakhstan will need to increase exports to nonsaturated markets with the Caucasus, China, the Islamic Republic of Iran, and South Asia that all offer strong potential. However, transportation and border clearance costs remain high, particularly compared with shipping costs that serve most leading exporters (Kazakhstan is the only sizable wheat producer that is landlocked). Upgrading international transport and logistics infrastructure, and improving the speed, cost and predictability of customs clearance, will be crucial to growing exports.

Figure 3.4: Kazakhstan’s wheat exports



Source: Derived from MIT’s Observatory of Economic Complexity.

Public sector reforms are needed in the short- and long-term. In the short-term, there are two areas critical for public sector reform. The first is in transport and logistics, and trade facilitation measures. Kazakhstani producers highlight a range of challenges in exporting even to western China, from a lack of

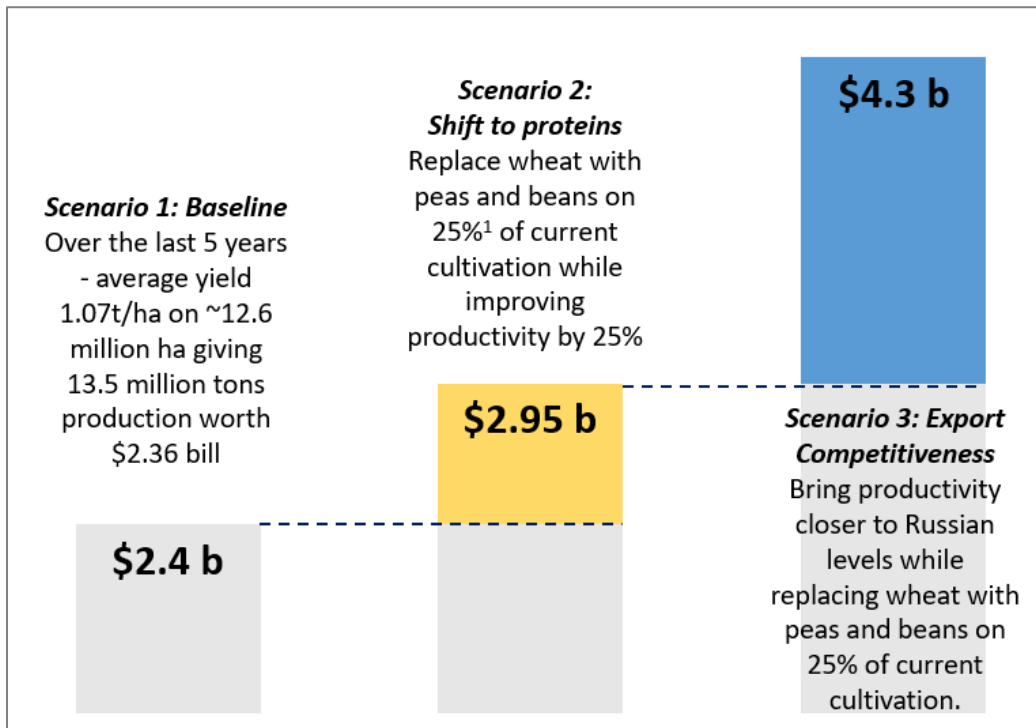
professional services at border clearance, a high level of informality and lack of transshipping rights in China, to issues with the recognition of quality standards. Anecdotal evidence suggests that it is cheaper to ship wheat to Urumqi from Vancouver, Canada, than from Almaty. The second key issue for the public sector is the role of state support and subsidies for wheat producers, which are still largely oriented towards production targets. Shifting incentives to be more oriented towards productivity, and more towards the delivery of public goods rather than private, would greatly impact productivity, as some nonviable firms would exit the market, while the remaining firms would benefit from sector-level investment into public goods.

There are some significant mid- to long-term risks that should also be addressed to ensure long-term competitiveness in the wheat sector. First, a long-term approach to land management and land usage that preserves soil quality and ensures efficiency in the allocation of public resources will be necessary. Kazakhstan has already set targets to reduce the land area under cultivation for wheat and this creates an opportunity to put in place a long-term land-usage policy. Second, Kazakhstan will face increasing challenges from the effects of climate change, not least from the greater volatility and severity of droughts. Mitigation measures will be needed both at the national level and the individual firm level.

The impact of opening the sector

Expanding the wheat sector through increased productivity would have a significant impact with potential to nearly double the size of the sector, double productivity, and increase wheat as a share of exports by more than 60 percent. In addition, the indirect benefits would include greater diversification in agricultural production with legumes replacing some wheat production, greater competitiveness in the livestock sector because of lower feed costs, and diversification in export destinations. Figure 3.5 shows the potential value of the sector under two scenarios. The first would involve a modest shift in productivity (largely driven by the reform to incentives in the sector mentioned previously) coupled with a shift of 25 percent of land from wheat to legumes—something already envisioned in the government strategy. The second scenario is more ambitious and would require productivity improvements to reach about 2.5 tons per hectare—the level of productivity in Russia—but still well behind every other major global producer. Under this scenario, Kazakhstan would increase exports to some nontraditional markets, with these larger new destinations driving the demand for productivity-enhancing investments.

Figure 3.5: Market Potential: Wheat



Livestock

Market potential

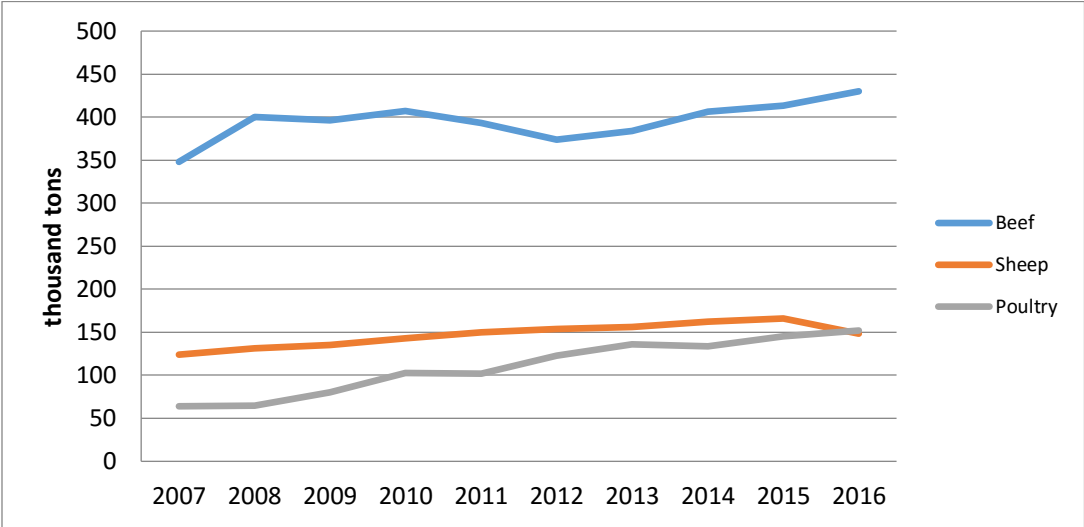
Growing regional demand for meat and dairy creates an opportunity for Kazakhstan. Asia is home to a disproportionate 87 percent of the next billion people who are expected to enter the middle class over the next decade. As households enter the middle class, their dietary preferences shift with greater consumption of animal products. This trend is already well underway in China and other Asian and Eurasian markets that would be logical export destinations for a more competitive Kazakhstani meat sector. Demand in China alone for animal products has grown fourfold over the past decade, from US\$4 billion in 2005 to more than US\$18 billion in 2014. This includes rapidly growing demand in western China and some evidence of consumer willingness to pay a premium for halal production.⁵⁶ Kazakhstan has a large and long-established livestock industry with production of beef, poultry, sheep, and dairy serving both domestic and export markets, the latter largely concentrated in Russia. Kazakhstan is a low-cost producer driven by large, low-cost rangeland, availability of feed, and proximity to markets. However, growing the export market will require greater productivity to compensate for high logistics and transportation costs, and difficult climatic conditions.

⁵ Consumption Patterns and Consumer Attitudes to Beef and Sheep Meat in China. Yanwei Mao, David L. Hopkins, Yimin Zhang, Xin Luo.

⁶ Consumption Patterns and Consumer Attitudes to Beef and Sheep Meat in China. Yanwei Mao, David L. Hopkins, Yimin Zhang, Xin Luo

Beef dominates production but poultry is growing rapidly. Kazakhstan has a large and stable beef production industry, second only to Uzbekistan in Central Asia for the size of the industry (figure 3.6). Sheep production has also grown steadily from a lower baseline, although in 2016 production declined, potentially signaling a plateau in growth. Poultry, an industry where Kazakhstan has the largest production in Central Asia, is growing rapidly at over 8 percent annually and will soon exceed sheep as the second-largest meat production in the country. All three segments are beginning to benefit from greater investment in industrial production, although such investment is concentrated among a small number of large firms. Nonetheless, with better management and technology, the scope to increase production and productivity is significant.

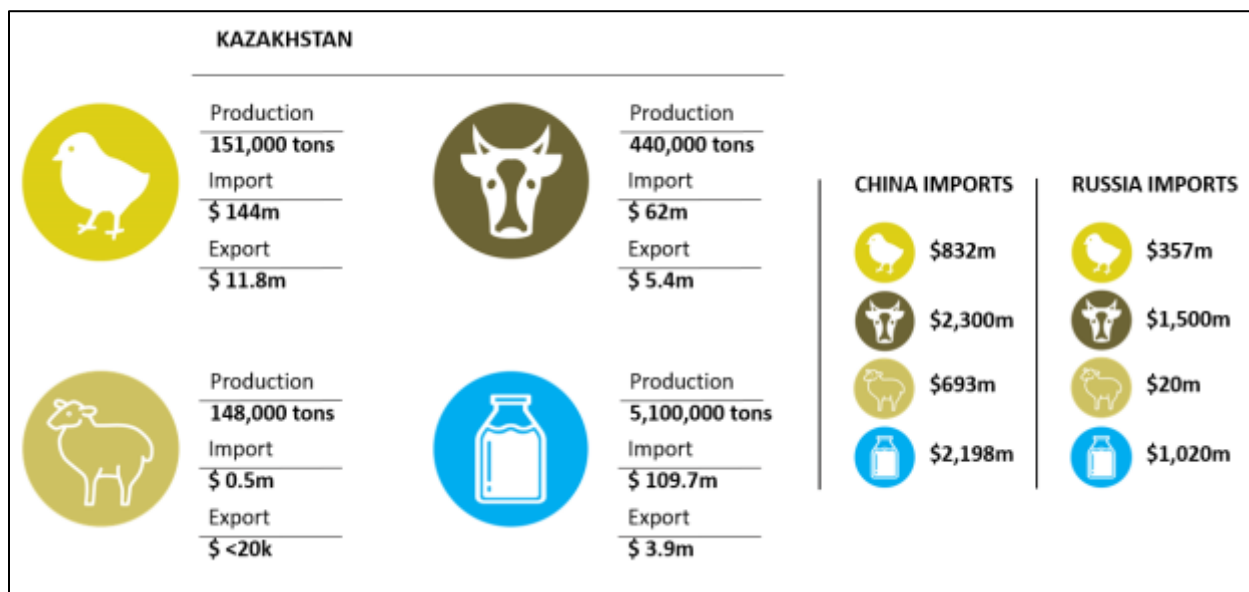
Figure 3.6: Meat production in Kazakhstan, 2007–16



Source: Derived from Kazakhstan Ministry of Agriculture.

There is both domestic and export demand. Kazakhstan is self-sufficient only in sheep, importing large amounts of poultry, beef, and dairy. Domestic producers (and increasingly processors) are investing in value chains to capture more of the domestic market. At the same time, the scope to serve neighboring markets is enormous, with Russia and China alone importing over US\$9 billion annually.

Figure 3.7: Kazakhstan’s meat production compared with imports into China and the Russian Federation



Source: Derived from the MIT Observatory of Economic Complexity.

Why has the sector not developed?

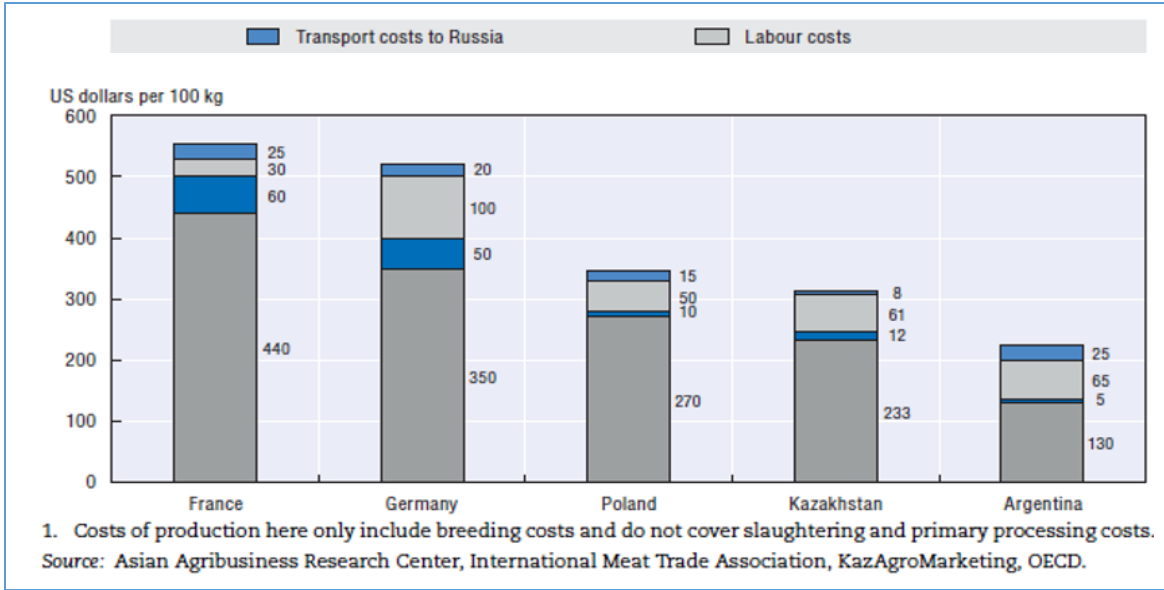
While the livestock sector has demonstrated steady growth over time, this has been driven by increasing domestic demand and import substitution. Exports of animal products still comprise a small share of total production, growing from US\$77 million in 2005, or 0.31 percent of exports, to just US\$145 million or 0.36 percent of exports in 2015. Even when oil and gas and metals are excluded, animal products currently comprise just 2.2 percent of exports. The following are some of the key issues that have slowed the development of the industry.

The market structure favors small-scale, decentralized, production. About 80 percent of meat and milk production comes from small producers—both private, backyard-livelihood production and small formal producers—and is sold to formal or informal markets close to production. This small-scale production is characterized by poor productivity, limited value addition, and limited quality standards, yet costs are low and market prices high enough to make this an attractive business or supplement to household income. The structure is also a natural adaptation to the large land size and poor infrastructure (physical and quality) that has so far slowed the expansion of the larger producers to serve local markets through a distribution and retail business model—although this is certainly already the norm in the larger urban areas and is continuously expanding. Another consequence of this market structure is that larger producers face many difficulties in trying to aggregate small-scale production. Small producers mostly do not maintain sufficient animal identification and vaccination to satisfy traceability requirements that are mandatory under both the Eurasian Economic Union and World Trade Organization (WTO) requirements (for the domestic market, as well as exports), while the lack of quality standards systems increases the costs and risks in the transportation and storage of fresh meat and milk products. This lack of enforcement of standards poses a serious challenge to the development of the sector more broadly as, without sufficient demand for quality systems, they will not be economical to provide, eroding the international competitiveness of the sector.

The missing middle-scale producers and input suppliers. The remaining 20 percent of producers who do not fall into the “small, decentralized production” category are large-scale producers, who are to a large extent vertically integrated, as this is the only viable way to maintain quality standards and ensure the reliability of the supply chain. These producers operate with much higher efficiency and are responsible for most of the new investment. But with production concentrated between the very small and very large, there is almost no presence of a middle-sized segment of the production market (the ‘family commercial farm’ model that is more prevalent outside the former Soviet Union region). As a result, there is not sufficient demand to build a professional industry around the supply of inputs and services that would improve productivity and quality for the sector as a whole. Thus, access to feed, genetics, nutrients, extension services, packaging, mechanization, veterinary services, cold storage, etc. is either largely missing for small-scale producers or done in-house for the larger producers.

Climate conditions and infrastructure add to costs and hurt competitiveness. While Kazakhstan has generally low production costs driven by inexpensive land rents and domestic production of feed, climate conditions and infrastructure are weaknesses relative to large exporters. Kazakhstan’s cold winters require that animals be kept indoors between two and four months of the year, which adds costs both for the facilities as well as the feed and also reduces the speed at which animals add mass. Similarly, the large land size of Kazakhstan and the poor domestic infrastructure (including border clearance infrastructure) imposes additional cost for products to reach markets. These factors put Kazakhstan at a considerable disadvantage relative to major exporters who have better climate conditions for meat production and who have low cost access to seaports. Nonetheless, there are several examples of countries with cold climates producing meat for export, such as Canada, which exports more than US\$4 billion worth of beef, poultry, and pork, just across to the United States.

Figure 3.8: Cost of beef production and exports to the Russian Federation, by major producers, 2007



Source: Asian Agribusiness Research Center, International Meat Trade Association, KazAgroMarketing, OECD.

What would it take to develop the sector?

Improving competitiveness in the livestock sector and building an export market will require a range of actions both at the firm- and economy-wide levels. In addition to these issues, which are highlighted in more detail below, investors have also cited a key long-term issue around land usage and ownership. The relatively undeveloped level of supply chains in Kazakhstan means that large producers and processors may need vertical integration to ensure quality and sustainability of inputs (indeed, many existing beef and dairy farms also have large land plots to produce feed). But without confidence on long-term usage and ownership rights, including the appropriability of improvements made to land, foreign investors are unlikely to make large investments in the country. Recent political events, including protests over planned changes to lengthen lease periods, have heightened such concerns. Addressing this issue will be core to any long-term strategy to improve competitiveness in livestock.

Market access remains a key issue with relevance to all tradeables

The potential competitive advantage of Kazakhstan in its close proximity to large and growing markets both in and out of the Eurasian Economic Union is undermined by high transportation costs and market access constraints. At the same time, the major global producers that already have significant productivity advantages benefit from more efficient domestic trade infrastructure, while overseas shipping adds relatively little to the final cost structure. To increase its competitive position, Kazakhstan needs to improve its market access broadly through the following measures:

1. **Improving domestic infrastructure:** Kazakhstan is a large, landlocked economy, making both domestic and international connectivity an important driver of competitiveness for tradeable goods. Kazakhstan has among the lowest road and rail densities of any country in the world with relatively high-quality rail and low-quality roads. Investing in growth-enhancing physical infrastructure should be a priority, but at the same time the quality of services should not be neglected. Kazakhstan scores 2.75 out of 5.0 on the World Bank's Logistics Performance Index for a rank of 77, which is roughly on par with the upper-middle-income countries, but significantly behind Europe and Central Asia on average. More worryingly, Kazakhstan's performance has declined since 2010 with particular weaknesses in customs and logistics competence.
2. **Improving trade facilitation:** Cross-border clearance procedures remain a problem for investors, with several firms highlighting uncertainty, delays and informal payments as adding significant costs to their exports. This is borne out in many analytical products—in the World Bank's Doing Business, for example, trade across borders is the country's worst performing indicator, ranking 119 out of 190 countries, and with a total time to export (border and documentary compliance together) of 261 hours, more than 450 percent higher than the Europe and Central Asia average of 55 hours. In the World Bank's Enterprise Surveys, firms rank customs and trade regulations as one of the top-ten greatest obstacles to growth, while 27.9 percent of firms report that they would need to give an informal payment to obtain an import license relative to 11.9 percent on average in the Europe and Central Asia.
3. **Investing in quality standards systems:** The Eurasian Economic Union and the WTO impose consistent standards for product safety built upon a set of technical regulations and quality standards. Meeting these requirements is essential to competitiveness and requires both public and private investments. Leading firms in the private sector have long been taking steps to demonstrate compliance, including firms such as KazBeef that are working with the IFC on quality standards. More can be done by the government at the regulatory level to streamline and

harmonize regulations, and also at the level of investment in quality standards infrastructure to bring down the costs of compliance at the firm level. The needs include improved veterinary services, national animal identification and vaccination, testing laboratories, storage and transport infrastructure (possibly developed in partnership with the private sector), and access to breeding and genetic services.

4. **Addressing bilateral trade policy issues:** As the competitiveness of Kazakhstani meat and dairy productions improves, trade policy constraints will take on greater importance, particularly outside the Eurasian Economic Union area. China is an obvious market for Kazakhstani livestock exports, but current tariff quotas limit market access. Nonetheless, China's expanding presence in Eurasia through initiatives such as the Belt and Road should be a foundation for Kazakhstan to raise bilateral market access priorities.

A stronger domestic retail and distribution industry will help to achieve economies of scale, efficiency, and the adoption of standards. Domestic production for a domestic market is a common entry point that allows firms to make initial investments in production and processing by benefiting from consumer preferences for local and fresh food. Importantly, as these firms grow and expand they create the market demand for standards, which in turn generates demand for professional services across the value chain. Eventually these firms can become competitive as exporters. Kazakhstan's retail and distribution sectors are growing, but with the large land size and sparse population density outside the major cities, there is still need for more investment in these areas. In addition, building knowledge and capacity among producers, consumers, and even regulators of quality standards and food safety practices would help to shift demand out of informal markets and into more professional, commercial production.

The impact of opening the sector

Expanding the livestock sector has significant economic and development impact potential. Even under conservative growth scenarios, the sector has potential to expand rapidly as domestic production takes an increasing share in the total market. Growing this domestic market will also bring a host of direct and indirect benefits including greater job creation in the sector, with many new jobs being higher productivity, the development of upstream services such as testing, logistics, distribution, packaging, marketing, and so on; and even improvements in food safety. As domestic demand drives the development of the domestic industry and improved standards and productivity, Kazakhstan can look toward growing exports, both to traditional and nontraditional markets.

4. Recommendations and Next Steps

The Kazakhstan CPSD includes recommendations for follow up activities, both on cross cutting priorities as well as sector specific recommendations. The team has also identified a set of process-related next steps that will ensure the CPSD is aligned with the Bank’s work program, government strategy, and political will for reform. It is important to recognize that the scope of the CPSD is not sufficient or intended to produce detailed policy recommendations at the sector level; such recommendations will require more detailed analysis. Rather the CPSD identifies potential opportunities to achieve development impact by opening sectors to greater private investment and the binding constraints or market failures that have prevented such investment from materializing. As such, the following recommendations and next steps are presented as initial suggestions which can be developed into a more detailed action plan.

Recommendations: Cross-cutting reform topics

Several cross-cutting issues have been identified in the CPSD that appear to constrain Kazakhstan’s competitiveness, not only in the three sectors assessed in the report, but likely across all tradeable and some non-tradeable sectors alike. These include trade logistics and facilitation, standards, competition policy, and the related topic of SOE reform. The findings of the CPSD suggest that increasing private investment will depend upon reforms and investment in each of these areas. Some priorities in each of these areas include:

- **Trade logistics and facilitation:** As a large and sparsely populated landlocked country, efficiency and predictability in trade plays an important role in Kazakhstan’s competitiveness in tradeables, as well as in domestic services such as logistics and distribution. Interviews with firms highlighted weaknesses both in trade facilitation—with slow clearance processes and high unpredictability—as well as in trade infrastructure including border facilities, multimodal transport infrastructure, and domestic infrastructure. Given the importance of the China market not only to Kazakhstan but also to exporters in the Kyrgyz Republic and Tajikistan, a more targeted assessment of trade policy and facilitation with regard to China is recommended as a next step.
- **Product quality and standards:** Kazakh exporters, particularly in the agribusiness sector, are constrained by weaknesses in compliance with international food and product safety standards. This affects exports both within the Eurasian Economic Union, as well as to WTO members such as China. Improving compliance will require regulatory reforms to technical regulations and product safety standards, along with efforts to improve animal health and identification, plus investments into quality infrastructure. Specific next steps could include a quality infrastructure gap assessment, with food safety reform priorities (the WBG recently supported the Government of Ukraine to improve food safety certification for the export of beef to China—a model that could possibly be replicated in Kazakhstan), and lessons learned from IFC’s experience supporting KazBeef on quality standards (and how/whether to scale this up to other potential exporters).
- **Competition Policy and SOE Reform:** Attracting greater private investment to Kazakhstan will require a more level playing field vis-à-vis SOEs and private firms with political exposure among their ownership. This issue is also central to improving productivity and the efficiency of public spending given the scope of incentives that are applied to the private sector, particularly in agriculture. Next steps in this direction may involve WBG support to the government’s own strategy on SOE and subsidy reform.

Recommendations: Sector-specific priorities

- There is one key question that should be the focus of the CPSD follow-up activity on agriculture, namely, can Kazakhstan have a competitive export industry for agricultural products? The potential to create a regionally competitive agriculture sector is constrained both by intrinsic factors such as climate and geography, and by issues such as low economies of scale, poor productivity and the distortive impact of incentives. The question is whether reforms to improve productivity and reduce the state role in the sector will compensate for the intrinsic challenges that drive up costs and thus reduce competitiveness (costs such as winter fodder because the climate is too cold to allow year-round grazing and increased transport costs to regional markets). If these intrinsic factors impose a ceiling on productivity that prevents Kazakhstan from ever developing a competitive regional agriculture export sector, then this would suggest reform efforts may be better targeted at other sectors or in aiming for a more efficient domestic (import substitution) agriculture sector. As a next step, the WBG could carry out an export parity study to quantify this question in a level of detail beyond the scope of this CPSD.
- In addition to the further analysis recommended above, there is an immediate opportunity to work with the Kazakh government on improving wheat competitiveness. The government has requested WB support to help restructure the wheat industry (recognizing the same challenges identified in this report). The CPSD can help to formulate a response to the government that addresses long-term sector potential.

Transport and Logistics

- For Kazakhstan to fully seize the opportunities to rebalance its economy towards tradeable goods other than oil and gas, such as agricultural products, it will need to become a world-class transport and logistics hub, so that goods can flow across its borders speedily and buyers (such as supermarket chains) can then resell them to their customers. This will require creating a state-of-the-art logistics system based on risk management and an integrated IT backbone. A smart risk-based system would need to include pre-arrival processing of import documentation and the establishment of a “Green Channel” for low-risk goods. This would also be a first step towards a national single window for trade operations—an online one-stop shop for traders that connects all agencies involved in international trade, and where permits and declarations can be requested, uploaded, processed and received.
- Improvements in transport and logistics infrastructure will also need to be addressed if the reforms above are to bear fruit. Outdated rolling stock and rail equipment that impede efficient rail operations will need to be replaced, while the interconnections between road and rail transport networks will require improvements towards increasing the efficiency of the overall logistics network. Such progress will allow Kazakhstan to increase its competitiveness as a transit corridor. Logistics outsourcing and attracting international 3PL providers will also serve as a catalyst to transform the sector into a modern logistics service industry.
- The liberalization of market access for intermodal operations will be vital for increased competitiveness, improvements in intermodal services, and a reduction of transportation and handling rates. Private intermodal operators play an important role in organizing block container trains and in the development of intermodal terminals. In order to attract the private sector, it will be necessary not only to have reasonably strong potential demand as well as a reliable supply of rolling stock and track access.

5. Conclusions and Lessons Learned

The global aid landscape is changing fundamentally. Many countries, especially in East Asia, have fulfilled the dream of development aid—to the extent of making it nearly obsolete. For many years, foreign direct investment has exceeded aid by a wide margin and this trend will likely to continue in other regions as well. By 2030, traditional development aid will most likely be concentrated to a few fragile countries, especially in Africa. The rest of the world will likely make great progress in ending extreme poverty. However, even if the world community succeeds, there will be at least 2 billion people with an income of US\$10 a day. Today, there are more than 3 billion people earning less than US\$10 a day. This bottom 40 percent of the population will also be the main beneficiaries of economies that create new markets and opportunities for everyone.

Knowledge transfer and private sector investment have been most important in creating prosperity, but combining the two can be remarkably transformative. This is the comparative advantage of the WBG and the extension of this comparative advantage has been the focus of this Private Sector Diagnostic for Kazakhstan. Already today, the WBG's comparative advantage is a comprehensive offering that combines analytically grounded policy advice, technical assistance, and financing (public and private). Over the past decade, the World Bank has often been successful in leveraging its analytical expertise for policy dialogue, which often resulted in development policy loans. The World Bank supported the overall economic governance framework of our client countries. The Private Sector Diagnostics can play the same role for private sector investments that standard World Bank diagnostics (Public Expenditure Review, Country Economic Memorandum, Investment Climate Assessments) played for policy and investment lending.

Appendixes

Appendix A: Structure of the Economy in Kazakhstan

Figure A. 1: Sectors' contribution to GDP in real terms, 2000–16

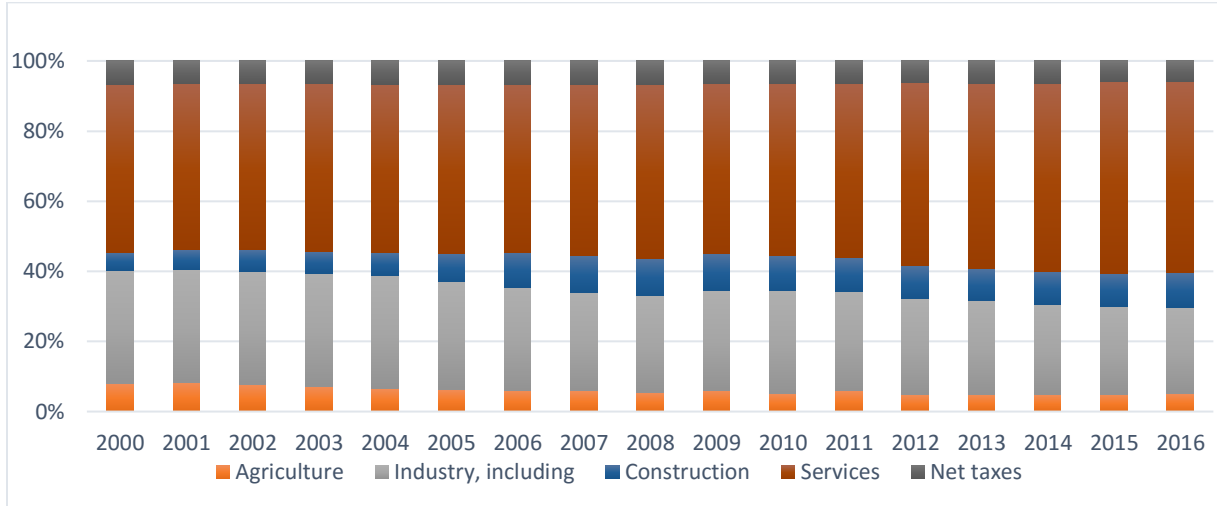


Figure A. 2: Employment, by sectors, 2000–16

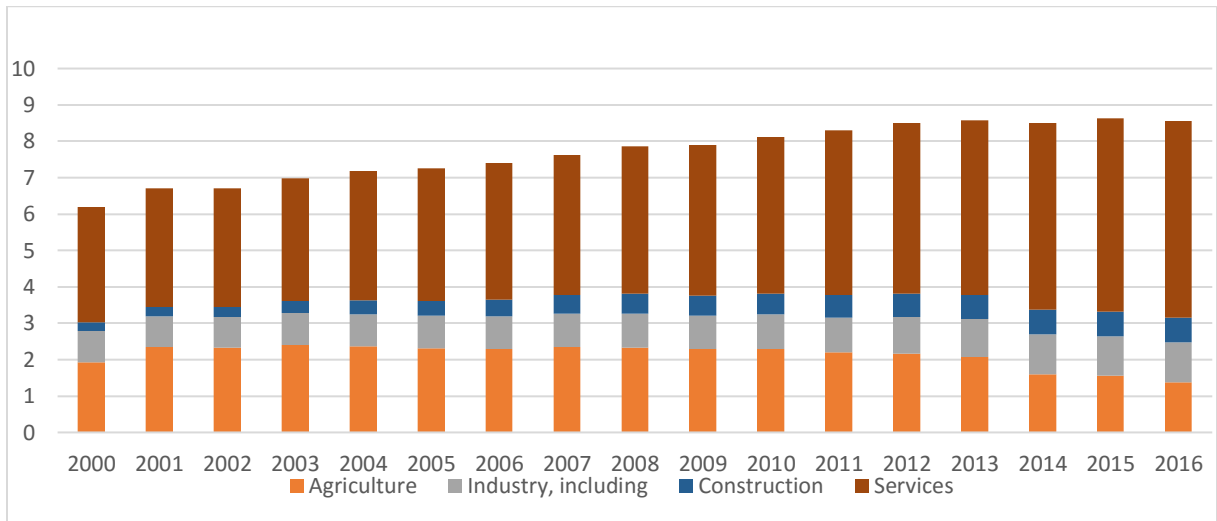
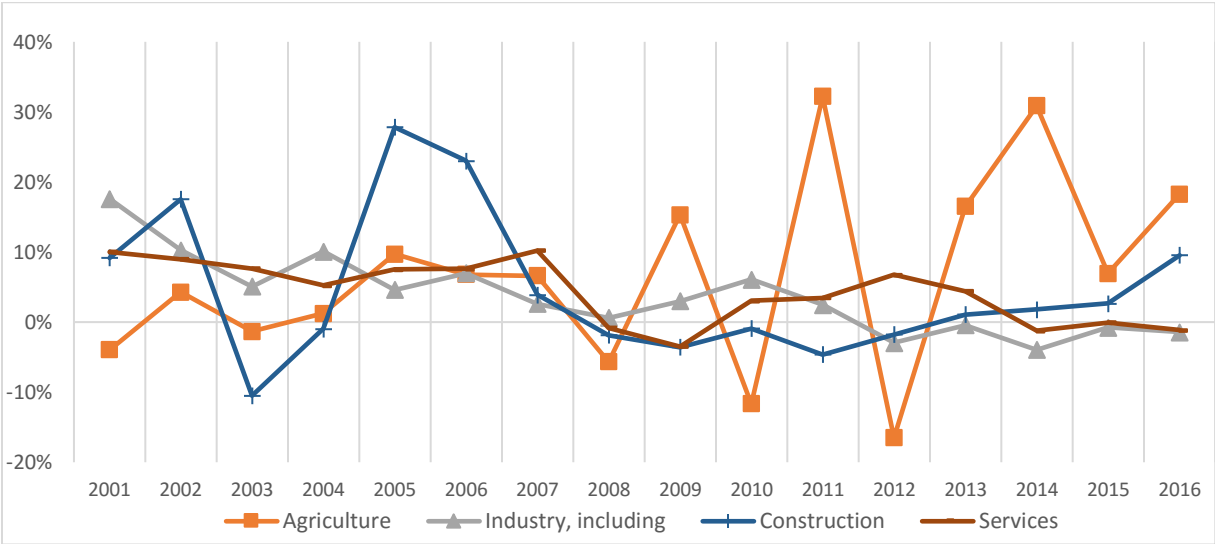


Figure A. 3: Labor productivity, growth in real terms, 2001–16



Appendix B: Financial Sector Overview

Kazakhstan's financial sector is highly bank-centric, concentrated, and lagging peers in terms of growth and inclusivity and, with deteriorating capital and profitability, is under severe strain. Kazakhstan's banking sector is made up of 34 licensed banks, with about US\$81 billion in assets as at January 2017, of which US\$49 billion is lending. The top-10 banks by asset size account for 84 percent of system lending, and 82 percent of system deposits.

Economic recovery and sustainable investment are constrained by a severely weakened financial sector that is struggling to deal with large under-capitalized banks. Bank lending was flat in 2016 reflecting banks' risk aversion and increasing attention to collections, with very few opportunities for new lending aside from remaining disbursements under the Kazakhstani government's economic support program.

Government participation in financial intermediation in recent years has been significant. This includes the government's economic stimulus program, lines of credit from international institutions, and the allocation of Unified Pension Fund assets to commercial banks. Although Kazakhstan boasts a largely private-sector banking system, the state, through fully- and quasi-state entities, is the largest depositor and borrower, and owners of the largest banks are closely related to the country's political leadership.

The problems of risk governance, ownership and the safety of deposits are intertwined. Reducing state exposure to these risks will not be easy, because the exposures maintain the liquidity—and sometimes the solvency—of the country's largest financial institutions. Unwinding these exposed positions carries serious risks, and the interconnectedness of the largest financial institutions with each other and the real economy will need to be approached with great care.

Non-bank financial institutions remain underdeveloped, including the insurance sector. With the insurance industry premium volume at T 323 billion as of January 2017, or about US\$63 per capita, and two-thirds of this represented by Almaty and Astana, Kazakhstan's insurance market is under-sized. The regulator and the insurance sector should address complex challenges related to market development, consumers' lack of familiarity with products, inadequate tax treatment (for example, of life insurance products), an undeveloped range of long-term investment instruments, and the need for improvements in the regulatory framework, especially surrounding solvency and risk management.

If the regulator and the Kazakhstani government were to take bold and coordinated steps to clean up the banking system and close insolvent banks, restructure some banks at least-cost to the state, and shore up depositor confidence, Kazakhstan's future banking system could unlock enormous growth potential. Distressed assets, including poorly governed under-performing corporates, unfinished construction projects, industrial assets, and residential mortgage portfolios, could all be managed effectively by competent, professional teams, sold to investors and restructured.

Just as the Kazakhstani government needs to take coordinated action to move the privatization agenda forward, it should also resolve the issue of insolvent banks and seek least-cost solutions in dealing with the overhang of distressed assets. Governments elsewhere that have tried to intervene discreetly have often led to even higher losses being incurred. Maintaining depositor confidence remains a top priority and calls for better coordination among safety-net players and appropriate public communications. Also important is the creation of an asset management entity for the work-out of distressed assets that is accountable, efficient, and transparent. In the case of Kazakhstan, this will likely be a state-owned entity.

Appendix C: World Bank Group Portfolio in Kazakhstan

Table C. 1: Kazakhstan: IBRD active portfolio, by GP, as of December 2016

| Resp Unit | Project Name | Date, Board App | Rev Closing | Proj Age in Yrs | Net Comm Amt (\$m) | Tot Disb (\$m) | % Disb | Disb in FY (\$m) | % Disb Ratio |
|-------------------|--------------------------------------|-----------------|-------------|-----------------|--------------------|----------------|--------------|------------------|--------------|
| GED03 | KZ SKILLS AND JOBS | 03/30/2015 | 06/30/2020 | 1.7 | 100.0 | 0.2 | 0.2% | 0.2 | 0.2% |
| GED03 | Youth Corps program | 03/26/2014 | 12/29/2017 | 2.8 | 21.8 | 0.4 | 1.9% | 0.4 | 1.9% |
| GEE03 | ENERGY EFFICIENCY PROJECT | 05/22/2013 | 06/30/2017 | 3.6 | 21.8 | 1.4 | 6.3% | 0.5 | 2.4% |
| GEN03 | UST-KAMENOGORSK ENV REMED | 02/01/2007 | 12/31/2016 | 9.9 | 17.3 | 5.5 | 31.5% | 0.1 | 0.8% |
| GFM09 | KZ: SEECA CRIF | 04/08/2016 | 12/31/2019 | 0.7 | 5.0 | 0.5 | 10.0% | 0.5 | 10.0% |
| GGO15 | Justice Sector Insttnl Strengthening | 03/19/2014 | 12/31/2018 | 2.8 | 36.0 | 1.1 | 3.2% | 0.5 | 1.4% |
| GGO15 | Tax Administration Reform Project | 02/16/2010 | 12/31/2018 | 6.9 | 17.0 | 5.0 | 29.4% | 1.3 | 10.0% |
| GHN03 | HLTH SEC TECH | 01/15/2008 | 06/30/2017 | 9.0 | 117.7 | 96.2 | 81.7% | 26.8 | 55.5% |
| GHN03 | Social Health Insurance Project | 04/27/2016 | 06/30/2021 | 0.7 | 80.0 | 0.0 | 0.0% | 0.0 | 0.0% |
| GMF09 | Kazakhstan Programmatic DPO | 11/03/2015 | 12/31/2016 | 1.1 | 1,000.0 | 1,000.0 | 100.0% | 0.0 | 0.0% |
| GPV03 | KAZSTAT | 03/31/2011 | 04/30/2017 | 5.7 | 20.0 | 18.5 | 92.3% | 2.3 | 60.2% |
| GTC10 | Kz: Fostering Productive Innovation | 12/22/2014 | 12/31/2020 | 2.0 | 88.0 | 8.4 | 9.5% | 8.4 | 9.5% |
| GTC10 | SME Competitiveness Project | 03/02/2015 | 06/30/2020 | 1.8 | 40.0 | 0.6 | 1.4% | 0.5 | 1.3% |
| GTI10 | Center West Regional Development | 06/09/2016 | 12/31/2021 | 0.5 | 977.9 | 0.0 | 0.0% | 0.0 | 0.0% |
| GTI10 | EAST-WEST ROADS | 05/01/2012 | 06/30/2017 | 4.7 | 1,068.0 | 531.9 | 49.8% | 111.0 | 17.2% |
| GTI10 | SOUTH WEST ROADS | 04/30/2009 | 06/30/2018 | 7.7 | 2,125.0 | 1,767.4 | 83.2% | 28.7 | 7.4% |
| GWA09 | IRRIG/DR 2 | 06/27/2013 | 12/31/2021 | 3.5 | 102.9 | 1.7 | 1.6% | 0.9 | 0.8% |
| Kazakhstan | | | | | 5,838.3 | 3,438.6 | 58.9% | 182.2 | 7.1% |

Table C. 2: Kazakhstan: IFC Outstanding Portfolio as of December 2016

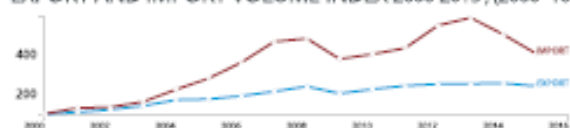
| | | Outstanding Balance - IFC | | |
|------------------------|-------------------------|---------------------------|------------|------------|
| | | Equity-EQ | Loan-GR | Total |
| 37442-KMF Swap I | Financial Markets | 0 | 520,085 | 520,085 |
| 35534-RG Brands | Agribusiness & Forestry | 0 | 8,861,533 | 8,861,533 |
| 35294-Arnur_Swap#6 | Financial Markets | 0 | 22,500 | 22,500 |
| 34328-KMF | Financial Markets | 0 | 2,181,807 | 2,181,807 |
| 33323-Arnur_Swap#5 | Financial Markets | 0 | 83,047 | 83,047 |
| 31830-Sberbank KZ | Financial Markets | 0 | 13,544,112 | 13,544,112 |
| 31760-Jambyl Cement RI | Manufacturing | 2,242,436 | 0 | 2,242,436 |
| 30975-ECT | Infrastructure | 19,759,369 | 10,840,039 | 30,599,408 |
| 30719-Jambyl RI | Manufacturing | 1,018,466 | 0 | 1,018,466 |
| 30249-Altyn-IMS IV | Agribusiness & Forestry | 0 | 723,750 | 723,750 |
| 28071-BCC Equity | Financial Markets | 7,792,273 | 0 | 7,792,273 |
| 26891-Jambyl Cement | Manufacturing | 4,747,000 | 14,285,500 | 19,032,500 |

Appendix D: Key indicators of business environment in Kazakhstan (from T&C Data 360)

| | Avg 2003-2012 | 2013 | 2014 | 2015 | PROJECTIONS | | | |
|---|---------------|-------|-------|-------|-------------|-------|------|------|
| | | | | | 2016 | 2017 | 2003 | 2017 |
| TRADE | | | | | | | | |
| Total trade in goods and services (% of GDP) | 86.02 | 65.41 | 64.97 | 53.14 | .. | .. | | |
| Trade balance, merchandise (% of imports) | 72.64 | 73.55 | 92.42 | 51.48 | .. | .. | | |
| Exports of goods and services (annual % growth) | 3.30 | 2.70 | -2.50 | -4.20 | .. | .. | | |
| Imports of goods and services (annual % growth) | 6.17 | 7.80 | -4 | -0.60 | .. | .. | | |
| Total reserves in months of imports | 4.16 | 3.27 | 4.30 | 5.69 | .. | .. | | |
| INVESTMENT | | | | | | | | |
| Total investment (% of GDP) | 28.29 | 24.57 | 25.79 | 29.50 | 28.23 | 26.90 | | |
| Gross capital formation (% of GDP) | 28.29 | 24.57 | 25.79 | .. | .. | .. | | |
| Gross fixed capital formation (% of GDP) | 25.95 | 21.88 | 21.56 | .. | .. | .. | | |
| Foreign direct investment, net inflows (% of GDP) | 9 | 4.23 | 3.20 | 3.57 | .. | .. | | |
| ECONOMY | | | | | | | | |
| GDP growth (annual %) | 7.21 | 6 | 4.20 | 1.20 | .. | .. | | |
| General government structural balance (% of GDP) | 3.45 | 4.19 | 2.24 | -6.67 | -4.16 | -6.10 | | |
| Personal remittances, received (% of GDP) | 0.12 | 0.09 | 0.10 | 0.11 | .. | .. | | |
| General government gross debt (% of GDP) | 9.69 | 12.60 | 14.50 | 21.88 | 21.08 | 21.80 | | |
| Inflation, consumer prices (annual %) | 8.52 | 5.84 | 6.72 | 6.65 | .. | .. | | |

EXPORTS & IMPORTS

EXPORT AND IMPORT VOLUME INDEX 2000-2015, (2000=100)



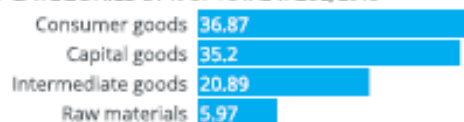
SOURCE: WORLD DEVELOPMENT INDICATORS (WDI)

TOP 5 EXPORTS BY % OF TOTAL VALUE, 2015



SOURCE: WORLD INTEGRATED TRADE SOLUTION (WITS)

IMPORT CATEGORIES BY % OF TOTAL VALUE, 2015



SOURCE: WORLD INTEGRATED TRADE SOLUTION (WITS)

BUSINESS ACTIVITY

GROSS VALUE ADDED BY ECONOMIC ACTIVITY 2015 (% GDP)



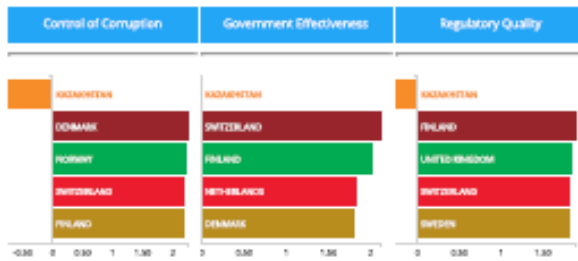
SOURCE: WORLD DEVELOPMENT INDICATORS

DOING BUSINESS 2017

| Indicator | Distance to Frontier | | | Rank | | |
|-------------------------------|----------------------|-------|-------|------|------|-----|
| | 2016 | 2017 | Δ | 2016 | 2017 | Δ |
| Ease of Doing Business | 70.45 | 75.09 | 4.64 | 51 | 35 | -16 |
| Dealing with Construction | 69.93 | 79.05 | 9.12 | 78 | 22 | -56 |
| Enforcing Contracts | 75.7 | 75.7 | 0 | 9 | 9 | 0 |
| Getting Credit | 55 | 55 | 0 | 70 | 75 | 5 |
| Getting Electricity | 64.81 | 73.64 | 8.83 | 102 | 75 | -27 |
| Paying Taxes | 79.54 | 79.54 | 0 | 57 | 60 | 3 |
| Protecting Minority Investors | 66.67 | 80 | 13.33 | 25 | 3 | -22 |
| Registering Property | 83.59 | 83.72 | 0.13 | 18 | 18 | 0 |
| Resolving Insolvency | 58.97 | 69.17 | 10.2 | 46 | 37 | -9 |
| Starting a Business | 89.95 | 91.94 | 1.99 | 54 | 45 | -9 |
| Trading Across Borders | 60.39 | 63.19 | 2.8 | 128 | 119 | -9 |

SOURCE: DOING BUSINESS REPORT 2017

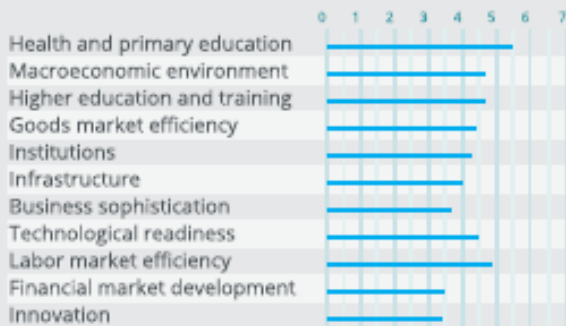
WORLDWIDE GOVERNANCE INDICATORS (WORLD BANK)
Compared with region's top 4 performers, 2014



SOURCE: WORLDWIDE GOVERNANCE INDICATORS 2014



WEF COMPETITIVENESS INDICATORS 2016-2017



SOURCE: WEF GLOBAL COMPETITIVENESS REPORT 2016-2017

ENTERPRISE SURVEY 2013

| | KAZ | ECS | All Countries |
|---|------|-------|---------------|
| Number of electrical outages in a typical month | 0.5 | 1.57 | 2.48 |
| Percent of firms with a bank loan/line of credit (%) | 19.2 | 38.3 | 10.85 |
| Proportion of investments financed by banks (%) | 8.8 | 14.35 | 4.44 |
| Proportion of investments financed internally (%) | 83.4 | 71.82 | 23.81 |
| Senior management time spent dealing with requirements of government regulation (%) | 5.5 | 11.85 | 3.35 |

SOURCE: ENTERPRISE SURVEY 2013

LOGISTICS PERFORMANCE INDEX



SOURCE: LOGISTICS PERFORMANCE INDEX (WORLD BANK)

TRADE POLICY

| | 2010 | 2014 |
|---|-------|------|
| MFN Tariff (Simple Average) ¹ | 8.67 | 7.55 |
| MFN Tariff (Agriculture) ¹ | 10.05 | 7.89 |
| MFN Tariff (Non-agriculture) ¹ | 8.21 | 7.4 |
| Applied Tariff (Incl. Prefers. and Trade-Weighted) ² | 7.56 | 6.95 |
| Import duties collected (% of tax revenue) ¹ | 7.26 | 4.95 |
| Services sectors w/ GATS commitments (2016) ³ | | 36 |

SOURCE: WDI (1), WITS (2), I-TIP SERVICES (3)

TOP 5 CONSTRAINTS

ACCORDING TO ENTERPRISE SURVEY 2013 (% RESPONDENTS)



SOURCE: ENTERPRISE SURVEY 2013

ACCORDING TO WEF 2016 (% RESPONDENTS AMONG 88 EXECUTIVES)



SOURCE: WEF GLOBAL COMPETITIVENESS REPORT 2016