

Establishing a Regional Financial Center in Almaty:
Is it feasible?

by

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Abstract

The Regional Financial Center of Almaty (RFCA) is one of the Kazakhstan government's premier projects aimed at diversifying the national economy and improving the country's position in the global market. This research examines the feasibility of the RFCA. For a financial center to succeed, a number of conditions must exist. Successful growth of a financial center requires a healthy financial sector and a favorable investment climate. Based on an analysis of the existing circumstances in Kazakhstan and the structure of its economy, I argue that the RFCA creates opportunities for the domestic economy, but its functional feasibility is currently constrained by the limited scope of a variety of financial services available in Kazakhstan, the distorted structure of the economy and the poor performance of the industrial sector. This analysis shows that the financial center is not feasible at this point in time and requires a sequence of investments in other sectors of the economy to support its operations and growth. Otherwise, there is a risk that the establishment of the RFCA may redirect a bulk of national resources away from other vital industries, where these resources are more needed, solely into the financial sector. This exclusive investment may ultimately lead to the failure of the RFCA.

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Introduction

The establishment of a Regional Financial Center of Almaty (RFCA) has been cited by the President of the Republic of Kazakhstan Mr. Nursultan Nazarbayev as an important milestone in the entry of Kazakhstan into the world economy and as a foundation for the future success of the country.¹ A financial center is one of many efforts to improve the environment for business and entrepreneurship development, which is the main goal of the government of the Republic of Kazakhstan.²

The government anticipates that the financial center, through infusion of liquidity into domestic security market will help to attract the best global technologies, improve the quality of retail services, enhance an investment culture in the people of Kazakhstan and, most importantly, create structural reforms in the industrial sector of the national economy. Finally, the government expects the financial center to be an important tool for providing macroeconomic stability.³

However, little has been written about the circumstances under which such a center might be developed in Kazakhstan and the actual conditions required for the viable functioning of a regional financial center in order to achieve the goals set by the government. This study provides an analysis of the characteristics and settings under which a successful financial center may take root in Kazakhstan.

The study does so by: a) analyzing the depth of the financial sector in Kazakhstan; b) estimating the demand for credit by the rest of the national economy; and, finally c) benchmarking Almaty's efforts to build a Regional Financial Center with the successful

¹ See the full text of Address by the President of the Republic of Kazakhstan Mr. Nursultan Nazarbayev to the People of Kazakhstan (2006) at: <http://kazakhstan.embassy.lt>

² Declared by the government of Kazakhstan on 24 November 2005. Retrieved from http://www.government.kz/ru/text_public.asp?ID=131

³ Ibid.

international initiatives in Dubai, United Arab Emirates. The goal of the study is to provide a better understanding of the feasibility of a regional financial center in Kazakhstan as well as general insights into the conditions under which a financial center can become an efficient tool for the region's economic development.

What is a financial center?

To appreciate the decision to create a financial center, one must have an understanding of what a financial center is. According to broad definitions in the economic literature, a financial center is a spatial hub of a network of established financial institutions and efficient markets offering an array of financial services, and consequently, serving as an intermediary between foreign and domestic customers (Tan, 1978). Moreover, a financial center can generate strong indirect impacts on economic growth, employment, tax revenue, construction and tourism.

The key attributes that identify a financial center are mechanisms for hosting markets for various forms of capital and insurance and being a center for a stock exchange, which provides the means by which the market prices of stocks can be fairly established and circulated to clients (Schenk, 2001). In addition to these common financial characteristics, industrial players are expected to be active participants both in present and potential dealings of the financial center.

In line with the general definition, Richard Roberts describes four types of financial centers: 1) domestic financial centers that are aimed at meeting the demands of domestic customers; 2) regional financial centers that reach outside of national borders to meet a particular economic region's demand for financial services; 3) offshore financial

center, which offer to its participants a special tax and regulatory regime to reduce the cost of offshore transactions; 4) international financial centers that offer services to global clients (Holtfrerich, 1999).

Regional and international financial centers get the most attention nowadays given their potential contribution to the economic sector and regional competitiveness. Historically, these types of financial centers tend to grow out of the commercial activity of the country where the center is located. At the same time, politicians support them by contributing to the overall business environment, in particular by providing regulatory framework and institutional infrastructure under which they would operate (Schenk, 2001). For instance, in London, New York and Honk Kong there was already an ongoing agglomeration of services and infrastructure. Consequently, these cities developed strong financial sectors, which were based on international trade that became the foundation for the emergence of financial centers.

However, financial centers in most emerging countries, such as Singapore and Dubai, did not develop gradually or organically. They were the outcome of more deliberate policy undertakings. The governments realized that a vibrant financial and banking sector could make significant contributions to the development of other sectors of the economy (Tan, 1978). In this sense, the decision of the government of Kazakhstan to create a regional financial center falls under the category of policy driven financial centers in emerging markets such as Dubai.

Diversification though a financial center in Kazakhstan

The project to develop the Regional Financial Center of Almaty came alive on the 5th of June 2006 after the President signed a law of the Republic of Kazakhstan “On a regional financial center of the city of Almaty”.⁴ The main goal of the proposed financial center was to ensure economic sustainability of Kazakhstan by strengthening the domestic financial system (Batyrbekov, 2006). Consequently, it is expected that the financial center will foster local economic development through attracting investments into the country and opening up opportunities for the country’s capital to enter foreign securities markets, specifically, through direct and indirect impacts the RFCA hopes to achieve⁵:

- Diversification of the local economy,
- Increased competitiveness of the financial sector,
- Development of Almaty as a financial hub for Central Asia,
- Creation of new highly paid jobs,
- Development of Almaty’s city and institutional infrastructure,
- Development of tourism in the south of Kazakhstan.

Kazakhstan is a big country, among the ten biggest in the world. With an area of 2,724.9 thousand square kilometers, the population of 15.2 million is unevenly settled in the various parts of the country. The central part of the country remains predominantly deserted.⁶ The country is best known for its western part, which is rich in oil and gas

⁴ See the presentation on Regional Financial Center of Almaty, 2006. Retrieved from http://www.centralasianipo.com/RFCA_eng.pdf

⁵ Ibid.

⁶ According to the Agency of Statistics of Kazakhstan, www.stat.kz

resources. Accordingly, oil reserves play a central part in the revenue collection for the country's central budget: in 2005, the oil and gas industry accounted for 16.6 percent of the country's GDP; while oil byproducts, such as fuel, comprised 69 percent of total exports.⁷ Exploited as it is now, the oil and gas sector of the economy is constrained by the volume of available resources, and is ultimately limited. Thus, there is an urgent need to diversify the country's economy beyond oil and gas.⁸

Consequently, President Nazarbayev in his address to the Parliament in 2004 put forward an initiative of setting up a regional financial center in the southern part of Kazakhstan, the former capital city of Almaty.⁹ According to Mr. Nazarbayev speech, it was important to form 'breakthrough points' for the growth of the domestic market with the aim of forming a new economy based on knowledge and expertise. Particularly, he recognized the potential of Kazakhstan and Almaty in particular, as an exporter of financial services. Currently, Almaty's financial and banking services comprise about 80 percent of the country's financial institutions, including the National Bank, the Kazakhstan Stock Exchange, and most of the insurance companies and pension funds.¹⁰

Fostered by the Presidential approval, in 2005 the government of the Republic of Kazakhstan engaged the Boston Consulting Group (BCG) to perform a study of the Kazakhstani securities market, in particular its 1) availability, 2) transparency, 3) reliability, 4) motivation of participants, and 5) government support.¹¹ The BCG's research supported the government's belief in the country's favorable environment,

⁷ Kazakhstan - country brief 2006. Retrieved from <http://www.worldbank.org.kz>

⁸ Diversification is defined as a balanced economic structure (Siegel et al., 1995).

⁹ Address by the President of the Republic of Kazakhstan Mr. Nursultan Nazarbayev on the Open Session of Parliament (05th of November 2004). Retrieved from <http://kazakhstan.embassy.lt>

¹⁰ Survey by the Times of Central Asia. No 19- May 12, 2006.

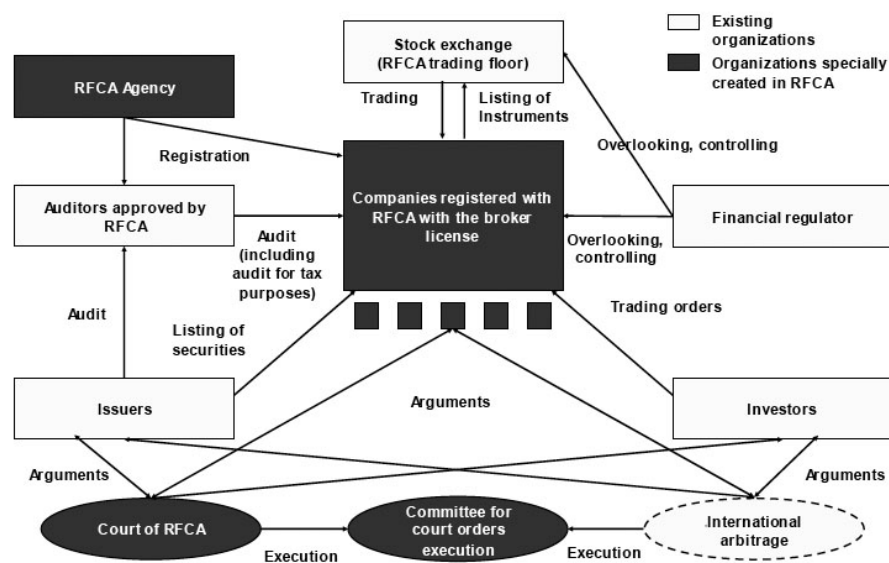
¹¹ Statements, publications of the Prime Minister and members of the government as of 24 November 2005. Retrieved February 15, 2007, from http://www.government.kz/ru/text_public.asp?ID=131

including its business reliability, developed infrastructure and educated workforce, concluding it was adequate to establish a financial center.

More to the point, according to the consultant's report, Almaty had all the necessary conditions for the financial center, including strong support from the government and a relatively advanced financial sector, which had grown rapidly in recent years (Batyrbekov, 2006). According to Grigory Marchenko, a former governor of the central bank, the ratio of the assets of Kazakhstan to its GDP is 55 percent (Pala, 2005). This measure confirms rapid growth of the country's financial services. In addition, Mr. Marchenko stressed that: "Poland's ratio is 60 percent and it's quite possible we will overtake them in a couple of years" (Pala, 2005).

In response, the Boston Consulting Group, together with the government authorities of Kazakhstan, designed a model for the RFCA based on the government's goal to enhance competitiveness and the successful examples of large international financial centers, such as those in Singapore, Dubai, and Dublin, (Figure 1).

Figure 1. Structure of the RFCA



Source: Central Asian Capital Market conference, <http://www.centralasianipo.com>

Simply put, the Regional Financial Center of Almaty (RFCA) is:

- A new trading platform to buy and sell securities,
- A new office building.

The RFCA operates in the form of a special zone under a special legal regime. The new regulatory framework simplifies the procedures to buy and sell securities both for residents and non-residents.¹² Yet, a new trading platform is not a new or different stock exchange. It is a set of different tax policies, under which capital gains of the members of the RFCA are treated as ordinary income (Moody Interview, 2007). Specifically, investors registered with the RFCA are free from the corporate income tax, the income tax on dividends and share price revaluation.¹³ As non-tax incentives, the RFCA allows its participants to (1) trade a wide range of securities, such as obligations, derivatives and other instruments, in US Dollars, Kazakhstan Tenge and other currencies, and (2) operate in the Kazakh, Russian and English languages.

To become a member of the RFCA, a firm or organization must meet two major requirements. First, it must be a professional participant in the securities market, accomplishing brokerage and dealership activities. Second, it must establish an office in the city of Almaty.

The construction of the RFCA complex has already started in Almaty. Skidmore, Owins & Meryll (SOM) is in charge of the master plan and design of the RFCA complex. Construction of the facility will be performed in three stages over three years: 2007, 2008

¹² Other monetary incentives include coverage of part of audit costs for issuers and discounted cost of registration on the RFCA exchange. See website of the Agency of the RK on Regulation of Activities of RFCA: <http://www.rfca.kz/>

¹³ See website of the Agency of the RK on Regulation of Activities of RFCA: <http://www.rfca.kz/>

and 2009.¹⁴ The outcome of the first stage should be four office buildings of about 160,000 square meters. Altogether, the government will invest more than \$2 billion in the construction of the financial center, which will include 30 office buildings along al Farabi Avenue, one of the most prestigious locations in Almaty.¹⁵

Apart from broker-dealer firms, the main groups of participants in the RFCA will be investors and issuers of shares, state-backed securities, credit linked notes, exchange-traded funds, obligations, derivatives and other securities instruments. The list of possible issuers includes medium and large companies from Kazakhstan; medium sized companies from Russia, Ukraine, and Central Asia; Kazakhstan banks, the RFCA brokers and other foreign issuers.¹⁶ As potential investors, the RFCA welcomes Kazakhstan pension funds, insurance companies, banks and companies; Russian and other regional banks; international and Islamic investors.

Since the official start of the RFCA in June 2006, 16 organizations have registered with the RFCA as of 2nd February 2007 (Appendix, Table A1). Furthermore, the RFCA prepared agreements to issue bonds at the stock exchange with a joint-stock company, “Kazyna”, the fund engaged in state administration and management of industrial and innovative development, and with a state holding company, “Samruk”, which is a shareholder in some of the largest companies in Kazakhstan, including “KazMunayGas” (oil and gas), “Kazakhstan Temir Zholy” (railways), “KazakhTelekom” (telecommunications), “KEGOC” (electricity grid operating company) and “KazPost”

¹⁴ Almaty Development. 2006. Retrieved from <http://almatydev.blogspot.com/2006/11/almaty-financial-plaza.html>

¹⁵ Ibid.

¹⁶ Agency of the RK on Regulation of Activities of RFCA. Retrieved from <http://www.rfca.kz/>

(post services).¹⁷ After all arrangements, the trading operations began on 27 of February 2007. As of 6th April 2007, there were 25 deals totaling about \$40 million dollars at the RFCA trading platform (Table 1).

Table 1. Deals made at the RFCA from 27 February to 6 April 2007

Date	No of deals	Total Amount, \$ USD	Comments
27.02.07	1	81,620	Corporate bonds of MAG JSC, Kazakhstan-based company engaged in the construction of residential, commercial and municipal buildings
14.03.07	2	179,700	Corporate bonds of MAG JSC
21.03.07	20	39,914,505	The holding Samruk sold the part of state stake of common shares of KazakhTelecom
29.03.07	1	161,600	Corporate bonds of MAG JSC
30.03.07	1	161,417	Corporate bonds of MAG JSC
TOTAL	25	40,498,842	

Source: Kazakhstan Stock Exchange, <http://www.kase.kz/eng/rfca>

If everything goes according to plan, based on the BCG experts' prognosis, the RFCA will reach the annual volume of \$5 billion worth of bonds issuance in 2008, which are expected to grow to \$8 billion by 2010.¹⁸ Moreover, the government expects to generate more than 1,000 jobs by 2008, as the result of the RFCA activity.¹⁹

Problem

Statement of the problem

One of the goals of the initiative to create a financial center in Almaty is to help diversify the domestic economy, which is currently concentrated on oil and gas

¹⁷ Website of Prime-Minister of Kazakhstan Mr. Massimov: <http://www.massimov.kz/?nc248&version=en>

¹⁸ See the official website of Almaty city: <http://www.almaty.kz/>

¹⁹ See the Survey by the Times of Central Asia as of May 12, 2006.

utilization, and to simultaneously seek other ways to enhance the security of Kazakhstan's position in global markets. Subsequently, the President decided to find an effective framework to boost the competitiveness of Kazakhstan based on his vision of where the country should be in the long-term. In this respect, the examples of Dubai and Singapore provide an encouraging empirical model of how the government, as the key actor in the economy, can create the enabling conditions to foster the inflow of foreign capital into the region and, consequently, bring prosperity to the people of the region. Likewise, BCG's research seems to confirm the similarities between the security markets of Kazakhstan and countries like Dubai.

However, little empirical research exists that examines the essential environment required to support and allow for the viable growth of the Regional Financial Center of Almaty in ways that can foster regional economic development. None exists which investigates the conditions under which a financial center can survive in Kazakhstan.

Therefore, the goal of this study is to investigate if the anticipated financial center with the newly created trading platform is the tool that the government of Kazakhstan should employ in order to accelerate the region's economic growth based on the existing set of conditions in the country. Specifically, this study provides an analysis of the characteristics and settings under which a financial center may successfully function and become an efficient mechanism for regional economic development.

Methodology

First, it is important to consider to what extent the financial sector of Kazakhstan, including its banking and non-banking institutions, is equipped to support the regional

financial center. The evidence of major financial centers in other parts of the world vividly illustrates that sound financial institutions provide macroeconomic stability and, consequently, serve as a foundation for strengthening the domestic securities market. Specifically, the new entrants will be attracted by the collection of advanced banking and insurance expertise combined with the sufficient capacity of pension funds (Schenk, 2001). In addition, growth of the stock exchange contributes to the emergence of an efficient financial center. Consequently, a healthy banking and financial system is essential for the attraction of investors into the RFCA.

Second, since the growth of the banking sector and the industrial sector are continuously reinforcing each other, this paper aims to show how the industrial structure corresponds to the role of the financial center. Essentially, the industrial sector of the economy is the engine of economic growth. It includes the production factor market, such as raw materials, and the output market that produces goods and services. The financial sector is important in the performance of the industrial sector since it provides funds to producers. However, an excessively international outlook by the banking system may impede the growth of domestic industrial finance and create an equity gap.²⁰ Firms would have limited access to the capital they need to reach their full potential. Thus, it is important to provide constructive insights into the impact of the financial sector on industry in terms of the industry's access to capital, specifically by small, medium and large size firms.

Third, assessment of the industrial structure and output is necessary, because the accumulation of wealth resulting from manufacturing and trade attracts branches of

²⁰ The equity gap is also called 'MacMillan' gap. The MacMillan gap means the lack in long-term financing available for small and medium firms (Frost, 1954).

overseas banks and brokers who aim to direct their savings into international markets (Schenk, 2001). In other words, more commercial banks will establish offices in Almaty, if the domestic economy has a strong and productive industrial sector.

Finally, since the government of Kazakhstan chose to follow the example of Dubai, there is a need to consider the likelihood of replicating the Dubai model in Kazakhstan. Benchmarking of current conditions of Kazakhstan with the successful international model is essential: if the financial center is not feasible at this point of time or requires a sequence of simultaneous investments in other sectors of the economy to support its operations and growth, then there is a risk that the establishment of the RFCA may redirect a bulk of national resources from other vital industries where they are more needed solely into the financial sector. This may lead to the failure of the RFCA.

Research design

To effectively address the main research problem outlined above, this study is divided into three central parts and a conclusion. The three central parts represent the analysis of the problem. There is also a brief discussion of the financial centers as a concept. The paper concludes with a brief summary of the RFCA implications.

Part I of the analysis answers the question: is there enough depth in Kazakhstan's financial sector to support a Regional Financial Center of Almaty? To answer this question, I study four components of the financial sector that can be directly related to the financial center: 1) the structure of the banking system, total assets in domestic banks, banking regulations and how banks can meet the needs of the RFCA; 2) the insurance sector's capacity to support investors' confidence and the opportunity for risk spreading;

3) the pension funds and accumulated domestic savings that are needed for participation in the trading platform; 4) the operation of the Kazakhstan Stock Exchange (KASE) and its relation to the new trading platform of the RFCA. There are other organizations that are in a category of non-bank financial institutions, such as leasing companies and mutual funds. Their presence in Kazakhstan is not significant; and, therefore, they are not part of this research.

In Part II, I analyze the industrial structure of Kazakhstan, specifically, firms' access to and demand for credit and whether the RFCA will narrow or widen the liquidity gap in industry's supply of credit. On the supply side, it is important to determine whether the financial center is a suitable tool to provide the inflow of capital into the domestic economy. On the demand side, the question is whether the presence of the RFCA may absorb investment away from the industrial sector by diverting loanable funds to the financial sector. In other words, it is important to identify if the potential foreign participants attracted to the RFCA will create a gap between the needs of industry and the needs of banks. In addition, I will analyze Kazakhstan's industrial performance and output in order to identify whether domestic industry is attractive for foreign banks and brokers for investment.

In Part III of the paper, I examine Dubai's financial center. First, I will evaluate the goals of the Dubai government and the history of the creation of the Dubai International Financial Center. Then, I analyze the actual business environment and the conditions that existed in Dubai that made it possible to create a financial center there. Finally, taking into account that the government of Kazakhstan chose Dubai as a model

for the RFCA, I benchmark conditions that were in place for Dubai's financial center with those that exist today in Almaty.

The main sources of information for the study on the RFCA are the Agency of the RK on Regulation of Activities of the RFCA, the Government of Kazakhstan, the Kazakhstan embassy, the Agency of Statistics of the Republic of Kazakhstan and the city of Almaty. Most of the financial data and information on industrial structure comes from the reports of the International Monetary Fund, the Asian Development Bank, the European Bank for Reconstruction and Development, the United Nations Development Program and the Pragma Corporation. Additionally, research findings are based on the literature and electronic articles on Kazakhstan's economic development. Finally, an email interview with Stephen Moody, the Senior Advisor to the Pragma Corporation that carried out a number of financial projects in Kazakhstan for the USAID, helped me to get valuable insights on the RFCA project.

Part I: Financial Sector in Kazakhstan

Financial centers have come to be seen as one of the most significant economic development mechanisms over the last fifty years. The development of financial centers has been fostered by the globalization of financial markets and the related liberalization of domestic capital markets around the world. If a sound microeconomic environment allows for the growth of the financial center and if it is managed well, then the spillover effects result ultimately in higher standards of living due to efficient resource allocation and improved risk distribution (Fischer, 1998).

Nevertheless, the increased volume and unpredictability of capital flows may result in serious problems in the domestic financial systems if there is not enough capacity in domestic financial institutions to support the securities market at the heart of any financial center. A country that experiences a large inflow of capital and lacks strength in the country's financial institutions at the same time, may not only fail to get the full spectrum of benefits of the financial center, but may also create a "risk damage to the living standards of its people, by increasing its own vulnerability; it may also become the epicenter of contagion effects that can have significant adverse effects on other countries" (Fischer, 1998).

Therefore it is important to analyze Kazakhstan's financial sector in terms of the form of its financial systems and the capacity of its financial institutions and structures. I analyze banks, insurance companies, pension funds and the capital market as direct participants of a financial center.

Banks

Even though the country is mainly recognized for its vast oil and gas reserves, Kazakhstan's banking sector is one of the leading sectors of the country's economy, and banking sector is currently drawing a lot of attention as a main actor and intermediary in the growth of the financial center. After the Soviet Union break-up in 1991, banks in Kazakhstan grew rapidly, led by eager young reformers. However, the effect of the Russian financial crisis in August 1998, when about 80 percent of Russia's banking assets disappeared, also affected Kazakhstan's economy.

As a result, the banking sector was restructured. The number of banks was reduced from 130 banks to 33 private owned and 2 state owned banks (Table 2). Similarly, the number of bank branches declined from 458 in 1998 to 377 in 2004 with the overall financial market heavily concentrated in the city of Almaty (Index of Economic Freedom, 2007). The banks that remained are diverse in their overall strategy and risk management, although smaller banks have to face more serious challenges in sustaining their feasibility. Still, this is seen as a positive experience for stimulating the national economy and boosting investor's confidence.

Table 2. Banks in Kazakhstan, 2004

Total banks	Banks with foreign participation	Total Assets	Deposits
35 (2 of them are state owned banks)	16	US \$10.8 billion	US \$7.1 billion

Source: The Microfinance Gateway 2004 and International Monetary Fund, Republic of Kazakhstan: Statistical Appendix, 2005

Additionally, the banking sector in Kazakhstan has benefited from the steady economic growth in the country, which has increased the domestic demand for financial services.²¹ For the most part, increasing oil revenue has facilitated the growth of the banking sector.²² Mortgage financing is another important growth factor of the banking sector. The demand for housing has been encouraged by the construction and real estate market growth (Appendix, Table A2). It has been stimulated mainly by the Kazakh housing programs and by transferring of the country's capital from Almaty to Astana.

²¹ International Monetary Fund. Country Report No. 04/338. Retrieved from <http://www.imf.org/external/pubs/ft/scr/2004/cr04338.pdf>

²² International Monetary Fund. Country Report No. 04/268. Retrieved from <http://www.imf.org.libproxy.lib.unc.edu/external/pubs/ft/scr/2004/cr04268.pdf>

This in turn pushed the major banks to diversify banking services and upgrade technologies, which are some of characteristics that are present in major financial centers.

Still, the best measure of the development of financial services in the economy is the ratio of Stock Market Debt, Securities Capitalization and Bank Assets against GDP (Table 3). In view of the fact that this can be done for all countries both emerging and developed, it gives a realistic quantitative assessment of financial sector development globally (Moody Interview, 2007). By this measure, Kazakhstan's financial sector is, to a large extent, further developed than the financial sectors in most European and Middle Eastern rising markets.²³

Table 3. Development of Selected Financial Sectors
(All countries except Kazakhstan EOY 2005, Kazakhstan EOY 2006 in US\$ Billions)

Area	GDP	Stock Market Capitalization	Debt Securities	Bank Assets	Total Financial Sector	Total as % GDP
Emerging Markets	11,969.0	6,573.7	4,479.3	9,432.8	20,485.8	171.2
Asia	5,393.7	4,408.6	2,379.7	6,522.4	13,310.7	246.8
Latin America	2,436.7	1,161.1	1,290.2	1,166.3	3,617.6	148.5
Middle East	1,120.4	159.0	61.5	734.3	954.8	85.2
Europe	2,211.3	295.6	625.4	679.2	1,600.2	72.4
United States	12,455.8	17,000.9	23,840.7	9,343.0	50,184.6	402.9
European Union	12,808.0	9,555.7	18,689.7	27,290.2	55,535.6	433.6
Kazakhstan	77.0	63.8	13.1	52.2	129.1	167.7

Source: IMF, Statistical Appendix to World Economic Outlook.

It appears Kazakhstan is now in the desirable position of being able to attract foreign investment banks to carry on their trade in a well-developed financial

²³ The numbers for Kazakhstan are for 2006 and the others are for 2005. However, it is still possible to get comparable results. Kazakhstan compares well to all other emerging market economies apart from Asia, which IMF defines as Hong Kong, Singapore, Taiwan, Korea and Israel (Moody Interview, 2007).

environment. Still, private investment banking, the so-called risk-takers, the arbitrageurs and financial engineers, are not well developed. This is the idea behind the RFCA - to fill in the gap in the financial sector.

On the one hand, foreign investors might be interested in the RFCA. Benchmarking of Bank Assets in the US to Bank Assets in Europe and then Market Capitalization and Total Debt Securities in the US to the same indicators in Europe shows that the ratio of Market Capitalization plus Total Debt Securities to Bank Assets, the so called 'Style Index', captures the style of the financial sector (Moody Interview, 2007). The results suggest that Europe is more bank-oriented, while the US is more market-oriented.²⁴ Therefore, the US financial markets are more flexible and lend themselves more easily to arbitrage and innovation. In this view, Kazakhstan that follows a strategy similar to the US may look attractive to foreign investors.

On the other hand, despite the progress in the banking sector, there are some significant obstacles in the framework of the financial sector in Kazakhstan. The major problem is excess liquidity. One measure of this is the ratio of money supply (M3) to GDP (Appendix, Figure A1).²⁵ Over the past three years this indicator has become less indicative and progressively driven by Foreign Reserves, specifically by the inflow of US dollars from oil export receipts. Consequently, excess liquidity creates the problem of inflation that may alarm possible investors.

In addition to liquidity problems that may limit investors' confidence, all of the major local banks, which have set up affiliates registered with the RFCA, are cautious

²⁴ It means that financial assets in Europe are valued once a year by auditors, whereas financial assets in the US are valued every day by the markets (Moody Interview, 2007).

²⁵ Ibid. This ratio measures the degree of monetization of an economy and the extent of potential financial intermediation. Hence, the higher the ratio, the greater the potential for intermediation is.

about the financial center idea (Moody Interview, 2007). It appears that the banks understand that if the RFCA in fact attracts foreign commercial and investment banks, they will lose what is now a practical monopoly on local business. The local bank's share in the domestic market might significantly diminish as a result of globalization.

Non-bank financial institutions

Operation of non-banking institutions parallels the task of banks as intermediaries of a financial center. Non-bank financial institutions (NBFIs), such as insurance firms, pension funds and capital markets, have a central role in the development of a strong well-diversified financial sector.²⁶ The non-bank institutions perform a range of roles that banks do not cover, consequently encouraging and improving the efficiency of investments. Efficient NBFIs help to enhance access to financial services, diminish the cost of financial transactions and improve the stability of the financial sector. The general characteristic of these institutions is that they mobilize domestic savings, which afterwards would be used to facilitate different financial activities including stock exchange. Because one of the goals of the RFCA is to export Kazakhstan's non-bank financial expertise to the region, the next section examines performance of non-bank institutions in Kazakhstan.

Insurance companies

In general, insurance companies are actively involved in the securities markets and in the allocation of long-term financial resources collected from insurers premium

²⁶ The World Bank. Unlocking Indonesia's domestic financial resources: The role of non-bank financial institutions. 2006.

(Tan, 1978). In Kazakhstan, the insurance sector has not received the same attention as given to the banking sector. Insurance gross premiums amounted for only 0.6 percent of GDP in 2003.²⁷ Consequently, it is rather small and underdeveloped to serve the needs of the RFCA.

Lack of expertise, complicated by the deficit of English fluency that limits international training, and lack of credibility with the public impedes the progress of insurance sector in Kazakhstan.²⁸ Besides, insurance companies' assumption of large amount of risks hampers the ability to set adequate prices for their products, which in turn may limit investor's confidence.

Like the banking sector, the insurance sector has been consolidating since 1998, which resulted in reducing the number of insurance firms from 71 to 32 in 2004, of which two are life insurance companies (FIRST Initiative, 2004). However, the restructuring did not solve the problem of inadequate capitalization of domestic insurance companies. In addition, the law of Kazakhstan restricts local insurers from re-insuring all their risks abroad. Moreover, non-resident insurance companies in Kazakhstan are prohibited from establishing branches.²⁹ This in turn may hold back foreign players from the domestic market.

Pension funds

Pension funds have an even greater influence on the financial system than insurance companies, since they are used to finance public investments. Therefore, an

²⁷ International Monetary Fund. Country Report No. 04/268.

²⁸ Kazkommerts Securities report "Kazakhstan. Financial sector overview for 2002." Available at: <http://www.kazakhstaninvestment.com/support-files/kazakhstan-finance.pdf>

²⁹ Doing business in Kazakhstan 2006. Almaty: Baker & McKenzie.

ability of the pension funds to accumulate domestic savings that are needed for participation in the trading platform of the RFCA is a significant issue. Like banks and insurance companies, pension funds experienced a pension reform in 1998 as well. The reform led to the opening of 16 private pension funds, including the state pension fund (SAF).³⁰ Accordingly, pension funds had accumulated US\$4.32 billion as of 2005.³¹ The pension reform changed the pension system from a pay-as-you-go defined-benefit format, to a scheme based on fully funded, definite payment principles.³² Consistent with the new system, pensions are based on contributions of 10 percent of income allocated to personal accounts and invested in financial instruments through a number of pension funds.

Still, the majority of the rural population and the self-employed do not participate in the fully funded pension system. It is also important to note that during the last twenty years self-employment experienced a large growth. If in 1995 self-employed people accounted for 16.6 percent of the employed population, by 2004, it had increased to 37.8 percent.³³ As a result, the ability of domestic pension funds to mobilize domestic savings and actual coverage of the new pension system is still small, taking into consideration the capacity of the system to create pensions for the whole working population of Kazakhstan. Therefore, the participation of the pension funds in the RFCA will be limited by these constraints.

³⁰ International Monetary Fund. Country Report No. 04/268.

³¹ The Pragma Corporation. (2005). Financial sector initiative. Report No. 21.

³² International Monetary Fund. Country Report No. 04/268.

³³ United Nations Development Programme. The great generation of Kazakhstan: Insight into the future. 2005

Capital market

The capital market is the final major component of the financial sector and by far the most important for the RFCA development. The Kazakhstan Stock Exchange (KASE) was created in 1993, immediately after the introduction of the local currency, Tenge.³⁴ Still, the capital market remains under-developed and concentrated on foreign exchange, repurchase agreements, and government debt instruments.³⁵ The limited variety of securities products relies heavily on short-term government bonds. Long-term corporate bonds are still trivial in the region. Even though the RFCA offers a wide range of securities instruments to its participants, the domestic capital market, which is currently concentrated on the limited range of such instruments, may be simply constrained by the lack of experience and expertise. In the worst-case scenario it will make the RFCA simply useless. In the best-case scenario the RFCA will enjoy the same benefits as the existing stock exchange KASE.

In addition, the stock market capitalization is very small. It comprises only 8 percent of the country's GDP. In the US, by comparison, it was 108 percent of the GDP in 2003 (Piedra, 2006). One of the reasons for this low capitalization is the fact that trading on the stock exchange has been slow to pick up. Marchenko, the head of the Halyk Bank, explains the slow capitalization of the domestic capital market by the fact that most A-listed companies are owned by strategic investors who do not wish to sell.³⁶ This means that the RFCA may have only a limited number of possible issuers. Furthermore, the existence of powerful financial-industrial groups might hinder pulling

³⁴ Kazakhstan Stock Exchange, <http://www.kase.kz/eng/geninfo/>

³⁵ International Monetary Fund. Country Report No. 04/268.

³⁶ International Monetary Fund. Country Report No. 04/337.

possible issuers into the RFCA trading platform. At the same time, the dominance of banks in the financial sector and the connection between the financial and industrial sectors may obstruct further expansion of the capital market.

Accordingly, the head of the Agency for Regulation of the RFCA's Activities sees some serious obstacles to the rapid development of the capital market. He suggested that the inadequate infrastructure of the securities market in Kazakhstan does not meet international standards.³⁷ Thus, there is a set of off-putting factors in the present capital market that does not benefit the image of the Kazakh stock exchange and the domestic securities market in general. This might jeopardize the development of the trading platform of the RFCA.

The study showed that both the banking and non-banking components of the domestic financial sector are still undergoing restructuring and have not reached a level of stability and sophistication to become a solid base for a financial center. The transformation of such a complex part of the economy as the financial sector is not easy and takes time. Most of the people in Kazakhstan are not yet familiar with the new financial alternatives such as securities. Additionally, providing only short-term security mechanisms, financial institutions will lack the functional role of financial intermediaries in the RFCA.

Conversely, if the government makes the creation of the RFCA one of Kazakhstan's main priorities, upgrading of the domestic financial sector may redirect national resources solely to the needs of the financial center and leave significant number of prospective borrowers without access to credit, consequently creating an equity gap.

³⁷ The development of Kazakhstan's financial sector. *The Economist*, May 29 2003.

The first and the most evident link between the financial center and the industrial structure is industry's access to capital. In light of the fact that the growth of the banking sector and the industrial sector are continuously reinforcing each other, it is important that industrial firms have a sufficient supply of credit in order to reach their full potential. Therefore, it is important to understand the access to capital by the small, medium and large- sized firms of the industrial sector, as the accumulation of wealth resulting from manufacturing and trade attracts branches of overseas banks and brokers who aim to direct their savings into Kazakhstan's market by means of the RFCA.

Part II: Access to credit

Demand for credit

The financial sector is important to the smooth functioning of all layers of industry (Osinubi & Akinyele, 2006). The non-finance industries, especially those engaged in producing goods, rely on the banking system for working capital to buy inputs for production and, therefore, are dependent on the availability of credit. This part studies current demand and supply of credit in Kazakhstan and its impact on the industrial structure, specifically small, medium and large enterprises.

According to the EBRD report, Kazakhstan's access to international capital markets improved during the period of 2004-2006 and totaled over US\$6 billion.³⁸ Companies in natural resources, such as Kazakhmys, a copper mining company, KazakhGold, a gold mining company and KazMunaiGas, a national oil and gas company,

³⁸ European Bank for Reconstruction and Development. (2006). Strategy for Kazakhstan. Retrieved from <http://www.ebrd.com/about/strategy/country/kaza/strategy.pdf>

raised a significant part of this amount.³⁹ Consequently, large firms, in particular those related to natural resources, fund themselves easily from sources outside of Kazakhstan and use less than 7 percent of domestic bank lending.⁴⁰ Foreign direct investments are a main driving force behind the growth of such enterprises. Kazakhstan has received in total more than US\$ 35 billion of foreign direct investment just for the country's raw materials industries (Jeffries, 2003). These findings suggest that large firms engaged in exporting natural resources already have access to credit and can successfully raise capital on international stock markets.

Domestic large firms that have not yet gained access to international markets are still in a favorable position in Kazakhstan. Consistent with the Pragma Corporation's report, large businesses receive between 9 to 17 loans per year from the commercial banks (Appendix, Table A3). In general, the large size of the firm provides it with better recognition and reputation, which enhances its funding alternatives. Therefore, large-sized firms, which numbered 2,127 in 2000 (Table 4), do not have a pressing need to raise capital through the RFCA, although they could.

Table 4. The Number of Registered and Operating Legal Entities, 2000

Type of Entities	Registered	Operating	Operating as % of number of entities registered
Small	125,566	97,939	78.0%
Medium	10,856	9,757	89.9%
Large	2,127	1,738	81.7%
Total	138,549	109,434	79.0%

Source: Becker et.al. Demand for bank loans and credit bureau services in Kazakhstan.2002.

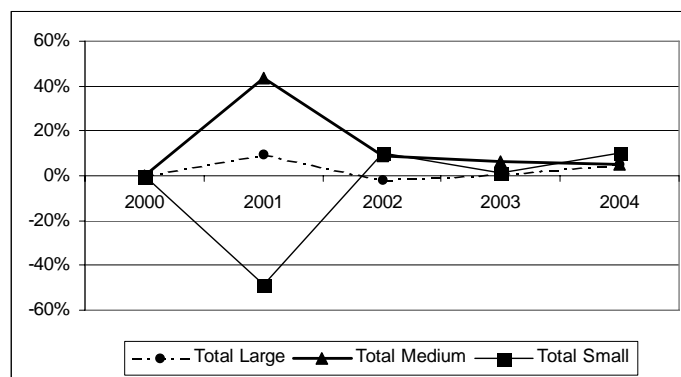
³⁹ Ibid. According to the EBRD report, Kazakhmys raised 600 hundred million British pounds, KazakhGold raised US\$ 196.5 million and KazMunaiGas raised US\$ 2 billion.

⁴⁰ International Monetary Fund. Country Report No. 04/268.

Conversely, medium and small enterprises (SMEs) do not have many alternatives in fund raising. But can they be linked to the RFCA and see it as a main source of capital? The RFCA indicated in its initial statement a goal of having medium-sized firms as potential investors. Also, the RFCA, as a part of a financial system, will have an impact on the availability of credit, in particular that of the middle class. The current number of medium firms in Kazakhstan is about 11,000 (Table 4). This number could be easily expanded if small firms grow to medium size. Therefore, medium enterprises should be analyzed together with small enterprises. The medium and small firms will be referred further as SMEs.

Statistics show that the number of operating SMEs is significantly lower than the number initially registered (Appendix, Table A4). Many small enterprises do not grow to the middle size. Consequently, the number of medium-sized enterprises remains low and unchanged (Figure 2).⁴¹ This indicates a problem of a ‘missing middle’ that becomes more prominent based on the fact that medium firms are those that the RFCA expects as active participants on their trading floor.

Figure 2: Employment growth in Small, Medium and Large Enterprises, 2000-2004



Source: IMF Country Report No. 05/239 and The Pragma Corporation: SME statistics – Republic of Kazakhstan. 2005.

⁴¹ The growth trend is based on the employment data, since employment is a valuable indicator of the firm’s capacity.

It is well known that SMEs face serious challenges in accessing credit (OECD, 2006). SMEs usually do not receive much foreign investments due to their low liquidity levels. They are also less popular with the commercial banks in Kazakhstan: medium-sized firms receive between 5 and 10 loans annually, while small enterprises can get only 1 loan per year (Appendix, Table A3). Consequently, a majority of small entrepreneurs specify the lack of financial resources as the key barrier to setting up a business (UNDP, 2005). Only 7 percent to 13 percent of all small and medium enterprises are established through the use of bank loans (Becker, et. al., 2002). The rest rely heavily on informal channels for financing that can be unpredictable and risky, and therefore, unreliable.

Domestic banks decline a large portion of loan applications from SMEs because of their failure to meet collateral requirements and the bank's fears that the loans would not be repaid. In order to get a loan, individuals have to gather letters from other banks confirming the status of their debts and accounts (Piedra, 2006). Unfortunately, rural borrowers are often not capable of getting the required certifications, because they have no assets other than their home, land, and livestock.

In fact, banks' strict collateral requirements and repayment schedules worry applicants with time-consuming bureaucratic procedures for loan approval. Banks' high interest rates and short loan terms push SMEs out of the formal capital market. In addition, the owners of small and medium-sized businesses have considerable gaps in the information and skills needed to access alternative official finance channels (OECD, 2006). SMEs typically use informal funding sources from family or friends, and are less linked to the trends in formal equity markets. Although bank credit can be replaced by

other financial sources at the initial stage, a bank loan remains a key tool for small enterprises to finance further growth and development.

Thus, in order to make the domestic market more attractive for foreign investors and pull up this middle class into the RFCA, it is important to give SMEs access to credit. Starting from the very first days of Kazakhstan's independence, SMEs have played a major role in the formation of the country's market economy. A robust SME sector is also essential in job creation. Moreover, fostering investment and access to credit at any stage of an SME's life cycle increases their potential to progress to the next level. Empirical studies of the life cycle of innovative SMEs show that, after expansion, they come to the stage called 'exit', which can occur in the form of an initial public offering (IPO) - IPO is the first sale of an enterprise's common shares to investors on a public stock exchange (OECD, 2006). In other words, by pulling up SMEs, the government can foster the growth of the RFCA.

Demand for microcredit is significant in Kazakhstan. In total, the demand is more than 800 million dollars (Table 5). The estimated number of individual entrepreneurs and micro enterprises that are constrained by limited starting capital is 86,500.⁴² However, this number could be expanded up to 200,000 people by taking into account the 20 percent of the unemployed population that have the necessary skills to start a business, such as management capacity and education.⁴³

⁴² United Nations Development Programme. (2005). Microfinance in Kazakhstan: An inclusive financial sector for all. Retrieved from http://europeandcis.undp.org/?menu=p_cms/show&content_id=3F6DF043-F203-1EE9-B229F6590491A9FE

⁴³ Ibid

Table 5. Demand for Microcredit

Microfinance clients	Demand for microfinance services (potential clients)	Demand for microfinance services (USD)
Unemployed	131,760 people	\$ 224,000,000
Individual entrepreneurs	70,000 entrepreneurs	\$ 1 75,000,000
Micro-enterprises	16,500 enterprises	\$ 41 3,000,000
TOTAL	218,260 clients	\$ 812,000,000

Source: Microfinance in Kazakhstan: An inclusive financial sector for all, UNDP. 2005

Supply of credit

Despite the high demand, the supply of credit is inadequate. Only 60,000 people out of a total of 200,000 clients that need credit received microcredit loans.⁴⁴ There are a range of organizations providing loans to SMEs, such as commercial banks, non-banking financial institutions, credit partnerships, microfinance institutions, NGOs and public funds (Table 6). In addition, international development banks such as the EBRD, the ADB and the World Bank have a number of programs to support credit access for all layers of the industrial structure. However, constrained by Kazakhstan's financial regulations and available resources, these organizations do not satisfy SMEs' demand for credit.

Table 6. Microfinance institutions in Kazakhstan

Level	Actors	Number
I	Second-tier banks	7
II	Non-banking financial institutions	32
	Credit partnerships	89
	Pawnshops	78
III	Microcredit organizations	208
TOTAL	Microfinance institutions	414

Source: UNDP. Microfinance in Kazakhstan: An inclusive financial sector for all. 2005

⁴⁴ United Nations Development Programme. (2005). Microfinance in Kazakhstan: An inclusive financial sector for all. Retrieved from http://europeandcis.undp.org/?menu=p_cms/show&content_id=3F6DF043-F203-1EE9-B229F6590491A9FE

The problem of funds disbursement to small and medium sized firms may become even more severe if the implementation of a large-scale project like the RFCA misdirects the funds. In that case, the RFCA is counterproductive in light of the role given to medium firms, to become participants on the trading platform of the RFCA. Thus, it is important that the presence of the RFCA will not impose even greater barriers to credit by diverting investments into the stock market.

One solution is to build simultaneously other mechanisms in addition to the RFCA that will increase the number of operating SMEs. While there is no evidence of how a financial center can directly foster SMEs growth to the level necessary to become issuers on the stock market, there are some alternative strategies that the government can employ to help SMEs in getting access to credit and foster the formation of a middle class, which is the key factor for long-term stability and the RFCA growth. One of the strategies to boost SME's development is strengthening the capacity of microfinance institutions.

Microfinance is a proven mechanism to build a comprehensive financial sector and to help the underprivileged to get access to financial services (OECD, 2006). According to the literature on economic development strategies, microfinance promotes long-term sustainable development and is closely linked with the formation of a middle class. It also encourages better use of productive capital through job creation by means of entrepreneurship and the number of new businesses. Specifically, *microcredit*, a core strategy of microfinancing, helps to fund start-ups and provides funds to expand existing enterprises. Therefore, microfinance institutions can fill in a gap in the financing of all layers of the economy. As SMEs become more capitalized, the middle-sized firms may

direct their funds into the stock market. Thus, the number of participants of the RFCA may increase. Moreover, a strong domestic industry will attract a larger number of foreign investors into Kazakhstan.

Box 1: Microfinance on the example of Bangladesh

Examples of micro-credit achievements, such as the Grameen Bank in Bangladesh, provides empirical evidence that fostering financial access to the underprivileged population can be a successful tool in a country's overall development. It is possible to say that Bangladesh's Grameen Bank is the world's most famous micro-financing institution. From its start in 1976 founders put a priority on recognizing people's needs. That made them capable of designing the right strategies to create of high quality financial services (Yunus & Jolis, 2003).

Through its activities Grameen turned into an independent bank that has a unique status with the Central Bank of Bangladesh. Grameen's strategy is based on a credit-saving scheme and obligatory savings deposits and is very proud of its self-reliance. Currently, the Grameen Bank covers almost all rural areas in the country. What is more, the Grameen Bank grants loans to people who don't have traditional collateral. Instead, group relationships serve as alternative collateral. Their monthly loans provide more than 2 million borrowers with total amount of USD 25 million in 36,000 Bangladeshi villages (Yunus & Jolis, 2003). The variety of loans and flexible repayment schedules are very encouraging features of Grameen Bank. However, the main characteristic of this program is removal of barriers from access to micro-credit.

Drawing on the experience of countries like Bangladesh (Box 1), the government of Kazakhstan can address insufficient credit flow in the country and develop a solid and secure middle class. On a foundation of a strong middle layer of domestic business in the Kazakhstan economy, in particular middle-sized firms engaged in trade and manufacturing, Kazakhstan can support and enhance the operations of the RFCA. Trade and manufacturing indeed can create the base for many other financial centers. The Dubai financial center is one example of such outcome.

The next section explains the Dubai case and evaluates the likelihood of replicating the Dubai model in Kazakhstan. Specifically, I benchmark the current conditions of the Kazakhstan economy with the successful international model of a

financial center in Dubai to ask whether the RFCA is feasible at this point of time in Kazakhstan or whether this initiative may require a sequence of other simultaneous events to support operations and growth of the country's financial sector.

Part III: Dubai Financial Center as best practice

Fostered by His Highness Sheikh Mohammed Bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, the government of Dubai established the Dubai International Financial Center (DIFC) to facilitate economic development in the UAE and the surrounding area. Particularly, the Dubai International Financial Center was designed to attract liquidity back into the region to contribute to its economic growth, to simplify privatizations, to provide an attractive market for investors, to create added insurance and reinsurance capacity and to develop a global center for Islamic Finance.⁴⁵ DIFC aims to be a catalyst for regional economic growth and diversification.

In order to reach this goal, the government of Dubai decided to create a financial center that would correspond in size of operations to the financial centers in New York, London and Hong Kong. Based on the example of these cities, the Dubai government expected that the creation of sophisticated domestic financial markets would help to transform the economies of the Gulf in a way that inflow of investment capital would create many new jobs in Dubai, all the UAE and neighboring countries. In this context, the Governor of DIFC, Dr. Omar Bin Sulaiman, said that the financial center would

⁴⁵ Dubai International Financial Center: <http://www.difc.ae>

foster the development of financial markets in the Middle East, North Africa and Central Asia region including Uzbekistan, Turkmenistan and Kyrgyzstan.⁴⁶

The first announcement of the government's intention to establish the Dubai International Financial Center was made in February 2002.⁴⁷ The government presented the idea of a financial center as a vision of a financial market serving the time zones between the London and Hong Kong financial centers and filling the gap not covered by them. Consequently, in June 2004, a federal law was signed to establish the DIFC as a federal financial free zone in the Emirate of Dubai.⁴⁸ A year later, the DIFC opened a Dubai International Financial Exchange (DIFX). Since, in the past, the pool of financial assets held by Middle East and regional investors has been invested outside the region through London, Geneva, New York, Hong Kong and Tokyo stock exchanges, it was expected that DIFX would act as a forceful alternative to the traditional practices used in borrowing money.

Conditions for the Financial Center in Dubai

Since the United Arab Emirates was formed in 1971, Dubai has been developing quickly (Peck, 1986). At the same time, UAE's economy, and Dubai's in particular, proved to be less dependent on the oil sector than the other Gulf countries. The oil sector accounted for 6.7 per cent of Dubai's GDP in 2004.⁴⁹ Dubai's government anticipates this figure to be reduced to 1 per cent by 2010.⁵⁰ In contrast, Dubai has strengthened its non-oil sectors. Dubai's strong transportation and communications infrastructure

⁴⁶ Dubai International Financial Center: <http://www.difc.ae>

⁴⁷ Ibid.

⁴⁸ Ibid.

⁴⁹ United Arab Emirates Yearbook 2006. Retrieved from: <http://www.uaeinteract.com>

⁵⁰ Ibid.

provided a base for creating one of the world's key *trade and shipment hubs* (Davidson, 2005). In addition, 23 free-trade zones encouraged internal investment and trade flow.⁵¹ Consequently, in less than two decades Dubai became the world's third largest re-export center after Hong Kong and Singapore.

Besides trade, Dubai's *manufacturing* sector showed a high growth rate. Its largest industrial manufacturing enterprises are engaged in aluminum production. In 2000, aluminum exports were 60 percent of Dubai's non-oil exports (Davidson, 2005). In addition, import and re-export of gold promoted the growth of the gold and jewelry industry, and made Dubai the fifth largest consumer of gold in the world in 2005.⁵²

Meanwhile, Dubai's rapid *construction* created an abundant supply of residential properties, office buildings and international schools. Most notable in Dubai is its offshore Palm and World Islands development, which is "the largest land reclamation project the world has ever seen" (Knight, 2006). Dubai also has specialist zones, including Dubai Internet City, Dubai Media City and Dubai Humanitarian City (Davidson, 2005).

Alongside these developments, Dubai offers world-class *tourism* with over 265 hotels. 78 of them are luxury hotels, including the world's first seven-star hotel, Burj Al Arab (Davidson, 2005). In addition, Dubai offers its tourists and residents the world's richest horse race, numerous high-class golf courses, shopping festivals and many other entertainment and retail activities.

Dubai is a safe place, with a near-zero crime rate that offers people a *stable and friendly place* to live in and work. The political climate in Dubai is considered to be

⁵¹ PricewaterhouseCoopers. (2006). Doing business in the Dubai International Financial Centre. Retrieved from <http://www.difc.ae>

⁵² United Arab Emirates Yearbook 2006. Retrieved from: <http://www.uaeinteract.com>

stable, experiencing no major internal conflicts and confrontations. Additionally, Dubai offers a range of financial incentives, including no personal taxes that have helped to expand consumption.⁵³ All in all, these factors fostered a steady inflow of a diversely skilled, well-educated and multi-lingual *workforce*. As a result, expatriates comprise over 80 percent of Dubai's population coming from over 150 nationalities.⁵⁴

Surprisingly, despite Dubai's growing image as a financial hub of the Middle East, the financial sector is the smallest contributor to Dubai's GDP.⁵⁵ Even so, Dubai satisfies major conditions that financial institutions look for. First, it is a cosmopolitan city, with a proven record of political and social stability. Second, it has a highly educated workforce. Third, it has delivered impressive projects in the construction, trade and tourism sectors. As a result, 140 of the Fortune Global 500 companies have already located in Dubai.⁵⁶ For all these reasons, UNCTAD World Investment Report ranked the UAE number 22 among the countries considered attractive to foreign investments.⁵⁷ Consequently, the Dubai International Financial Center was a logical development in the context of all of Dubai's other recent achievements.

At the same time, the Dubai example clearly shows that a financial center can function effectively only if the domestic economy offers certain conditions to support their activities. These conditions include political stability, strong institutions, efficient infrastructure, skilled experts, trade and industry, innovations and specializations. Thus, the question is: based on the current set of conditions in Kazakhstan, can the financial

⁵³ United Arab Emirates Yearbook 2006. Retrieved from: <http://www.uaeinteract.com>

⁵⁴ PricewaterhouseCoopers. (2006). Doing business in the Dubai International Financial Centre. Retrieved from <http://www.difc.ae>

⁵⁵ According to Dubai Chamber of Commerce and Industry, the financial sector represents 9.5% of total Dubai real GDP in 2004. Retrieved from: <http://www.dcci.gov.ae>

⁵⁶ PricewaterhouseCoopers. (2006). Doing business in the Dubai International Financial Centre. Retrieved from <http://www.difc.ae>

⁵⁷ Ibid.

center of Almaty become an effective tool that the government of Kazakhstan can employ in order to accelerate the region's economic growth? Moreover, can the RFCA survive under the current economic conditions prevailing in the country?

Conditions for the Financial Center in Kazakhstan

Kazakhstan's economy is still transitioning into a market economy. On the one hand, steady GDP growth, changes in the regulatory structure, and improvements in the banking sector are optimistic signs for the development of a financial center. On the other hand, the RFCA may enjoy limited success as a tax haven for key international investment banks operating in the region, since none of the financial reforms will be successful so long as the poor performance of the industrial sector of the domestic economy and the large scale poverty in the southern part of the Central Asian region continue to exist.

The biggest share of investment in Kazakhstan goes into *natural resources*: oil and gas, metallurgy and the mining sectors. As said by Lyazzat Kiinov, Deputy Energy and Mineral Resources Minister, "Investment in exploration and production of hydrocarbon resources makes up the largest share, and has overall increased to \$5.3 billion in 2003 from \$900 million in 1996."⁵⁸ Particularly, the oil and gas sector is flourishing. The investments in hydrocarbon business were 72 percent of total investment in the country's raw materials sector in 2003.⁵⁹ It is expected that the export of raw materials will continue to be a major supplier of hard currency. However, the natural

⁵⁸ The times of Central Asia. The Times of Central Asia. (2007). Reserves at Kazakhstan Sector of Caspian total 15 bln tones. Retrieved from <http://www.timesca-europe.com>

⁵⁹ Ibid.

resources may run out one day. Besides, an economic concept ‘Dutch disease’ suggests that the exploitation of natural resources causes a decline in the manufacturing sector.⁶⁰

Assessment of the industrial sector in Kazakhstan shows that, after Kazakhstan declared independence from the USSR in 1991, the collapse of all its established economic ties harmed the domestic economy. In Soviet times, Kazakhstan was one element of a massive economic system. Consequently, the country’s economic structure was never considered independently.

As a part of a complex, spatially disaggregated economic system, Kazakhstan’s *agriculture* sector was one of the most productive sectors. By 1990, Kazakhstan had become a leader in wheat production alongside Canada and Australia. However, the changes that occurred in Kazakhstan’s economy after the disintegration of the Soviet Union have radically influenced the situation in the agrarian sector. The first five years of self-governance resulted in a 47 percent decrease in agricultural output (Kalyuzhnova, 1998). Despite the Kazakh government’s efforts to provide assistance to the domestic agricultural sector, such as the creation of the Agricultural Support Fund, it is evident that this sector requires radical reforms. In other words, one of Kazakhstan’s leading sectors is currently straggling to remain competitive.

The growth potential of Kazakhstan’s *financial* sector is also limited by the country’s demographic and geographic constraints. If the idea behind the RFCA is to export Kazakhstan’s non-bank financial expertise to the wider region surrounding Kazakhstan, the RFCA might face serious constraints. Russia and China are likely to try to protect their own financial territory.

⁶⁰ The theory is that an increase in revenues from natural resources will deindustrialise a nation's economy by raising the exchange rate. Thus, it will make the manufacturing sector less competitive. (De Silva, 1994).

Equally, close proximity to Russia and China creates constraints for the country's ability to diversify the economy out of oil and mineral extraction into the light *manufacturing* of consumer products (Moody Interview, 2007). In fact, current domestic manufacturing is declining. Statistical data on employment shows a decline in manufacturing from 9.2 in 2000 to 7.1 percent in 2004 as a percent of total employment.⁶¹ The collapse of the Soviet Union disintegrated the region's manufacturing value chain. Parts of this structure were located in various post-soviet countries. As a result, some industries, such as machine building and chemical industries, are undergoing gradual degradation in Kazakhstan (Sharpe, 2005).

The country's *construction and real estate* sectors are booming however, fueled by the availability of mortgages and the transfer of the capital from Almaty to Astana. However, this growth also fostered a substantial rise in residential and commercial property prices. Property prices grew by over 900 percent in the major cities of Kazakhstan, causing a great shortage of affordable housing and administrative buildings (Voronina, 2006). Since, in order to become a member of the RFCA, the potential member needs to establish an office in Almaty, the problem of reasonably priced office space may limit the potential of the RFCA's growth.

In addition to the real estate constrains, the *human capital* pattern of skilled workforce seen in Dubai is not matched in Kazakhstan. Kazakhstan experienced significant human capital loss after gaining independence in 1991. According to the census, population fell from 16.4 million in 1989 to 15.2 million as of 2006. A considerable number of educated people emigrated to Russia and to the West. In addition, many residents have been driven out of scientific and technical employment by the

⁶¹ International Monetary Fund. (2005). Republic of Kazakhstan: Statistical Appendix.

reduction of government funding for R&D (Kaser, 1997). The establishment of foreign firms and the attraction of international missions and assistance programs had a clashing effect on the labor force in Kazakhstan. On the one hand, these programs promoted the inflow of human capital and foreign managerial personnel. On the other hand, foreign aid aggravated immigration from Kazakhstan. Even though the immigration has been partly offset by the return of ethnic Kazakhs from other republics and neighboring countries, the county's population is still small compared to the size of its territory.

Tourism, which played a decisive role in Dubai, is still in its infancy in Kazakhstan. The air and ground infrastructure scored only 3 out of 7 according to the MIGA ranking.⁶² The number of hotels and the quality of rooms do not meet international standards.⁶³ This limits not only the number of tourists, but also the number of foreign businessmen and investors that the RFCFA hopes to attract.

Another area of concern for Kazakhstan is widespread *corruption*. The Transparency International index put Kazakhstan in 107th place out of 158 as one of the most corrupt countries (Pala, 2005). Sergey Zlotnikov, executive director of Transparency Kazakhstan (TK), a local anti-corruption group said, "Actually it is a recognized fact, even by the government, that corruption has a systemic character in Kazakhstan."⁶⁴ Moreover, Zlotnikov said, "There is high corruption in the oil industry." Since the major economic activity for Kazakhstan is oil and gas sector, this means that the half of the economy lacks transparency. The black economy is 50 percent of the total.⁶⁵

⁶² Kazakhstan. Country/Economy profiles. The World Economic Forum. Retrieved from <http://www.weforum.org/pdf/tourism/Kazakhstan.pdf>

⁶³ Ibid. Hotel rooms ranked 95 out of 124 in Kazakhstan.

⁶⁴ IRIN news. (2004). Kazakhstan: Corruption remains a major cause of concern. Retrieved from <http://www.irinnews.org/report.aspx?reportid=24355>

⁶⁵ Ibid.

Corruption is a problem that obstructs many projects. It may obstruct the operation of the RFCA as well.

In sum, Kazakhstan is lacking many of the conditions that have to be in place for the RFCA to succeed. For a financial center to succeed, a number of conditions must exist. First, investors must have confidence in the market in order to be interested in trading securities. In addition, in order to have a successful financial center, the country must have a solid trade sector, have productive manufacturing and have an advanced service base. Abulgazy Kusainov, chairman of the Committee for Technical Regulation and Metrology under the Ministry of Industry and Trade recently stressed the current weaknesses of Kazakhstan economy: “Our economy has such features as weak competitiveness, small domestic market, insufficient domestic commodity exchange with other countries, prevailing raw material exports and imports of foreign goods with high value added, and high prime cost of domestic products, with a trend to rise.”⁶⁶ Therefore, a number of changes in the current conditions in Kazakhstan will need to occur to motivate the demand and supply for financial services necessary for the RFCA to become a successful venture like in Dubai.

Conclusion

The economy of Kazakhstan is concentrated on its extensive natural resources. Instead of relying exclusively on the oil and gas that are ultimately limited, the President of Kazakhstan Nursultan Nazarbayev, together with the government, decided to seek other ways to improve Kazakhstan’s position in the global market. The Regional Financial Center of Almaty (RFCA) became one of the government’s key projects aimed

⁶⁶ The Times of Central Asia. (2005). Beyond comparison. Retrieved from East View Universal Databases.

at diversifying the national economy. The government, remaining committed to the transition to a free-market economy, hopes that the financial center will reinforce the domestic financial sector through the inflow of investments into the country, and consequently, that the financial center will foster the economic development of Kazakhstan.

However, empirical comparisons show that there are characteristics and conditions required to support the successful growth of a financial center. Successful growth of a financial center requires a network of efficient financial institutions, surplus funds ready for investment, beneficiaries that need access to credit and a productive domestic industry.

With respect to the conditions outlined above, this research paper demonstrates that the Regional Financial Center of Almaty is not feasible at this point of time under the current conditions prevailing in Kazakhstan. A financial center in Kazakhstan creates many opportunities, but its success is currently constrained by limited financial services, ill structured industry and poor industrial performance of the industrial sector in Kazakhstan. Although it is possible to create a financial center based on the current domestic economic environment, it is doubtful that it will spur domestic growth and economic development.

First, the financial sector of Kazakhstan is not deep enough to support large inflows of investments. At this point, it will be important to take steps to support non-banking financial institutions, such as insurance companies, pension funds and the capital market, which all suffer from serious distortions. Small coverage and insufficient capitalization of both insurance and pension funds do not offer significant pool of

domestic savings. The existing stock exchange shows problems of inadequate capitalization and of a limited number of issuers. Altogether, the financial sector of Kazakhstan is challenged by liquidity problems and is still undergoing a transformation process. This process could take a long time since people in the region are themselves not familiar with the notion of securities and how to use them.

Second, the government of Kazakhstan should simultaneously foster more intense development of alternative sources of credit for small and medium enterprises. Small and medium-sized firms (SMEs) lack a stable supply of credit. Since the RFCA indicated middle-sized domestic firms as their potential issuers, it is important to help these firms to grow. There is no empirical evidence of how a financial center can play a role in increasing credit supply to SMEs. However, there are alternative strategies for that, such as the development of microfinance institutions. By supporting the growth of SMEs, the country will also create a wealthy middle class, which is presently missing. In Western countries, the middle class is seen as the foundation of economic and social development. Because of this class's wealth, it is the most dynamic consumer of goods and services. Consequently, its purchasing power fosters the success in a county's industry and service sectors.

Finally, the government should invest in the industrial sector of the domestic economy, particularly, in manufacturing and agriculture. Comparative analysis of Dubai with the conditions that are in place for the RFCA in Kazakhstan shows a need to develop a stronger commercial base and a more favorable regulatory environment. The Dubai financial center successfully operates not only because of its strong financial sector, but because the Dubai economy has developed trade, manufacturing and tourism. Kazakhstan,

on the contrary, is still undergoing the restructuring of its industry that is somewhat complicated by the country's demographic and geographic constraints.

To conclude, my evaluation of Kazakhstan economic conditions, and of processes that are vital for the financial center's operations suggest that the government created the RFCA far too early. However, based on the fact the financial center has already been initiated, the government of Kazakhstan can support its growth by enforcing simultaneous reforms in the industrial sector of the domestic economy, particularly in the productive industry. If these reforms succeed, then it is possible to expect that the RFCA indeed will become an effective developmental tool, and will have a positive impact on the domestic economy, promoting stability and the prosperity of all people in Kazakhstan.

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Appendix

Table A1. No of organizations registered with the RFCA

№	The list of companies registered with RFCA	Category "A" membership in KASE
1	LLP "AIM Capital"	Solution of Exchange Council of 02.02.2007
2	JSC "Brokerage company "Astana-Finance"	Solution of Exchange Council of 29.01.2007
3	JSC "Affiliated company of Kazakhstan Halyk Bank "Halyk Capital"	-
4	Affiliated company of JSC "ATFBank" JSC "ATF Finance"	-
5	LLP «Kazcommerce Invest RFCA»	-
6	LLP «BCC Securities»	-
7	JSC «Alem Capital»	-
8	LLP "ABS Securities"	-
9	LLP "MAG Capital"	-
10	LLP "VISOR Capital"	-
11	LLP "Asyl-Finance"	-
12	LLP "AFC Capital"	-
13	LLP "Kazcommerce RFCA" (affiliated company of JSC "Kazcommercebank")	-
14	LLP "Resmi Investment house Almaty "	-
15	LLP "ATRIX CAPITAL"	-
16	LLP "CENTRAS FINANCIAL"	-

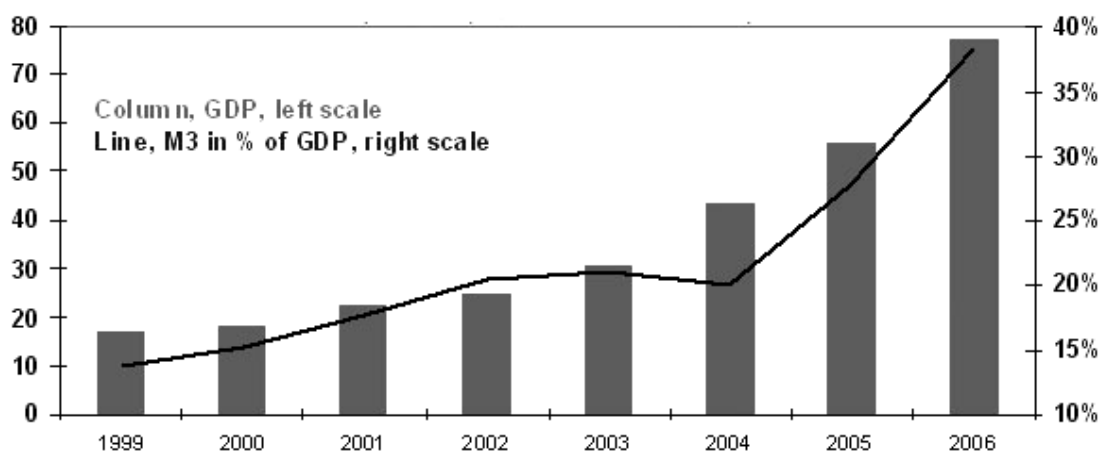
Source: Central Asian Capital Market conference, <http://www.centralasianipo.com>

Table A2. Kazakhstan: Sectoral Composition of Capital Investment in Current Prices, 2000–2004 (In percent of total investment)

Sector	2000	2001	2002	2003	2004
Total	100.0	100.0	100.0	100.0	100.0
Agriculture, hunting, and forestry	1.4	1.3	1.4	1.3	1.3
Mining industry	49.8	44.3	41.5	35.5	33.1
Manufacturing industry	12.0	11.1	9.4	9.9	10.7
Production and distribution of electric power, gas, and water	3.0	2.9	2.5	2.1	1.6
Construction	3.6	4.3	4.6	6.2	6.9
Trade, car repair, and household goods	3.5	3.3	4.3	4.4	2.4
Hotels and restaurants	0.5	0.2	0.3	0.3	0.1
Transport and communication	9.5	11.1	11.1	12.3	10.0
Financial sector	1.6	1.3	0.9	0.9	0.3
Real estate	9.7	11.5	12.6	14.4	17.2
Public sector	3.2	6.7	9.7	11.0	14.8
Education	0.7	0.8	0.7	0.7	0.6
Health and social sectors	0.2	0.4	0.4	0.2	0.3
Other municipal, social, and personal services	1.3	0.8	0.6	0.8	0.7

Source: International Monetary Fund. (2005). Republic of Kazakhstan: Statistical Appendix.

Figure A1. Money Supply (M3) as Percent of GDP (1999-2006, in US\$ Billions and %)



Source: National Bank of Kazakhstan, (Moody Interview, 2007).

Table A3. Estimation of the Number of Bank Loan Borrowers in 2000

Borrower category	Average number of loans extended per one borrower/ year	
	Optimistic estimate	Realistic estimate
Small entrepreneurial entities	1.1	1.1
Large businesses	9.5	17.1
Medium businesses (based on polling 11 banks)	5.3	9.6

Source: Becker et.al. Demand for bank loans and credit bureau services in the Republic of Kazakhstan.2002.

Table A4: Total number of small and medium enterprises

TOTALS	2000	2001	2002	2003	2004	2005
Number of Registered Entities	88,038	109,156	124,227	138,822	208,409	223,096
Small enterprises	76,743	98,300	113,319	128,187	195,707	209,758
Medium size Enterprises	11,295	10,856	10,908	10,635	10,676	11,296
Number of Operating Entities	73,764	85,262	95,284	100,750	155,940	170,612

Source: The Pragma Corporation. 2006. SME statistics - Republic of Kazakhstan. 2005.