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## ROLE OF FOREIGN DIRECT INVESTMENT IN KAZAKHSTAN ECONOMY DURING INDEPENDENCE YEARS

*Foreign direct investment (FDI) is known as an important accelerator for economic growth, especially for developing and transitional economics. It affects host countries' economic growth by transferring technology, increasing human capital formation and stimulating domestic investment, and opens access to global markets. This paper is about economic development features in Kazakhstan and characteristics of FDI during the independence years. The main purpose of the paper is to investigate the impact of FDI on Kazakhstan's economic growth since 1991.*

*Keywords:* foreign direct investment; economic growth; Kazakhstan.

*JEL Classification:* F21, F43.

Айжан Хойч

## РОЛЬ ПРЯМИХ ІНОЗЕМНИХ ІНВЕСТИЦІЙ В ЕКОНОМІЦІ КАЗАХСТАНУ ЗА РОКИ НЕЗАЛЕЖНОСТІ

*У статті показано, що обсяг прямих іноземних інвестицій (ПІІ) відомий як важливий прискорювач економічного зростання, особливо в країнах з економікою, що розвивається, і перехідною. Він впливає на економічне зростання країн-реципієнтів шляхом передачі технологій, розвитку людського капіталу, стимулювання внутрішніх інвестицій, а також відкриває доступ до світових ринків. Наведено особливості економічного розвитку в Казахстані і характеристики прямих іноземних інвестицій за роки незалежності. Основною метою роботи є вивчення впливу ПІІ на казахстанське економічне зростання з 1991 року.*

*Ключові слова:* прямі іноземні інвестиції; економічне зростання; Казахстан.

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## РОЛЬ ПРЯМЫХ ИНОСТРАННЫХ ИНВЕСТИЦИЙ В ЭКОНОМИКЕ КАЗАХСТАНА В ГОДЫ НЕЗАВИСИМОСТИ

*В статье показано, что объем прямых иностранных инвестиций (ПИИ) известен как важный ускоритель экономического роста, особенно в странах с развивающейся и переходной экономикой. Он влияет на экономический рост принимающих стран путем передачи технологий, развития человеческого капитала, стимулирования внутренних инвестиций, а также открывает доступ к мировым рынкам. Приведены особенности экономического развития в Казахстане и характеристики прямых иностранных инвестиций в годы независимости. Основной целью работы является изучение влияния ПИИ на казахстанский экономический рост с 1991 года.*

*Ключевые слова:* прямые иностранные инвестиции; экономический рост; Казахстан.

**Introduction.** In spite of the empirical studies offering rich insights on the impact of FDI and economic growth in a host country, they provide mixed evidence on its effects and role. FDI enhances the foreign technologies absorptive capacity, assists in innovation and technology and management skills transfers, promotes international trade integration and strengthens the competitive environment in a host country.

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Quite enough of the studies suggest the significant positive effects while some studies find no independent effects of FDI on a host country's economic growth. Besides, the existing studies have mostly focused on exploring impact of inward FDI on a host country economic growth. For example, De Mello (1999) suggested that whether FDI contributes to economic growth depends on the quantum of skilled labour in a host country. Borensztein et al. (1998) also established that although FDI has a positive impact on GDP, the magnitude of effect depends on the human capital level. In the same vein, Xu (2000) found that FDI brings technology and it forces into higher economic growth only when a host country has minimum threshold level of human capital. Alfaro (2003) found that total FDI has an ambiguous effect on host country economic growth; FDI inflows into primary sector tend to have negative effect on growth, manufacturing sector has positive spillover. Balasubramanyan et al. (1996) found that FDI enforces economic growth and its effect is relatively stronger for the countries that pursue outward-oriented trade policy.

According to the studies, it seems that FDI has no single effect on a host country economy. It depends on country specific conditions. FDI brings more positive effect and spillover if host countries have minimum threshold level of human capital, and country is more export-oriented, and if FDI is focused on more technology intensive sectors.

For Kazakhstan FDI was an engine to restore the economy after the collapse of the Soviet Union. The first few years of Kazakhstan's independence were characterized by an economic decline (mostly due to the destabilizing force of disintegration of the Soviet Union). By 1995, real GDP dropped to 61.4% of its 1990 level. But from 1999-2000 Kazakhstan economy was growing rapidly, on average there was a 10 % increase annually (Kazakhstan, 2010). To reach this growth, as in many other developing countries attracting FDI has become a key part of national development strategies in Kazakhstan in early 90s. At the national level there are efforts not only to reduce entry barriers but also to provide special stimulations to foreign firms to attract more FDI. During independence years the country attracted more than 120 mlrd. of to its economy. FDI in Kazakhstan averaged more than 6 mlrd. of USD per year, or about 1200 USD per capita, in 2009 and 2010 (Statistical Agency of Kazakhstan, 2011).

Now Kazakhstan is a rapidly growing. Kazakhstan is important to global energy markets because it has significant oil and gas reserves and production. UNCTAD World Investment Report (2010), for instance, notes that "due to lack of diversification of productive capacities, FDI to land-locked developing countries remained concentrated in the primary sector of few recourse-rich countries. For instance, Kazakhstan alone received 58 % of (12.6 mln. of dollars) the total FDI to LLDC in 2009 because of its natural resources".

The present paper seeks to contribute to the empirical literature on the relationship between economic growth and FDI flows in host countries and characterizes the role of FDI in Kazakhstan economic growth, and shows dynamics and main resources of FDI and its sectorial distribution. With dramatical advance of FDI economy growth increases respectively. But from the empirical data we can see FDI is strongly concentrated within the primary sector and geological exploration. More than 90% of this sector is oil & gas production. Manufacturing sector which is larger requires technology intensive share is for all the years less than 10%.

From this point of view as Alfaro (2003) mentioned benefits, such as transfers of technology and management know-how, introduction of new processes, and employee training tend to be related to the manufacturing sector rather than primary sector.

This study postulates for Kazakhstan for long time period focusing on energy sector can bring negative effects on economic growth. Quantitatively, FDI is growing and it has a grand role in rise of Kazakhstan economy but as mentioned above FDI spillover is weaker in the primary sector so it has no future growth prospects. Also being highly dependent on one sector economy can demonstrate Dutch disease with unexpected conditions.

**Literature review: theoretical development.** Theoretically there are numerous studies which investigate the impact of foreign direct investment on economic growth of a host country. Especially for developing countries FDI is an important vehicle for the transfer of technology, knowledge, forming domestic capital, and opening to global market. While there are ample intuitive reasons to believe FDI has positive economic growth impact on host countries, especially in developing countries FDI is an engine of growth, the empirical evidence is mixed.

The beginning of the early 90s was characterized by the increased flows of international capital to developing countries, which triggered the empirical research on the impacts and consequences of these flows on the macroeconomic indicator of the recipient countries (Borensztein et al., 1998; Bosworth and Collins, 1999; Hansen and Rand, 2004). FDI has obtained significant importance over the past decade as the tool for accelerating economic growth and development in transitional countries (Janicki et al., 2004). Almost all the studies on FDI have found its positive influence on economic growth of a host country. For a host country it brings advantages on standard of living and possibility for economic growth as it imports technology, managerial skills and provides market access, and thus accelerates growth and development.

But some studies such as Carkovic and Levine (2005) found that FDI does not exert a robust influence on economic growth.

There is also a vast empirical literature that deals with the effect of FDI on economic growth, especially in developing countries. Its total FDI flows for wide cross section of countries generally suggest a positive role in generating economic growth, especially under particular conditions. For instance, Borensztein et al. (1998) found evidence that there is a strong complementary effect of FDI on economic growth, although the magnitude of this effect depends on the stock of human capital available in a host country. If a host country has a minimum threshold stock of human capital, then FDI is more productive than domestic investment. For the countries with low levels of highly educated workforce, the direct effect of FDI is negative. While Blomstrom et al. (1994) found no evidence that human capital is critical, they argued that FDI is positive and significant only for higher income countries and has no effect in lower income countries.

Balasubramanyan et al. (1996) explained the effect of FDI on economic growth of developing countries from the other side. According to their estimation results, trade policy regime is crucial for gaining positive growth effect from FDI. It effects relatively stronger for the countries that pursue export promoting policy. But for import substituting economics, the positive effects of FDI were weaker. It was also

found by Alfaro (2003) that the sectors where FDI takes place, matter a lot. According to Alfaro, benefits of FDI on economic growth vary greatly across economic sectors, namely primary, manufacturing and service sectors. Using sectoral data for the period 1981-1999, Alfaro showed that, while total FDI exerts an ambiguous effect on growth, FDI in the primary sector tends to have negative effect on growth, whereas FDI in manufacturing has positive effect, evidence from the service sector is ambiguous.

Carkovic and Levine (2005) postulated that FDI doesn't have an absolute and positive effect on economic growth. However, for FDI-generated economic growth, especially in particular environments, the magnitude depends on a host country condition. This conditions include a threshold level of human capital, income level, a well-functioning capital market and openness to global market. The authors use both panel and cross-section data for 72 developing and developed countries for the time period of 1960-1995. Their result indicated for both developing and developed economies FDI inflows do not exert a robust influence on economic growth.

Some other authors focused more directly on the causality between FDI and growth. Choe (2003) and Zhang (2001) analyzed the causality between economic growth and FDI. Choe (2003) found evidence that economic growth and FDI are interdependent. The tendency that FDI causes a host country growth or rapid economic growth could effect in an increase of FDI inflows. According to the findings of Zhang (2001), economic growth is enhanced by FDI, but again, a host country conditions such as trade regime and macroeconomic stability are important.

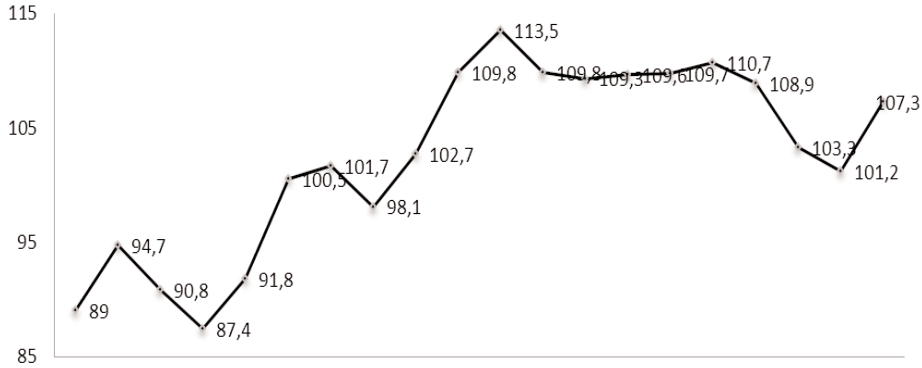
In other words, only FDI inflows cannot effect notably. Hansen and Rand (2004) analyzed the relationship between FDI and GDP on the sample of 31 developing countries for the time period of 1970-2000 and they found a bidirectional causality between the FDI/GDP ratio and the level of GDP. FDI is found to have a long-lasting effect on the GDP level, while GDP has no long-run effect on the FDI/GDP ratio. In other words, FDI causes economic growth.

To briefly conclude the literature review we can point out 3 main ideas. First, FDI always has no independent effect. It depends on the level of highly educated human capital. Second, FDI is more effective in export-oriented countries than import-substituting. Third, result of its effect depends on FDI attracting sector. More technology intensive sectors get more spillover from FDI. So FDI spillover couldn't be always positive. It depends on the countries' economic specific conditions.

**FDI and Development of Kazakhstan.** Dosmukhamedov (2003) describes that in Kazakhstan, about 17 mln people populate an arid swath of Central Asia 4 times the size of Texas and larger than Great Britain, France, Germany, Spain, Austria, Holland, and Denmark combined. It's a land of harsh winters and parched summers, expansive deserts and remote mountains. It's also a land rich with natural resources: prior to gaining independence in 1991, Kazakhstan produced 70% of the Soviet Union's lead, zinc, magnesium, tin and titanium; 60% of its silver and molybdenum; 35% of its copper; and considerable amounts of its gold, uranium and coal.

Due to the destabilizing force of Soviet Union disintegration, the first few years of Kazakhstan's independence were characterized by an economic decline (see Graph 1.). From 1991 it continued to decline and by 1995 the real GDP dropped to 61.4% of its 1990 level. GDP started to increase slowly from 1996 by 0.5% only. But

from 1999-2000 Kazakhstan economy was growing rapidly on average of 10% increase annually. Only in 2008 and 2009 GDP growth rate decreased to 103.3% and 101.2% respectively. It can be explained by the global financial crises impacts. (Kazakhstan, 2010).



Source: Statistics Agency of Kazakhstan Republic.

Figure 1. GDP growth rate (in % to the previous year)

To make clear the graph above we postulate some main macroeconomic indicators in the tables below. Comparison is done for the years of economic increase. In this time period we can see rapid economic growth in all the macroeconomic indicators. For instance, from 1996 to 2010 GDP per capita has increased 7 times, investments — about 40, foreign investment and export — 80 and 10 times respectively (Table 1). At the same time ratio of investments to GDP increased from 8.4 to 21.3% and ratio of foreign investments GDP from — 1.1 to 5.7%. This means country is open to attract both domestic and foreign investments to its economy. Only the last indicator or ratio of oil and gas sector in export is increasing dramatically from 21.3 up to 61.8%, once more confirming the UNCTAD list in which Kazakhstan is one of the countries in "Developing and transitional economic countries with high dependence on exporting minerals" UNCTAD (2007, p. 87).

Kazakhstan has an open economy, it trades with many countries. For 2010 we can mention trade partners of Kazakhstan briefly. The biggest trade partners are its neighbors: Russia (14.3% of export and 47.7% of import) and China (16.9% of export and 12.9% of import). 53.6% of export goes to the EU (mineral goods mostly). 47.7% of import comes from the CIS countries (technical and agricultural goods) (see Table 2).

Kazakhstan borders with 7 countries including Caspian Sea borders. Its biggest trade partners are Russia and China. Kazakhstan on the way of long-term development policy established "Kazakhstan 2030" strategy. This strategy has certain policy on attracting FDI. This policy tends to economic development, advance competitiveness of country and economics diversification. For this reason Kazakhstan needs both domestic and foreign investment. Specially joint ventures and other foreign investments into Kazakhstan are not just permitted, but actively encouraged. Among all the countries of Eastern Europe and the former Soviet Union, Kazakhstan is one of the most open to foreign investment.

Table 1. **Some macroeconomic indicators and comparison**

Indicators	1996	2000	2004	2008	2010
GDP, mln. tenge	1415749.7	2599901.6	5870134.3	16052919.2	21815517
GDP, mln. USD	21036.4	18292.4	43150.1	115306.1	148052.4
GDP per capita, tenge	90880.2	174684.7	391003.8	1024175,1	1336465,9
GDP per capita, USD	1350.4	1229.0	2874.2	8513.5	9070.0
Invements, mlrd.tenge	119.0	595.7	1703.7	4210,9	4653,5
Foreign investments, mlrd.tenge	15.5	148.9	301.4	1064.8	1240.8
Export, mln.USD	5911.0	8812.2	20096.2	71183.6	59830.3
in ratio					
Ratio of investments in GDP	8.4	22.9	29.0	26.2	21.3
Ratio of foreign investments in total investments	13.0	25.0	17.7	25.3	26.7
Ratio of foreign investments in GDP	1.1	5.7	5.1	6.6	5.7
Ratio of oil and gas sector in export	21.3	48.2	56.8	61.1	61.8

Source: Statistics Agency of Kazakhstan Republic.

Note: depending on the database the indicators given in different currencies.

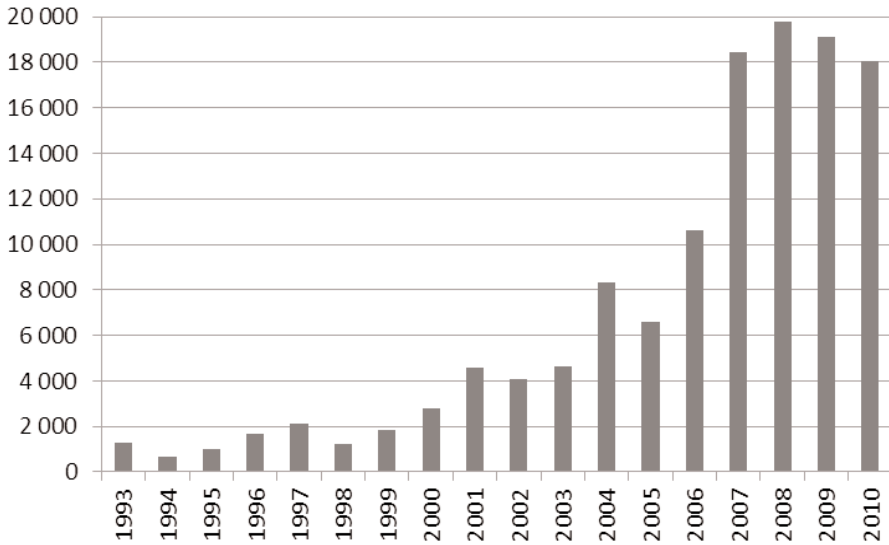
Table 2. **Kazakhstan foreign trade structure by countries, 2010**

Countries	Export		Import	
	mln USD	%	mln USD	%
Total	59830,3	100	30839,3	100
CIS	8554,8	14,3	14701,6	47,7
Russia	5387,1	9,0	12063,9	39,1
Ukraine	665,7	1,1	1358,5	4,4
EU	32051,7	53,6	7536,4	24,4
Asia	15209,5	25,4	6452,9	20,9
China	10122,1	16,9	3964,5	12,9
Americas	3835,7	6,4	1977	6,4
USA	868,1	1,5	1313,1	4,3
Other countries	178,6	0,3	171,4	0,6

Source: Statistics Agency of Kazakhstan Republic.

According to the UNCTAD (World Investment Report 2007, p. 14) for investors Kazakhstan is one of the most attractive countries among the developing ones.

Kazakhstan is ranked third among the CIS countries in terms of total amount of FDI inflow after Russia and Ukraine. During the independence years the country attracted more than 120 mlrd USD to its economy. Foreign direct investment (FDI) in Kazakhstan averaged 6.3 mlrd USD per year, or more than 1200 USD per capita in 2010. After 2000 FDI inflow is growing rapidly annually (National Bank of Kazakhstan, 2010). For example, in 2003 and 2004 it annually grew more than by 4 mlrd USD. In 2009 it increased by 60.5% and reached 19.7 mlrd USD, and 18 mlrd USD in 2010 respectively (see Graph 2).



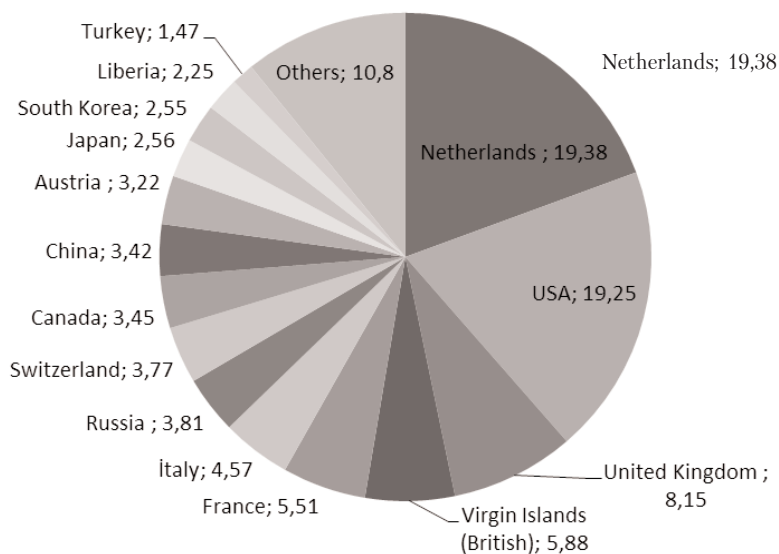
Source: National Bank of Kazakhstan Republic

Figure 2. Dynamics of FDI inflow into Kazakhstan, 1993-2010 (mln USD)

For all the main investor country, was the USA investing more than 30 mlrd USD (about 20% in total FDI in the country), the Netherlands and the United Kingdom — 19.3% and 8.15% respectively. Country's two biggest neighbors, Russia and China, invested 3.81% and 3.42% respectively.

So why do countries invest in Kazakhstan? Theoretically, attractiveness of a country to FDI depends on economic factors, such as the trade and investment regime, the "openness" of a host country, and the adequacy of basic infrastructure. All sectors of the country's economy are open to foreign investment and foreign investors are allowed to participate in privatization. Foreign investors are involved in the primary sector, which contains on average more than 90% of oil and gas production. From total FDI in 1993 to 2010 the share of the primary sector and geological exploration did not change significantly: from 76.8% to 74.9%. But it is no more than 10% for manufacturing sector which requires more technological intensiveness. Most studies on FDI spillover include manufacturing sector (Alfaro, 2003). And third, which is rapidly increasing in share and close to world average, is the service sector.





Source: National Bank of Kazakhstan Republic.

**Figure 3. Main investors to Kazakhstan economy, 1993-2010 (%)**

In this case, basing on the evidence by Alfaro (2003), impact of FDI on economic growth in the primary sector tend to be negative, whereas manufacturing sector has positive effect. But evidence from the service sector is dependable. In other words, effects of FDI on economic growth vary greatly across economic sectors, namely primary, manufacturing and service sectors. In addition to this, UNCTAD states that Kazakhstan is one of the countries with high dependence on exporting minerals among developing and transitional economics.

**Table 3. Foreign direct investment by sectors in Kazakhstan, mln USD**

Sector/year	1993	1994	1997	2000	2005	2008	2009	2010
Primary + Geological exploration	976.8 (76.8)	560.8 (85.0)	1,398.30 (66.4)	2,277.60 (81.9)	5,319.50 (80.4)	10,970.40 (55.5)	13,469.20 (73.1)	13,538.70 (74.9)
Manufacturing	44.7 (3.5)	58.7 (8.9)	370.1 (17.6)	246.9 (8.9)	303.6 (4.6)	1,918.30 (9.7)	1,444.60 (7.8)	2,042.80 (11.3)
Service	249.9 (19.7)	40.2 (6.1)	338.5 (16.1)	256.8 (9.2)	995.5 (15.0)	6,866.60 (34.8)	3,515.00 (19.1)	2,494.20 (13.8)
Total	1,271.40	659.7	2,106.90	2,781.20	6,618.60	19,755.20	18,428.80	18,075.80
* Share of oil and gas production in the primary sector	100	100	48.6	98.2	93.6	84	87	78.7

Recourse: calculated on the basis of National Bank of Kazakhstan Republic database.

Note: numbers in parenthesis shows the share of a sector in total FDI.

Laws on foreign investment, the Agency of the Republic of Kazakhstan for Investment (ARKI) and the Foreign Investors' Council all encourage and support foreign investors. The Law "On Foreign Investment" (27 December 1994) protects



foreign investors from nationalization/expropriation, changes in legislation, and illegal actions by state agencies or officials and guarantees the unrestricted use of income and currency convertibility for dividends and other use. In addition, the Law "On the State Support of Direct Investment" grants state assets and concessions, income, land and property tax holidays for 5 years with additional periods at reduced rates, plus duty and VAT exemption for imported machinery and inputs for varying periods. Furthermore, foreign investors may own and lease land according to the Law "On Land" (24 January 2001).

**Conclusion.** The paper attempts to show FDI role in Kazakhstan economic growth and its future prospects. Within the Central Asia and the CIS Kazakhstan is one of the rapidly growing and one of the most FDI attractive countries. For instance, in 2009 country attracted alone 58% of all FDI to land-locked developing countries. Kazakhstani economy is growing rapidly and role of FDI in economy is also growing. However, since its independence in 1991 more than 80 mln. USD or 70% of all FDI inflows were involved in primary sector and geological exploration. As Alfaro postulated above, investing in the primary sector can be harmful for economic development. Investing in manufacturing can bring most favorable spillovers for the economy.

Kazakhstan's government formed the most favorable conditions for investors. As UNCTAD noted, Kazakhstan is FDI attractive, at the same time it is highly dependent on its energy sector. For a long time being highly dependent on energy sector can bring negative impacts. It could be better to direct FDI to other sectors to assure long-time growth for the technology intensive sectors.

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