PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: PIDC2885

Project Name	KZ Competitiveness and Access to Finance (P147705)
Region	EUROPE AND CENTRAL ASIA
Country	Kazakhstan
Sector(s)	General industry and trade sector (60%), SME Finance (40%)
Theme(s)	Micro, Small and Medium Enterprise support (60%), Other Private Sector Development (40%)
Lending Instrument	Investment Project Financing
Project ID	P147705
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Regional Development, DAMU (Entrepreneurship Development Fund)
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/ Updated	06-Feb-2014
Date PID Approved/ Disclosed	11-Feb-2014
Estimated Date of Appraisal Completion	30-May-2014
Estimated Date of Board Approval	23-Sep-2014
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

Kazakhstan is a resource rich country and its economy is concentrated in few sectors. Kazakhstan's economy remains highly dependent on the hydrocarbons and extractive sectors. Non-oil exports, for instance, amount to two thirds of oil and gas exports. Similarly, manufacturing and agriculture, for which Kazakhstan has endowments and which could potentially develop into competitive industries, accounted for 11 and 5 percent of GDP in 2013. The Government agenda of economic diversification has proven difficult in the face of booms in commodity prices.

As a result, Kazakhstan faces several development challenges and risks, most notably a lack of shared prosperity. Although Kazakhstan has enjoyed average GDP growth of 8 percent over the past decade, the gains in prosperity have not been shared adequately. Against a benchmark of a poverty line at the PPP-corrected US$5 per capita per day, some 42 percent of Kazakhstan's population were living in poverty in 2009; even though this number fell significantly from 79 percent in 2001. Likewise consumption per capital for the bottom 40 percent grew only marginally higher, by 6 percent, than the average consumption for all households, which grew by 5 percent, during 2006–2010. In addition, advances in living conditions have been skewed towards the urban areas due to lagging regional development.

Development of the SME sector can play a key role in addressing these development challenges and risks, and in advancing shared prosperity and poverty alleviation. SME development across Kazakhstan's regions can help diversify the income sources of the economy across activities that are not directly related to each other. Such diversification can protect the economy from wide-spread impacts of negative external shocks, such as commodity prices. By enabling SME growth across regions, an environment more conducive to shared prosperity could be created including through access to new and better jobs. New and better jobs can also encourage local migration of labor to the nearest urban centers in the regions where SMEs tend to cluster. For SMEs, it could be easier to flexibly respond to opening market niches and operate closer to the market that they know and serve than for large corporations. The Government's development program puts a major emphasis on increasing the contributions of non-oil sectors to growth, especially through SME development in regions.

SME development, however, is hindered by major obstacles due to market and government failures. The 2009 Enterprise Survey, the 2013 Global Competitiveness Index, the 2013 Country Economic Memorandum, and discussions with private sector representatives point to four main obstacles that currently constrain SME development: (i) lack of professional skills to manage SMEs, (ii) access to investment financing, (iii) the time managers spend on managing Government bureaucracy, and (iv) incidence of informal payment requirements. In addition, a recent EBRD study provides specific empirical evidence on the lacking capacity of entrepreneurs in Kazakhstan to manage SMEs.

This project aims to address two of these key obstacles. This project focuses on mitigating two obstacles to SME growth: (a) lack of professional skills to manage SMEs, and (b) access to investment financing, in order to stimulate Government action and reforms in support of greater competitiveness and economic diversification of the SME sector.

Other World Bank and Government projects address the remaining key obstacles to SME development. Regarding obstacles (iii) and (iv) noted above, the World Bank is assisting the Government with implementation of the ongoing Customs Modernization Project and Tax Administration Reform Project. The World Bank is also assisting with the implementation of reforms in the business environment through JERP, including improvements in the insolvency regime and reform of the permits system regulating business activities. Other related projects in the World Bank pipeline include the Justice Sector Institutional Strengthening Project.

Recent economic developments show that growth in Kazakhstan has decelerated after a rapid economic recovery from the 2008 crisis, but reaches still solid 5 percent. Inflation and unemployment rates are stable around 6 percent and 5 percent, respectively. The recovery in the financial sector is much slower due to slow progress on the resolution of persistently high non-performing loans. However, growth prospects remain strong owing to the expected increase in oil production. The economy is forecasted to grow above 5 percent in 2014. The stabilized macroeconomy and appropriate policy mix grant the Government an opportunity to advance on resolving the large stock of NPLs and unlock the support potential of the financial system for economic diversification and growth; and to strengthen the monetary and fiscal policy frameworks and promote sustained and inclusive growth and mitigate vulnerabilities to shocks.

Going forward, policy makers agree on the need to reduce the economy's dependence on oil by promoting non-oil activity, and to lower the large presence and reach of state-owned enterprise activities throughout the economy. The Governments vision of developing Kazakhstan into a major diversified emerging market economy requires, however, concerted efforts to strengthen the policy architecture. Enhancing the diversification strategy, including by strengthening institutions, the business environment, and human capital, while carefully managing the country's oil wealth are key attributes of any such effort.

Sectoral and Institutional Context

The SMEs tend to be concentrated in a few, traditional economic sectors. Kazakhstan has over 750,000 SMEs that employ over 2.5 million people and produce about 28% of GDP. To date, SMEs represent 92% of all enterprises in the country. However, in 2009, only 64% of registered firms were actually active. Almost two thirds of SMEs are concentrated in the trade (37%) and services (30%) sectors, which are characterized by low risk and modest start-up capital. The remaining SMEs are active in agriculture (23%), transport and communications (8%), and manufacturing (3%). Such high a concentration of SMEs in few sectors is symptomatic of limited support to SMEs in the exploitation of adjacent sectors and business models. Second, the SME sector has been disproportionately skewed towards Astana and Almaty, where 40 percent of registered SMEs are located.

Financial intermediaries constitute a key support system for enterprises that enables their innovation, growth, diversification, and informed risk-taking. At the end of 2013, however, the financial system operated below its potential. Banks and MFIs were challenged by difficult access to long-term liquidity, foreign currency risk exposures, the accumulated stock of non-performing loans (NPLs), deficient functioning of financial infrastructure, and substandard financial sector regulation and supervision of lending to SMEs. Nonperforming loans remain high—37 percent of total loans by October 2013—and constrain banks' abilities to provide new credit to the non-extractive sector of the economy, notably SMEs in the regions.

The Government has strived to stimulate NPLs workouts through new provisioning rules and tax incentives for loan restructuring and collection. Moreover, the Government established an asset management company for the banks to be able to off-load their bad loans at competitive third-party valuations. But these policy measures do not seem to have produced the desired results and the credit institutions are hesitant or reluctant to extend investment loans to SMEs in this environment of prevailing market and government failures.

Overall, the Government's medium-term agenda for stimulating private sector investment, productivity, and economic diversification is outlined in the State Program for Accelerated Industrial and Innovative Development 2010–2014. The Business Roadmap 2020 Program (BRM 2020), which focuses on SMEs and is implemented by the Ministry of Regional Development (MRD), is a critical component of the Innovative and Industrial Program. Under the BRM 2020, a number of initiatives are being undertaken to strengthen entrepreneurial capacity, but the reach, quality, and consistency of these initiatives needs to be dramatically enhanced to substantially increase impact.

The Ministry of Regional Development (MRD), a newly established ministry and the main counterpart for the project, focuses on identifying sources of sustainable economic growth in each region of the country, and implementing programs to facilitate their growth. MRD's goals include economic diversification (into non-extractive industries), regional economic growth, and job creation. The MRD has been tasked with addressing market failures relating to the SME sector in regions and ensuring that all Kazakhstani nationals have access to the same resources in starting their own businesses.

Relationship to CAS

The operation is directly linked to the first pillar or Kazakhstan's Country Partnership Strategy (CPS) FY12-FY17 on Improving competiveness and fostering job creation. The project aims to support the Government targets of improving Kazakhstan's ranking on the WEF's Global Competitiveness Index from 72nd place (out of 139 economies) in 2012 to 50th place by 2020. The operation will focus on two critical influencers of the index: (i) business capacity and competitiveness, and (ii) efficient and sustainable financial intermediation.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The project objective is to help increase economic competitiveness and diversification of the SME sector in Kazakhstan.

Key Results (From PCN)

• Increased productivity, value added, and/or exports, measured in terms of firm revenues, among SMEs participating in the project

• Establishment of new enterprises in non-extractive economic sectors and in priority regions of the country or expansion to new markets, or introduction of new products by SME entrepreneurs participating in the project

III. Preliminary Description

Concept Description

In order to increase SMEs' competiveness and diversification, the project shall enhance, rationalize, and expand current government programs, and introduce new targeted interventions to improve (i) capacity of entrepreneurs and SMEs for business development and (ii) ease access to investment finance. In addition, the project will explore innovative financing arrangements to extend its development impact to local currency markets and crowd-in private resources. The project shall have two components:

Component 1: Enhance capacity of entrepreneurs and SMEs. Entrepreneurs, owners and managers of SMEs in Kazakhstan lack adequate capacity to improve firm productivity to compete in external markets, and to pursue new business opportunities offered by opening market niches. Component 1 aims to address this market failure through activities in two sub-components.

• Sub-Component 1.1. Programs and policies for promoting SME development have largely been inherited by the newly established MRD. Within this context, the Ministry is responsible for deploying a national program that meets a variety of SME needs. Sub-Component 1.1 will begin with technical assistance focused on a diagnostic assessment and gap analysis of existing programs to support SMEs. The TA will determine the need for consolidation of existing programs, scaling down of ineffective programs, and even introduction of new programs.

• Building on the recommendations from Sub-Component 1.1, Sub-Component 1.2 will focus on quality enhancement and expansion of SME support programs, ensuring the introduction of global good practice, tailored to local context. This component will draw heavily upon recently published approaches to targeted SME support and entrepreneurship education and training with a focus on ensuring the appropriateness of program characteristics, outcome domains and moderating factors. The sub-component will fund the scaling up of the identified core SME capacity building programs throughout the country, with a view to significantly changing the landscape of support offered to new and existing firms.

Component 2: Ease access to investment finance for SMEs. SME investment in expansion, diversification, or innovation requires credit financing that has characteristics closer to those of equity financing (longer maturity with a grace period), because of the significant risks associated with such investment. Without access to this type of credit, SME development will be restrained.

• Banks and non-bank credit institutions (NCFIs) are challenged by difficult access to long-term liquidity, foreign currency risk exposures, the NPL stock, and deficient functioning of financial infrastructure and substandard financial sector regulation and supervision, among others. Sub-Component 2.1 will provide technical assistance to the integrated financial sector regulator (the NBK) to improve financial consumer protection of SMEs, the regulatory and supervisory framework for NCFIs, financial sector infrastructure related to credit history, the secured transaction (collateral) framework, NPL workouts related SMEs, and the insolvency framework for SMEs.

• Further, state financial support provided through the Entrepreneurship Fund (DAMU) neither meets the volume of SME demand for investment lending nor does it genuinely encourage SMEs to graduate into commercially viable borrowers. Sub-Component 2.2 shall stimulate provision of competitively priced investment loans to SMEs across regions channeled through eligible Banks, MFIs, and Leasing Companies. Exploiting several institutional channels of financial intermediation can help achieve the desired combination of secured and unsecured lending to SMEs and use different branch networks for diverse physical access to financial intermediaries to enhance the project M&E framework.

During the project preparation, the team will assess the need for a capacity building component for the MRD in the area of M&E systems, and design and implementation of regional policy. A survey of entrepreneurs participating in the project will be regularly conducted using a third-party monitoring approach.

In project preparation, the team will identify and analyze gender issues relevant to the project objectives or components, report relevant findings and determine whether it is meaningful to incorporate gender into the design and/or M&E to address gender issues.

The project will explore innovative financing arrangements to extend its development impact to local currency markets and crowd-in private resources. More innovative approaches can eliminate foreign currency risk from the project and extend the project's development impact to local currency markets.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01	x		
Natural Habitats OP/BP 4.04		x	
Forests OP/BP 4.36		x	
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11		x	
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12	x		
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

V. Financing (in USD Million)

Total Project Cost:	100.00	Total Bank Financing:	100.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	0.00
International Bank for Reconstruction and Development	100.00
Total	100.00

VI. Contact point

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