Kazakhstan:
The Road to Independence

Energy Policy and the Birth of a Nation

Ariel Cohen
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<th>Full Form</th>
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<tr>
<td>APK</td>
<td>Assembly of Peoples of Kazakhstan</td>
</tr>
<tr>
<td>BCM</td>
<td>Billion cubic meters (of natural gas)</td>
</tr>
<tr>
<td>BTC</td>
<td>Baku–Tbilisi–Ceyhan Pipeline</td>
</tr>
<tr>
<td>CEC</td>
<td>Central Electoral Commission</td>
</tr>
<tr>
<td>CES</td>
<td>Common Economic Space</td>
</tr>
<tr>
<td>CICA</td>
<td>Conference on Interaction and Confidence-Building Measures in Asia</td>
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<tr>
<td>CITIC</td>
<td>China International Trust and Investment Corporation</td>
</tr>
<tr>
<td>CNPC</td>
<td>China National Petroleum Company</td>
</tr>
<tr>
<td>CPC</td>
<td>Caspian Pipeline Consortium</td>
</tr>
<tr>
<td>CPSU</td>
<td>Communist Party of the Soviet Union</td>
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<td>CSTO</td>
<td>Collective Security Treaty Organization</td>
</tr>
<tr>
<td>DVK</td>
<td>Democratic Choice of Kazakhstan (<em>Demokraticheskiy Vybor Kazakhstana</em>)</td>
</tr>
<tr>
<td>EEU</td>
<td>Eurasian Economic Union</td>
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<tr>
<td>EITI</td>
<td>Extractive Industry Transparency Initiative</td>
</tr>
<tr>
<td>EurAsEC</td>
<td>Eurasian Economic Community</td>
</tr>
<tr>
<td>FCPA</td>
<td>Foreign Corrupt Practices Act</td>
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<tr>
<td>FDI</td>
<td>Foreign direct investment</td>
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<tr>
<td>GDP</td>
<td>Gross National Product</td>
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<tr>
<td>GNI</td>
<td>Gross National Income</td>
</tr>
<tr>
<td>HDI</td>
<td>Human Development Index</td>
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<tr>
<td>IEF</td>
<td>Index of Economic Freedom</td>
</tr>
<tr>
<td>IOC</td>
<td>International oil company</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>KBTU</td>
<td>Kazakh-British Technical University</td>
</tr>
<tr>
<td>KCTS</td>
<td>Kazakhstan Caspian Transportation System</td>
</tr>
<tr>
<td>KEGOC</td>
<td>Kazakhstan Electricity Grid Operating Company</td>
</tr>
<tr>
<td>KIMEP</td>
<td>Kazakhstan Institute of Management, Economics and Forecasting</td>
</tr>
<tr>
<td>KSNU</td>
<td>Kazakh State National University</td>
</tr>
<tr>
<td>MEMR</td>
<td>Ministry of Energy and Mineral Resources</td>
</tr>
<tr>
<td>MGIMO</td>
<td>Moscow State Institute of International Relations</td>
</tr>
<tr>
<td>MoU</td>
<td>Memorandum of Understanding</td>
</tr>
<tr>
<td>MTOE</td>
<td>Million tons oil equivalent</td>
</tr>
<tr>
<td>NFRK</td>
<td>National Fund for the Republic of Kazakhstan</td>
</tr>
<tr>
<td>NIOC</td>
<td>National Iranian Oil Company</td>
</tr>
<tr>
<td>NOC</td>
<td>National oil company</td>
</tr>
<tr>
<td>ODIHR</td>
<td>Office for Democratic Institutions and Human Rights</td>
</tr>
<tr>
<td>OSCE</td>
<td>Organization for Security and Cooperation in Europe,</td>
</tr>
<tr>
<td>PPCK</td>
<td>Party People’s Congress of Kazakhstan</td>
</tr>
<tr>
<td>PSA</td>
<td>Production sharing agreement</td>
</tr>
<tr>
<td>RAO EES</td>
<td>Russian Unified Energy Systems</td>
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<tr>
<td>SCO</td>
<td>Shanghai Cooperation Organization</td>
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SGP  Second Generation Project
SME  Small- and Medium-scale Enterprise
SPECA  Special Program for the Economies of Central Asia
SWG  Special Working Group
TCP-gas  Trans-Caspian Pipeline - Gas
TCP-oil  Trans-Caspian Pipeline - Oil
UDP  United Democratic Party of Kazakhstan
UNCTAD  The United Nations Conference on Trade and Development
UNDP  United Nations Development Program
UNECE  United Nations Economic Commission for Europe
UNESCAP  United Nations Economic and Social Commission for Asia and the Pacific
UPUK  Union of People’s Unity of Kazakhstan
USSR  Union of Soviet Socialist Republics
WTO  World Trade Organization
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Introduction

Kazakhstan in an Energy Dependent World

With energy prices reaching new heights, sources of oil and natural gas outside the unstable Middle East are more important than ever. The Caspian region has the third largest oil and gas deposits in the world after the Persian Gulf and Russia. In contrast to the Gulf, it demonstrates relative political stability and a lower level of terrorist threats and religious strife. The Gulf, on the contrary, has not known a peaceful period since 1979, when Ayatollah Khomeini overthrew the Shah of Iran.

Kazakhstan is a country of great importance to the West and the region. It has emerged as a regional leader and an example of successful economic development for the rest of Eurasia’s New Independent States (NIS). With estimated oil reserves of 39.8 billion barrels, proven natural gas reserves of 105.9 trillion cubic feet (3 trillion cubic meters),¹ and other natural resources, such as uranium, coal, and metals, and a fast-growing services sector, Kazakhstan’s future looks promising to its people and attractive to foreign investors.

However, the great powers and regional actors are playing a “New Great Game”² around the Caspian’s energy resources. In this new geopolitical reality, the region is drawing increasing attention from the U.S., Russia and China as well as Iran, India and other regional players. It is also attracting multibillion-dollar investments and becoming the subject of international intrigues.

This monograph reviews the development and future prospects of independent Kazakhstan, a major Caspian oil supplier, and explores its politics and the national economy, with particular attention to the energy sector, through the prism of its uneasy but to date relatively successful independence and through an analysis of its relations with the world’s most powerful geopolitical players. This book also reviews the country’s oil, natural gas, electricity, and nuclear industries in detail.

² “The Great Game” is a term apparently introduced by Arthur Conolly, a British intelligence officer, in the first half of the 19th century. It describes the strategic conflict between the British Empire and czarist Russia for control over Central Asia. The classical period lasted from 1813 to 1907. Peter Hopkirk, The Great Game: The Struggle for Empire in Central Asia, Kodansha International, 1992.
The Geo-economics of Kazakhstan: from Nomadic Steppe to World-class Energy Exporter

From ancient times, the counties in the Caspian region have known about oil. Azerbaijanis were aware of and even used “black gold” in the religious cult of Zoroastrianism. However, its presence in the arid steppes of Kazakhstan was unknown. There, the Turkic-speaking Muslim native Kazakhs, whose ethnic, linguistic and cultural roots go back to Genghis Khan’s Mongols, continued their nomadic lifestyle well after their subjugation by the Russian Empire in the 18th-19th centuries. In the 1920s, Joseph Stalin ordered accelerated construction of the Turkestan-Siberia railway, intended to bring Uzbek cotton to Russia’s factories via the Kazakh territory. At the time, the Soviets managed to identify only 3,000 proletarians (industrial workers) out of Kazakhstan’s population of 3.5 million. Nevertheless, rich with natural resources, Kazakhstan quickly became a major supplier of raw materials and semi-finished goods for the Soviet Union, primarily in the defense and nuclear industries. Kazakhstan provided the USSR with vital commodities including coal and steel from Karaganda, as well as non-ferrous metals. Later, the country’s deposits of uranium served as a basis for developing the Soviet nuclear program.

Over a span of more than two centuries, similarly to other ethnic elites in the Russian Empire and, later, the Soviet Union, the Kazakh elite underwent modernization and integration into world culture. Ultimately, despite the distortions imposed by Soviet ideology and Russian chauvinism, it managed to develop its own sense of national self-awareness. Kazakhstan produced its own artists, writers, composers, and scientists who prompted the creation of a unique historical narrative. An important implication of this process was that some representatives of the Kazakh elite began striving for greater autonomy, initially within the Russian Empire, and later within the USSR. This eventually led to a push for formal independence.³ Among other aspects, the notion of autonomy included attaining greater control over the Republic’s natural resources. Unsurprisingly, these ambitious notions evoked little sympathy from among the communist leadership of the Soviet State Planning Committee (GosPlan), the Soviet Council of Ministers, and the Communist Party of the Soviet Union (CPSU) Central Committee in Moscow.

With the collapse of the Soviet Union, the process of self-identification of multiethnic Kazakhstan as an independent nation accelerated. Today, the Moscow-Almaty connection between the imperial master and its former colony has

weakened; however, the deep-seated ties that evolved between the metropolis and its dependency continue to bind these two countries, despite their differences in size, wealth, and reach.

During the Soviet era, Kazakhstan in particular and the Caspian basin in general comprised the *de facto* strategic petroleum reserve of the Soviet Union. Although discovered in the 1970s and 1980s, the large hydrocarbon deposits of the Caspian region remained practically unexplored until the mid-1990s. The giant Tengiz oil field was the only exception. Work on this field started in the late 1980s. As part of Mikhail Gorbachev’s policy of openness to the West, the Soviet Union signed a major investment deal with US-based Chevron, which became the first major Western corporation to enter the country. Eduard A. Shevardnadze, former Soviet Foreign Minister in Gorbachev’s Cabinet, spoke of the Chevron deal as a primary test of Gorbachev’s ambitious economic reform plans. The *New York Times* quoted Shevardnadze in 1991 as saying:

> It is no secret that the United States will judge our readiness to cooperate by the success or failure of this project... Should we continue to ‘develop’ our natural resources in the same barbaric way or should we turn for help to knowledgeable and skillful people equipped with advanced technology and experience in running business and making profit?[^4]

Since the collapse of the USSR, Kazakhstan has been competing with Russia in the growth rate of its energy sector. Between 1997 and 2003, Russia demonstrated high rates of oil production growth. However, after the Kremlin initiated measures to renationalize large energy assets, including its crackdown on the YUKOS Oil Company, the development of Russia’s oil and gas producing sector began to slow down.

These developments brought Kazakhstan to the forefront as the largest energy producer in the Caspian basin. As was mentioned previously, the country holds 105.9 trillion cubic feet (or 3 trillion cubic meters) of proven natural gas reserves, and proven oil reserves of 5.5 billion tons (or 39.8 billion barrels).[^5] In 2000-2007, its oil production growth rate averaged 10.7 percent per year and gas production growth averaged 13.9 percent annually.[^6] Since 1991, the total inflow of foreign direct

investment, mainly in the country’s booming oil and natural gas industries, reached $40 billion.\(^7\)

The country’s national leadership, and policies of coherent economic development integrated with market reforms and openness to Western investment, were key factors in achieving gross domestic product growth rates of nine to twelve percent annually between 2000 and 2006,\(^8\) and in boosting Kazakhstan’s industrial output, particularly in hydrocarbon production. Foreign capital fueled most of Kazakhstan’s energy projects during the 1990s, including the exploration of the giant Tengiz, Karachaganak and Kashagan fields.

\(^7\) National Bank of Kazakhstan, “International Investment Position,” at http://www.nationalbank.kz/?docid=3478uid=00F85A88-802C-E8FB-3C28AB953B3C4C02 (February 5, 2008).

Part One:

Seventeen Years of Soveriegn State Building
Challenges on the Road to Independence

The Soviet Union’s disappearance from the world political map posed both an opportunity and a challenge for the newly born Eurasian states. This was their chance for self-determination, sovereignty, and national renaissance. At the same time, it was a test that demanded full commitment in the struggle for survival.

The founder of modern Kazakhstan, Nursultan Nazarbayev, had to take Kazakhstan through a crash course in nation building. In the process, he made his way from serving as Kazakhstan’s Communist Party First Secretary to becoming a recognized national, regional, and international leader.

Between the late 1980s and the early 1990s, the approaching collapse of the Soviet Union was an unattractive scenario for the Kazakh Soviet Socialist Republic. Nazarbayev was aware of the consequences that abrupt rejection of the failing centralized administration could bring. For a resource-rich country that had been managed from an imperial “center”—first Russian, then Soviet—for over a century, sudden sovereignty could easily have led to serious social strife and a national security crisis.

Under the centralized Soviet economic model, Moscow had held the “monopoly on foreign trade” as envisaged by Vladimir Lenin. The mostly ethnic Russian communist bureaucracy in Moscow held the reins of both internal economic development and trade with the outside world tightly in its hands. Lacking direct foreign economic connections, Almaty was fully dependent on the Soviet foreign trade establishment and its Moscow-based state trading companies.

Nazarbayev was a supporter of the USSR’s “velvet reformation” program, which had been developing since 1989. Then-Soviet president Mikhail Gorbachev was planning to implement it after the constituent USSR republics would have signed the Novo-Ogarevo agreements to reconstitute the Union, however the August 1991 coup effectively put an end to this idea. This approach held out the promise of a more independent ethnic policy and greater authority and autonomy for the Soviet republics while preserving domestic economic links.¹ In a March 1991 national

¹ Ekaterina Dobrynina, Marina Volkova, “Uyti, chtoby ostatsya” [To leave in order to stay], Rossiyskaya Gazeta, December 20, 2006, at http://www.rg.ru/2006/12/20/eksperty.html (February
referendum, the majority of Kazakhstan’s population voted in favor of continuing the USSR in the form of a confederation. However, after the Belovezhskoe Agreement formalized the dissolution of the Soviet Union in December of 1991, the pressure toward economic independence became irresistible.

In 1991, on the eve of independence for many of the former Soviet republics, the international community was concerned with potential instability in the Caspian region.2

In the subsequent years, all fifteen of the former Soviet republics lived through a difficult period of post-communist transition. Their economies suffered from hyperinflation, abrupt industrial recessions, and food crises. For months, people went without receiving their wages and social security payments.

The possibility of interethnic conflicts and violence in some cases further exacerbated the challenges of transition in the New Independent States (NIS). The world viewed the five Central Asian states as fractious and vulnerable to ethnic unrest, especially since Stalin had deliberately drawn their boundaries to create diaspora communities throughout the region. The risk of regional destabilization by radical Islamic elements created additional fears. These groups were already active in Central Asia in the late 1980s, and their numbers could grow due to the more porous borders between the NIS after 1991.3

The Poles used to joke that switching from a market economy to (socialist) central planning is as difficult as making fish soup from an aquarium full of fish, but switching from central planning to the market is like trying to create an aquarium from fish soup.

From the beginning of the post-communist transition, international financial organizations, such as the World Bank and the International Monetary Fund, provided assistance to the former Soviet republics in order to support economic reform aimed at creating diversified and sustainable economies. Whenever possible, the West targeted this aid toward designing, implementing and stimulating macroeconomic reforms, which it viewed as a necessary first step for all of the states, even the oil-rich ones, to transition to markets.

3 Ibid.
Political reforms received significantly less attention than economic measures, in part due to the lack of prior experience in developing such programs, and due to the international community’s greater capacity to engage in macroeconomic policy technical assistance. Often, the reluctance to take on challenges in the political arena head-on was justified by the argument that economic reform had to precede political reform.\(^4\) Local regime leaders often insisted that it was necessary to assure social stability as a prerequisite to pushing for reforms in other areas.

The Government of Kazakhstan and other Eurasian governments had to address a number of specific problems in addition to the common transition issues. Their industrial-agrarian economies lacked the capacity to produce competitive finished goods. Most consumer products and machines, as well as food supplies, had been imported from Russia and southern “sister republics.” Small and medium sized business was virtually non-existent, and the service sector, trade and food industries were all weak.

During the Soviet era, Moscow had emphasized the development of extractive and heavy industries in Kazakhstan while processing and light industries were concentrated in Russia, Ukraine, Belarus, and the Baltic Republics. Moreover, the entire transportation and communications infrastructure across the Republic’s three time zones had been oriented in the northward direction, toward Russia. The Westward-going infrastructure, towards the Caspian and the Black Sea, or to the East and South, was nonexistent or incomplete and in need of massive modernization. This distortion complicated Kazakhstan’s access to new foreign markets, particularly to China, Iran, the Middle East, Eastern and Western Europe. Thus, investment in the transportation and communications infrastructure to reduce Kazakhstan’s dependence on Russia became a priority among the international aid programs.

Immediately following the collapse of the Soviet Union, in the absence of viable economic alternatives, Kazakhstan attempted to preserve the trade, political and military connections it had developed over the preceding 70 years. With this rationale in mind, Nursultan Nazarbayev became an advocate for the creation of the Commonwealth of Independent States (CIS). Though not comparable to the USSR or the EU in its level of integration, the CIS played an important historical role in transitioning from the Soviet empire toward independence and developing non-centralized regional integration.

In Nazarbayev’s view, the declaration to create the CIS was, in essence, a constructive counterweight to the sudden disintegration of the Soviet Union. The

\(^4\) Ibid.
leadership of 12 of the sovereign post-Soviet states (Lithuania, Latvia, and Estonia did not join) signed the agreement in Almaty on December 21, 1991. The organization aimed to preserve transportation, humanitarian, and information links and to maintain visa-free movement among the member states. The founders of the CIS attempted to regulate issues of common security. They established the CIS United Armed Forces,\(^5\) determined the legal status of waterways and basins, and discussed the demarcation of borders. The Declaration held open the possibility for countries aspiring toward future integration to pursue it. Overall, the CIS helped stage a “civilized divorce” in what could instead have become a bloody and destructive Balkans-style scenario.

**Building the Kazakh Society**

On December 1, 1991, Nursultan Nazarbayev won the first nationwide presidential election with a “Soviet-style” result of 98.7 percent of the vote.

The entire system of government was in need of systemic reform. From his first day in office, President Nazarbayev worked on setting up new administrative, legislative and judiciary systems despite the economic and social stagnation of the early 1990s.\(^6\) The President and his team demonstrated that they were open to learning international best practices as they drafted and built the foundations of Kazakhstan’s own statehood. For instance, when the working group was drafting the new Constitution of Kazakhstan, it examined many European, Asian, North and Latin American constitutions.

In early 1990s, the leadership of Kazakhstan had to make some fundamental decisions concerning the political and economic foundations of the state. Kazakhstan was transitioning towards democracy, market economy and a foreign policy that envisaged ties not just with Russia and the CIS countries, but also with Europe, the United States, China, Iran, the Middle East and others. At the same time, the leadership was preoccupied with selecting the right development model for its unique Eurasian country.

Kazakhstan is as large as the entirety of Western Europe, with a population only 1.5 times larger than the population of the city of Moscow. Its leaders examined the

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experiences of other independent states with similar transition paths over the last decade, primarily the countries of Eastern Europe and Southeast Asia. State-building priorities at the time included strong national security and a gradual transition to a market economy while emphasizing interethnic tolerance and political stability. Nazarbayev pursued an “economy first, politics second” approach to the country's gradual transition from central planning to a market economy, pointing out, “the market is democracy based on rigorous financial accountability.” The Kazakh public demonstrated its support for this thesis in a number of polls. At that time, only 4-5 percent of the population saw promoting democratic processes as a top priority, while over 60 percent primarily wanted a stable lifestyle, peace and personal security.8

**Development challenges.** Regional demographic changes and migration trends posed additional threats to Kazakhstan’s development potential. The outflow of qualified non-Kazakh personnel, most notably ethnic Slavs and Germans, reached alarming proportions after independence. Those with marketable skills left first: Russians and Ukrainians for their Slavic homelands and the Germans for the Federal Republic. This was partially to pursue better opportunities in the West or in Russia, and partially due to fear of possible ethnically based discrimination or even violence.

In the northern areas of Kazakhstan, the ethnic Russian population had reached 65 to 75 percent under the Soviets, constituting a major workforce for the regional industrial complex. Their rapid emigration during the 1990s contributed to regional economic, social, and demographic decline. During its first decade of independence, the population of Kazakhstan decreased by over one and a half million, from 16.5 million as registered in the last Soviet Census in 1989 to 14.9 million in 2002.9 Emigration also changed the country’s ethnic makeup, driving the proportion of ethnic Russians down from 37 percent to 25 percent.

Kazakh society appeared split between the Russophone industrialized north (with its ethnic Russian population reaching 45-65 percent, depending on location, and a

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Kazakh minority of 17-28 percent), and the Kazakh agrarian south. While the northern regions were losing workforce due to emigration, the southern and western regions were economically stagnant and overpopulated, with extremely high levels of poverty and unemployment—that of course also posed the risk of unrest.

The Slavic and German “brain drain” was jeopardizing further development as the country lost its most capable population. Nazarbayev was also feeling the pressure of the so-called “Malaysian problem.” When Malaysia gained independence, the ethnic Malays were primarily involved in the agricultural sector or low-paid urban jobs, while ethnic Chinese—a sizable minority making up 26 percent of the population—dominated the business sector. After the race riots of 1969, the Malays received preferential treatment under the Constitution, including the imposition of a 30-percent equity quota for publicly listed companies and discounts on houses and cars, creating additional grounds for continuous ethnic tensions.

In Soviet times, Kazakhstan was one of the very few countries in the world where the so-called “titular nation”—the Kazakhs—were a minority group in their own land.

In Kazakhstan, nationalist appeals from the ethnic Kazakh population became more frequent at a time when ethnic Russians, Ukrainians, Germans, and Jews continued to emigrate throughout the 1990s. The country’s leadership, however, was determined not to move in the direction of establishing a privileged status for the ethnic Kazakhs, but instead to build a tolerant multiethnic society.

During this period, the Soviet mentality inherited through over 70 years of totalitarian rule exacerbated Kazakhstan’s socioeconomic problems. The population had become used to the state playing the dominant role in resolving most social problems. People lacked initiative and entrepreneurial spirit, and the country lacked market mechanisms and the institution of private property. Kazakhstan’s Soviet-era officials, in a similar manner, retained the notion of the state as the key player in determining the fortunes of the people. In most Central Asian countries, including Kazakhstan, the state remains to this day an economic “heavyweight,” with free market relations only partially in place.

The state established three main priorities in its ethnic and demographic policy:

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Uphold the right of ethnic Kazakhs to serve as a state-forming nation.

Prevent human rights violations based on ethnicity.

Develop a comprehensive demographic policy to reverse population decline.

Language policy. In multiethnic Kazakhstan, the government adopted a go-slow, incremental approach to reviving the dominant role of the Kazakh language. The 1995 Constitution of Kazakhstan granted official status to the Russian language. Thus, the influence of Russian language, media, literature, theatre, and music has remained strong to date. Many Russian TV channels continue to broadcast, while most national and local newspapers appear in both Kazakh and Russian. Ultimately, Kazakhstan has remained one of the most Russophone states in the CIS.

In the educational sphere, while 60 percent of the secondary schools have switched to Kazakh as the principal language of instruction, 40 percent still teach in Russian. Secondary education in Kazakhstan is also available in 15 other languages. University instruction in both Kazakh and Russian continues while a few colleges teach in English, and students are able to select the language of instruction.

Language policy, nevertheless, remains a sensitive area for Kazakhstan. The state agencies have not yet completely transitioned into Kazakh, though the state launched a transition program in the late 1990s. Similarly, Kazakhstan has not completed the transition of the Kazakh language from Cyrillic to the Latin alphabet to this day. Mastering the Kazakh language remains slow and insufficient among the non-native speaking residents. The Government has developed a policy of encouraging the non-Kazakh population to learn the state language without limiting the rights of the Russian-speaking community, as the state is trying to preserve the educated Russian population and prevent their migration to the more prosperous Russian Federation.

Ethnic and religious freedom policy. The Kazakhstani population is diverse and multiethnic. Representatives of over 130 ethnic groups and 45 religious faiths live in the country. Figure 1 on the next page presents the historic dynamics of Kazakhstan’s ethnic make-up. The principal confessions in the country are Sunni Islam (47%), Orthodox Christianity (44%), and Protestantism (2%).

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ethic cultural associations, 19 ethnic national and local newspapers, radio- and TV programs, and six theaters represent these groups.13

To facilitate policy coordination with Kazakhstan’s ethnic elites, Nursultan Nazarbayev initiated the creation of the Assembly of Peoples of Kazakhstan (APK) in 1992, and made it an official body with his March 1995 Decree. The APK is a unique interethic association that acts as a representative body of the groups and religions living in Kazakhstan. On a local level, ethnic-cultural centers (Ukrainian, Chechen, Tatar, Uzbek etc.) represent the APK. The Assembly holds advisory status to the President and assists the State in implementing state ethnic policy. According to Kazakhstan’s new election laws, the APK can nominate candidates to the Majilis (the lower house of Parliament). Nazarbayev is lifetime chair of the Assembly, which strives to “form and promote the ideas of spiritual unity, and strengthen and preserve international friendship and concord.”14 The APK also works to prevent the violation of ethnic minority rights, and to promote the culture and history of all of the country’s ethnicities.

Kazakhstan’s effective state ethnic policy has practically eliminated any immediate grounds for ethnic intolerance and conflicts. Nevertheless, occasional ethnically

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based confrontations do occur in the densely populated southern regions, which elicit a prompt response from law enforcement. Recent incidents included a mass scuffle between Kazakhs and Uighurs in the Shelek district of the Almaty region in May and November 2006. Similar widespread fighting erupted between Chechens and Kazakhs in Almaty’s Enbekshiqazaq district in March 2007. To reconcile interethnic tensions, the Kazakh authorities typically set up an advisory council composed of elders representing all sides to the conflict. The government pays serious attention to building interethnic tolerance and national cohesion in the Kazakh society.

A clear state policy of protecting religious rights has served as an additional stabilizing factor. Since 1991, religious communities have built two thousand mosques, and renovated and constructed tens of churches, temples, and synagogues. The Muslim holiday of Kurban Ait and the Orthodox Christian Christmas were made public holidays.

In September 2003 and 2006, sessions of the Congress of Leaders of World and Traditional Religions took place in Astana, bringing together over 45 national delegations to discuss religious freedom and tolerance, and receiving generally positive feedback in the international media and public opinion, including among American and Western European political elites. Another Congress is scheduled for 2009.

US President George W. Bush wrote in his address to Nazarbayev dedicated to the September 2003 Congress:

The United States firmly supports the goal of the Congress to deepen inter-confessional understanding in order to develop freedom of faith and freedom in general. Such meetings underscore the importance of promoting such values as tolerance and respect that form the foundations of democracy.

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18 Assembly of the Peoples of Kazakhstan, “Who is Who in the Assembly of the Peoples of Kazakhstan,” Volume 1, at
At the same time, the possibility of regional destabilization by radical, political Islamic elements posed risks for Kazakhstan’s post-1991 transition. To mitigate the extremist threat, the Kazakh authorities exercise close control over radical Islamic elements and the various religious sects active in the country. Between 2004 and 2005, the Supreme Court of Kazakhstan pronounced eleven extremist international organizations, including Al-Qaeda, Hizb ut-Tahrir, the Taliban, and the Zhamaat (Jamaat) mujahideen of Central Asia, as terrorist groups. The Kazakh government has to date stood firm in the fight against terrorism, primarily on the ideological, political and law-enforcement fronts. As of this writing, there have been no terrorist attacks on Kazakh soil or against Kazakh citizens abroad. Kazakhstan contributes to humanitarian assistance and reconstruction missions in Afghanistan, Iraq and Tajikistan.

With inter-religious tolerance being a widely supported state policy, and the standard of living going up, Russian and other non-Kazakh minorities are apparently feeling secure and see no immediate reason to engage in political activities that could lead to separatism and threaten the independence and stability of the Kazakh state.

**Demographic policy.** Negative demographic and migration trends remain a challenge for Kazakhstan. As noted earlier, following the collapse of the Soviet Union, the country’s population declined to 15 million people and was insufficient to support industrial sector growth. In an attempt to counter this trend, Kazakhstan launched a repatriation program directed at the Kazakh diaspora. According to some estimates, China, Uzbekistan, and Russia alone are home to approximately 4 million ethnic Kazakhs.

In 2000, the Kazakh government launched a program to stimulate the birth rate and attract working age migrants from among former residents of Kazakhstan. By 2001, domestic economic growth and political stability reversed the population outflow, with the number of people applying for Kazakhstani citizenship 2.5 times higher than those wishing to give it up. In 2004, Kazakhstan reached a positive migration balance and the country has now become a net recipient of migrants, and an attractive place for labor from such areas as the Caucasus, Central Asia, China,

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India and Turkey. According to the World Bank, it has become one of the top 10 countries receiving immigration. As of July 1, 2005, over 110,000 Kazakh families had returned to Kazakhstan.21

At the same time, the growing labor migration into Kazakhstan has brought with it two additional concerns. First, the number of unregistered immigrants in the country is growing. Moreover, there are occasional conflicts between the Turkish, Chinese, and Kazakh workers in large enterprises. Nevertheless, despite these issues, the foreign labor force plays an important role, filling in gaps in the country’s demographic makeup. It also facilitates the development of the construction sector, the oil and gas industries, as well as the trade and service sectors. Similar processes are underway in the U.S., Western Europe, the Middle East and Russia.

Over the last 16 years, the Kazakhstani population underwent significant urbanization. In his 2006 address to the Assembly of Peoples of Kazakhstan, Nazarbayev touched on topics that had long been taboo:

All of us remember the social fabric of the Kazakhstani cities. With the exception of small group of party officials and intelligentsia, the vast majority of Kazakhs were engaged in low-paid and non-prestigious work. Today, the urban ethnic Kazakh population is well represented in all areas of business, management, IT, and other most prestigious fields. This shift is fundamental for understanding the current societal processes. The Kazakhs’ level of national status and national self-esteem became correspondent to the status of a state-building nation.22

Small and medium businesses and the middle class form the social basis for the relatively stable Kazakh society. According to a 2007 poll conducted in seven CIS countries by the Russian Centre for the Study of Public Opinion, Kazakhstan had the highest proportion of respondents satisfied with their lives (73 percent). Half of the respondents also were optimistic and confident that within a year their lives would be better.23 A symbol of this new country and new life is the new capital of Astana.

21 Nazarbayev, Address to the Third World Kazakh Round-Table.
22 Nazarbayev, Address to the XII Session of the Assembly of the Nations of Kazakhstan
**A new capital city.** The 1997 relocation of the national capital from the southeastern city of Almaty to centrally located Astana has spurred the country’s economic development, while Astana’s favorable location has enhanced Kazakhstan’s geopolitical standing. The relocation invigorated construction, the production of building materials, transport, communications, and engineering sectors. The Kazakh Parliament approved the decision to move the capital in 1994. On December 10, 1997, the country declared Akmola (renamed Astana on May 6, 1998) its capital.

Astana has attracted some $12 billion in investment since 1997. The preferential tax regime provided by Astana’s special economic zone since 2002 drew a large share of private sector investment. The city is still partially under construction. By 2007, the population had reached 700,000 people, and it will likely reach 1 million in the coming decade.²⁴ In 1999, UNESCO awarded the Cities for Peace Prize to Astana for initiatives that contribute to strengthening social cohesion and improving living conditions in sensitive neighborhoods.²⁵

The official reason for moving the capital from Almaty was the city’s limited development capacity and its location in an area fraught with seismic risks. However, analysts agree that the real reasons for relocation were largely geopolitical and ethno-political in character. A major motivator was Nazarbayev’s aspiration to shift the regional ethno-demographic balance and stimulate the migration of excess labor force from the southern region to the industrialized northern cities, as well as to involve the ethnic Kazakhs in the industrial and agricultural production of central and northern Kazakhstan.²⁶ Since 1997, the ethnic make-up of the new capital region has shifted in favor of the ethnic Kazakhs.

Establishing a capital in Astana helped strengthen the territorial integrity of the state and prevent separatist sentiments and movements among parts of the ethnic Russian population in the northern region from gaining the upper hand. In April-May 1997, the Kazakh government implemented a major administrative-territorial reform. The government merged five regions with predominantly Russian populations with areas where Kazakhs prevailed. One of the Kazakhstani experts

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²⁶ Sadovskaya, “Capital Relocation from Almaty to Astana.”
involved in the capital city relocation, Edward Shats, noted, “...having physically relocated the state institutes to the epicenter of presumed unrest, Nazarbayev demonstrated immediate preparedness to oppose the threats.” Moving the capital to the geographical center of the country, along with administrative changes helped strengthen the territorial integrity of the state.

The geopolitical disadvantages of Almaty included its location on the southeastern edge of the country. The Almaty region borders on China’s Xinjiang-Uighur Autonomous Region that has repeatedly voiced aspirations for Uighur independence. Kazakhstan hosts a large Uighur diaspora, and may one day suffer cross-border separatist unrest. Furthermore, Kazakhstan and China had unresolved border disputes up until 1998. The new capital is geographically close to Russia. At the same time, Kazakh officials often present Astana as a “link between Europe and Asia, a ground for dialogue between the East and the West, the North and the South.”

During the early years of its sovereign development, Kazakhstan managed to build a relatively stable and harmonious ethnically diverse society, which some experts have described as an island of stability in a volatile region. This internal stability is vital to the development of the young country’s external relations.

**A School for Kazakh Diplomacy**

Newly independent Kazakhstan launched its sovereign diplomatic effort almost immediately after the Supreme Soviet signed the Law on State Independence on December 16, 1991. The country’s chief diplomat at the time, then-Minister of Foreign Affairs Kasym-Zhomart Tokayev, who currently serves as Chairman of the Senate, described the country’s first steps toward independence in his book *Perseverance*.

In the first months of 1992, Kazakhstan’s leadership needed to gauge the attitude of the world powers to the republic’s sovereignty. The young state also had to address some complex international security issues vital to its status and sovereignty, such as border demarcation and denuclearization.

28 Sadovskaya, “Capital Relocation from Almaty to Astana.”
At the time, independent Kazakhstan had no embassies, and the majority of its newly appointed Foreign Ministry officials had no practical experience in diplomacy, as the USSR had conducted its foreign policy from the Foreign Ministry in Moscow’s Smolensky Square.

Nursultan Nazarbayev and the Ministry of Foreign Affairs had to set strategic foreign policy priorities for Kazakhstan. On the one hand, a small part of the country’s territory is located in Europe, which could serve as a good argument in favor of European integration. On the other hand, the local elites and the general population tended to support partnership with the Islamic world, East Asia and Russia.

Ultimately, the leadership opted to pursue a “Eurasian” development model based on a “multi-vector” foreign policy. From 1990 to 1994, Nazarbayev paid official visits to the United States, China, the U.K., Germany, Russia, Turkey, Japan and other states. By 1996, 120 nations had recognized Kazakhstan, and it had established diplomatic relations with 92 countries.

The first major diplomatic initiatives targeted strategic issues, such as dealing with the “nuclear legacy,” obtaining international security guarantees in the aftermath of denuclearization, and delimiting the borders. These strategic priorities largely determined the direction of Kazakhstan’s foreign policy and national economy for several years to come.

**Renunciation of nuclear weapons.** On August 29, 1991, President Nazarbayev signed a decree closing the Semipalatinsk nuclear testing ground. After 40 years of operations, the Semipalatinsk site was the second largest in the world. The Soviet Union had conducted over 450 nuclear tests there, contaminating a large adjoining area, and ruining the lives of some 1.5 million local residents.30

However, the leadership could not resolve another, more important problem with the stroke of a pen. Kazakhstan was “home” to a huge Soviet military arsenal consisting of 1400 nuclear warheads deployed on 104 silo-based RS-20 missiles (NATO designation SS-18 “Satan”) and 40 strategic bombers Tu-95 MS (“Bear”) with 240 nuclear cruise missiles. Moreover, this huge military complex was under the command of the Russian military.

From the first days of the post-Soviet era, the United States, regardless of the political origins of its administration, had made nuclear disarmament and non-

proliferation in the region a top foreign policy priority. The U.S., UK, France and other nuclear powers pressured Kazakhstan for immediate removal of nuclear weapons from its territory. Washington insisted that Kazakhstan, Ukraine and Belarus, which had all inherited Soviet nuclear arms, give them up. The White House was convinced that an attempt by any of these republics to keep nuclear weapons would prompt other countries to develop their own arsenals.

Washington kept its intensive disarmament efforts deliberately behind closed doors to avoid exciting nuclear ambitions that the West was trying so hard to restrain. US officials worked on getting the newly independent nuclear states to acknowledge that their international recognition would depend on renouncing nuclear weapons. During a high-profile visit to the three republics in 1991, US Secretary of State James A. Baker III explained that America viewed nuclear proliferation as a factor that was likely to endanger the region.

Persuading Kazakhstan to give up its warheads became a major US foreign policy goal, causing Baker to visit the country twice in 1991. US officials hinted that Kazakhstan might not be eligible for Western economic and technical assistance unless it agreed to a timetable for transferring the warheads to Russia for destruction and signing the Nuclear Non-Proliferation Treaty as a non-nuclear state.

In response to the international pressure, Kazakhstan formulated a policy of “security assurances in exchange for disarmament.” Nazarbayev utilized the warheads as a valuable bargaining chip with Moscow and Washington. At the same time, military analysts said the Kazakh leadership was keen to portray itself to the West as more co-operative than Ukraine on nuclear disarmament and indicated that the country would eventually strike a deal for the best terms it could get. In the long run, the country’s political leadership viewed non-nuclear status as the only alternative for Kazakhstan’s future and a key step toward ending the Cold War. As Kasym-Zhomart Tokayev noted in his book:

33 Ibid.
Nuclear ambitions impose a high cost on Kazakhstan and wipe out the prospects of its existence as an independent nation. First, our nation that has long been striving for genuine sovereignty, could find itself in international isolation... Secondly, viewed as a rogue state, Kazakhstan would certainly be unable to reap the benefits of international economic and investment cooperation... and, finally, rejection of the nuclear legacy became the basis for strengthening Kazakhstan’s international positions.35

In pursuit of his objective, Nazarbayev worked in coordination with the late President of Russia, Boris Yeltsin, and the leaders of other nuclear powers. US involvement was also crucial. Beginning in 1991, Kazakhstan cooperated with the U.S. under the Nunn-Lugar program to remove all nuclear weapons from its lands and to eliminate the test site’s infrastructure.36 The parliament of Kazakhstan approved the ratification of the START I Treaty on July 2, 1992. Two years later, on February 14, 1994, Kazakhstan formally acceded to the Nuclear Non-Proliferation Treaty (NPT). The country had removed the entire warhead arsenal to Russia by May 1995. The U.S. facilitated this transfer by providing a $100 million assistance package under the Cooperative Threat Reduction program.

Nazarbayev called on Russia, the U.S., and China to conclude a non-aggression pact with Kazakhstan that would also guarantee the republic’s territorial integrity. On December 5, 1994, the U.S., the UK, and Russia signed a Memorandum on Security Guarantees to Kazakhstan based on the Non-Proliferation Treaty (NPT). Later, the governments of China and France added their signatures to the Memorandum. Kazakhstan had also destroyed the nuclear testing infrastructure of Semipalatinsk by July 2000.37

A 2006 US House of Representatives resolution recognized Kazakhstan’s outstanding cooperation with the U.S. on nonproliferation matters as a model for other countries to follow. Furthermore, in June 2008, US Representatives Darrell Issa (R-California) and Charlie Melancon (D-Louisiana) proposed nominating Kazakhstani President Nazarbayev and US Senators Lugar and Nunn for the

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Nobel Peace Prize “in recognition of their commitment to nuclear disarmament and nonproliferation.”

Border delimitation. Another foreign policy priority stemmed from Kazakhstan’s need to consolidate its territorial integrity. The Kazakh Government had to determine the status of 14.5 thousand kilometers of the border with five different countries, including the 7,000 km long border with Russia—the longest land border in the world.

Foreign Minister Kasym-Zhomart Tokayev led the complex negotiation process. A China expert by training, Tokayev began his diplomatic career at the Embassy of the USSR in the People’s Republic of China (PRC). By 1994, he had managed to negotiate an almost complete settlement of the border disputes with China. In April 1994, in Almaty, the leadership of the two states signed a landmark agreement that ended four decades of dispute between the USSR and China. The agreement determined the delineation of the border over its full length with the exception of two controversial sections. On July 4, 1998, Nazarbayev and Jiang Zemin, President of China, signed a supplementary agreement on the Kazakhstani-Chinese border dispute, which brought the issue to a final settlement. The parties based both documents on the Czarist and Soviet Russian agreements stipulating the division of the disputed territories on a ratio of 53 percent to Kazakhstan and 47 percent to China. The settlement of territorial disputes with China opened the way for a strategic eastward diversification of Kazakhstan’s external relations. Kazakhstan gained new opportunities to develop political relations with the rapidly rising Asian power, thus reducing its traditional dependence on Moscow.

Border delimitation talks with Russia took more time, but the two countries successfully concluded them as well. In 2005, Russia and Kazakhstan signed and ratified an agreement on the state border, which included evenly splitting and developing the disputed Imashevskoye oil field in the Caspian region—the last obstacle to settlement. The parties committed to commence border demarcation in 2009. The agreement facilitated further expansion of cross-border cooperation between the two countries. Similar agreements with Uzbekistan, Kyrgyzstan and

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38 A letter of nomination circulated by the US House of Representatives Foreign Policy staff, June 23, 2008.
Turkmenistan concluded the complex political process of border delimitation. Although Azerbaijan, Kazakhstan, and Russia signed on a maritime boundary based on a modified equidistant line on the Caspian seabed, the states have no consensus on dividing the water column. To complicate things further, Iran to date has refused to recognize this delineation, and insisted on possession in common of both the water and the continental shelf, including mineral resources.42

Reaching a border deal with Russia was an important achievement for Kazakhstani diplomacy, especially considering Moscow’s immutable track record of long-running border disputes with neighboring states. The unresolved dispute with Japan over four islands occupied by Soviet troops at the close of World War II (Etorofu, Kunashiri, Shikotan, and the Habomai group, known as the “Southern Kurils” in Russia and the “Northern Territories” in Japan) has prevented the two states from signing a formal peace treaty until this day.43 In the meanwhile, Russia is attempting to repopulate the islands and boost their economic development to support its claims.

In May 2005, Russia recalled its signatures to the 1996 border agreements with Estonia (1996) and Latvia (1997), when the two Baltic States issued unilateral declarations referencing Soviet occupation and ensuing territorial losses.44 It took 16 years to settle the border disputes with Lithuania and Latvia, while the disagreement with Estonia is still unsettled. The Russian-Ukrainian dispute over the Kerch Strait and Sea of Azov boundary remains unresolved. Moscow and Kyiv are bickering about the Russian naval base in Sevastopol on the Black Sea, and Mr. Putin even questions Ukrainian sovereignty over the Crimea. Finally, the Russian Duma has yet to ratify the 1990 Bering Sea Maritime Boundary Agreement with the U.S.45 Thus, Kazakhstan succeeded where many other—and more powerful—countries failed.

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45 Ibid.
The Logic of Political Reforms

During the first years of independence, renouncing communist ideology and the move towards privatization and market economics dominated Kazakhstan’s politics. Nevertheless, in the early years, the country experienced a lack of policy cohesion, and harsh confrontations took place between the executive and legislative branches of the government. In his book, *On the Verge of the 21st Century*, Nazarbayev noted that these power struggles were common in many CIS countries. Suffice it to recall the 1993 confrontation between President Boris Yeltsin and the Supreme Soviet, in which Yeltsin deployed tanks against the rebel parliament.

In the early 1990s, the 500-member Supreme Soviet of Kazakhstan, the country’s highest Soviet-era legislative body, was delegated authority to carry on most wide-ranging functions. Its deputies, though they may have been well intended, came from a political culture in which the communist party and the Moscow bureaucracy decided all key policy issues. Consequently, the Kazakhstan deputies often had no idea what policy formulation and implementation really were about.

As Kazakhstan moved toward independence, elected representatives fiercely lobbied for increases in public funds for their respective regions. The debate was often so fierce that it prevented a coherent budgetary process and coordinated policy implementation—endless arguments simply smothered many important decisions. The country suffered from a deep economic recession and needed a rapid and comprehensive reform package to accelerate its transition to a market economy. The Supreme Soviet, however, failed to live up to the task. It passed just seven laws during four years of work.

In the 1990s, though many political parties were registered in the country, their activity was weak and underdeveloped. Freedom House stated in its 2003 Kazakhstan country report:

> Since gaining independence in 1991, Kazakhstan has seen the rise and eclipse of numerous political parties, most of which have been sponsored by interests or personalities within the regime. All parties in Kazakhstan lack well-developed organizational structures and significant national
membership... Pro-presidential parties, which claim to be independent, confine their criticism to the prime minister and the cabinet and pledge allegiance to the president. Opposition parties target their criticism mainly at the president and his close associates.1

The earliest opposition groups emerged during Gorbachev's *perestroika* (restructuring), including the Communist Party of Kazakhstan (CPK) and its spinoff, the Socialist Party of Kazakhstan (SPK), which positioned itself against the new authorities. Another major anti-establishment player was the People's Congress of Kazakhstan Party (PPCK), led by writers and public figures such as Olzhas Suleymenov and Mukhtar Shakhanov.2 While such parties as the Communist Party of Kazakhstan were rooted in the Soviet regime and communist ideology, many newly created parties cast about for ideological inspiration in pre-revolutionary nationalism or Western liberalism, at times representing narrow interests or specific personalities and lacking broad appeal.

Several early nationalist groups, such as the Azat Republican Party, played an important role in pushing for Kazakhstan's independence, but failed to evolve into influential forces. Freedom House reported that in the 1990s, forces within the regime, particularly the Ministry of the Interior, endorsed a number of smaller political parties, such as the Renaissance Party, Azat, and Alash, to champion the interests of ethnic Kazakhs against the Slavs and foreigners.3

In late 1993, the pro-presidential Union of People's Unity of Kazakhstan (UPUK) and the Party People's Congress of Kazakhstan (PPCK) carried out a joint effort to dissolve the Soviet-era Council of People's Deputies. The Supreme Soviet of Kazakhstan dissolved itself, with the deputies submitting early resignations.4

The next Supreme Soviet, elected in March 1994 via 135 single-mandate constituencies, was the first professional Parliament of Kazakhstan in which deputies worked on a permanent basis. Non-presidential parties won a considerable number of seats in the new body, with the PPCK and SPK being the largest opposition groups represented.

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The major factions were Nazarbayev’s Union of People’s Unity of Kazakhstan (32 seats), the Party of Popular Congress of Kazakhstan (22 seats), the Socialist Party of Kazakhstan (12 seats) and the Federation of Trade unions (12 seats). The Constitutional Court subsequently invalidated the first legislative elections, held in March 1994, due to technical irregularities, and Nazarbayev dissolved the parliament in 1995.

**Strengthening the Presidency**

Being aware of the major strategic challenges facing the state, Nazarbayev and his team drafted a new constitution that strengthened the executive branch. Ninety percent of the population supported the new “presidential” Constitution, which gave broader authority to the Head of State, in two consecutive nationwide referendums held on April 29 and August 30, 1995.

Under the new law, the Parliament consisted of the Senate, the upper chamber, elected for six years, and the Majilis, the lower house, elected for five years. Elections to the new bicameral National Assembly took place in December 1995, giving most of the seats to the pro-presidential coalition led by the People’s Union of Kazakhstan Unity party. The broader presidential powers he secured with the backing of a loyal parliament enabled Nazarbayev and his team to act on the most pressing social problems, especially unemployment and poverty, as well as to initiate reforms in agriculture, healthcare and education.

The April 1995 referendum also extended the President’s term of office until December 2000, paving the way for Nazarbayev’s re-election in the January 1999 early vote and again in the December 2005 election. Nazarbayev is one of the longest-serving leaders in Asia—and on the planet.

In the October 1999 elections to the Majilis, nine political party lists competed for ten of the 77 seats; the voters also elected 67 members who competed in single-mandate districts. The election drew very low voter turnout in the first round—only 33 percent of voters in the former capital, Almaty, and 43 percent in the current capital, Astana. Four parties passed the threshold—Otan [Fatherland], the Civic Party, the Agrarian Party, and the Communist Party.

The president’s Otan party, launched in January 1999, gained the largest number of seats. The pro-business Civic Party, created in 1999, which represented the interests

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5 Ibid.
of the Eurasia corporate group, which controlled six of the major metallurgical enterprises in Kazakhstan, also won seats in the Majilis. According to Kazakhstani political analysts and the media, Alexander Mashkevich, the principal owner of the Eurasia Industrial Association, bankrolled the party. Active intervention on the part of the executive branch into party politics and the election of the legislature triggered complaints and criticism inside and outside the country.

Since the mid- and late 1990s, Kazakhstan has come under criticism from the West amidst claims that the country’s leadership was reversing the democratic progress of the first years of independence. In response, Nazarbayev has made an effort to explain his course internationally, but has not changed his policies. After several years of instability and administrative reform, Kazakhstan gained governability and public order. Altogether, the government has succeeded in conducting a series of economic reforms, reinvigorating business activity, and reviving many sectors of the economy. At the same time, critics at home and abroad point out that the state achieved these results by eschewing some political freedoms.

The World Bank noted the country’s economic success in the 1990s:

Following independence in 1991, Kazakhstan was one of the earliest and most vigorous reformers among the countries of the former Soviet Union. In the early years of transition, the state liberalized prices, reduced trade distortions, and facilitated the privatization of small- and medium-scale enterprises (SMEs). The state has also dramatically improved treasury and budget processes... The government has established a basic framework to attract foreign direct investment (FDI) into its resource-rich oil and mineral sector. Banking reforms and state-of-the-art pension reform followed.

Kazakh Political Opposition

Even with his increased authority, Nazarbayev did not destroy the political life of the country, as was the case in some neighboring CIS countries, such as Uzbekistan and Turkmenistan. He also did not allow internal conflicts to escalate, as happened in Tajikistan, which suffered through a civil war (1992-1997) in which up to 100,000 people lost their lives and about 1 million people became refugees and internally

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8 For more on Mashkevich see Elektronnaya Evreiskaja Entsiklopedia, at http://www.eleven.co.il/article/15580 (July 29, 2008)
displaced persons." No revolution swept the regime aside, as occurred in Kyrgyzstan in 2005.

In the 1990s, a number of political parties registered in Kazakhstan, including the opposition Socialist party, the Democratic Party, National Democratic Party, and the People’s Congress Party of Kazakhstan. Until the end of the 1990s, Serikbolsyn Abdildin, ex-chairman of the last Supreme Soviet of the Kazakhstan Soviet Socialist Republic, led the Communist Party of Kazakhstan. The People’s Opposition Communist Union, a part of the Democratic Choice of Kazakhstan electoral bloc in the parliament, included a Communist faction until 2004. That year, as Democratic Choice received only 3.44 percent of the vote, the communists received no seats in the parliament.

In the mid-1990s, the major opposition figures came from the ranks of former high-level government officials disillusioned with the expanding presidential powers. In April 1996, ex-Ministers Petr Svoik and Galim Abilsiitov created the new Azamat movement, officially registered as a party in March 27, 1999. Lacking funds and connections, the group did not emerge as a serious political challenge to President Nazarbayev’s rule. Ex-prime minister Akezhan Kazhegeldin joined the ranks of the opposition in 1998 with appeals for the promotion of democratic values in Kazakhstan. In early 1999, supported by some smaller groups, Kazhegeldin founded the Republican People’s Party of Kazakhstan (RPPK). However, changes in the election laws disallowed him from running for office in the 1999 presidential elections, and the RPPK did not get any seats in the 1999 parliamentary elections. In October 1999, Kazhegeldin led the Forum of Democratic Forces of Kazakhstan (FDPK) in another attempt to rally the opposition. However, the group suffered from internal conflict and the government succeeded in suppressing its activity.

In addition to increased political activism, Kazakhstan’s civil society has also experienced rapid development. In the period from 1995 to 2005, the number of non-governmental organizations (NGOs) grew from 400 to 5,000. Although many of these engage in cultural and community activity, some have been working on rule of law and democratization initiatives, often supported by foreign grants and economically powerful Kazakh opposition figures. Also during this period, drastic changes occurred in the Kazakh media, with over 2,000 media outlets publishing in the country supported by various political forces, including the radical opposition.

11 Kusainov, “Kazakhstan’s Critical Choice.”
Eighty percent of all media in the country was (and is) privately owned. However, some media channels were close to the president, and one—Khabar media holdings—was even, for a while, owned by Nazarbayev’s daughter Dariga Nazarbayeva. While some media opposed the presidency and the ruling group, others were loyal.

**Main opposition forces in the 2000s.** Many of the opposition figures in the early 2000s came from the ranks of Kazakhstan’s new business elites, who had gained control over some of the country’s most lucrative industries during the 1990s privatization of state property. Key figures combining financial power and political influence included Mukhtar Ablyazov, energy minister and head of the Astana-Holding investment group; Zeinulla Khakimzhanov, state revenues minister, well connected to Kazkommertsbank, the leading financial group, and others. To date, Nazarbayev has been able to balance the interests of various factions competing for control of property and industrial assets, and to play them off against each other.

Kazakhstan’s domestic business heavyweights grew dissatisfied with their declining influence as Nazarbayev’s administration began pushing for greater economic control while welcoming foreign investment in major industries. According to some experts, the authorities were also considering a consolidation plan for major industries into national companies under state management. Economists viewed this plan as potentially benefiting those in the president’s closest circle at the expense of other influential business groups.

In November 2001, opposition politicians from among the Kazakh business elite, some holding high government posts, founded the Democratic Choice of Kazakhstan (Demokraticheskiy Vybor Kazakhstana, or DVK in Russian) movement. Main figures in the new movement included the previously mentioned Mukhtar Ablyazov, the youthful Uraz Dzhandosov, then-Deputy Prime Minister and Finance Minister, and Galimzhan Zhakiyanov, ex-Governor of the Pavlodar region. The DVK proclaimed its commitment to greater economic liberalization and decentralization, as well as anti-corruption efforts. However, it was also a rather clear-cut attempt on the part of members of the group to secure their own

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14 Kusainov, “Kazakhstan’s Critical Choice.”
economic and political interests by limiting Nazarbayev’s power. The president reacted by sacking some of the DVK-connected officials, while a number of major figures resigned.

Meanwhile, older-generation opposition activists formed another political group—the United Democratic Party (UDP)—in 2001. While welcoming the DVK’s anti-corruption and pro-democracy stance, the opposition veterans were generally suspicious of the DVK’s ties to the government and its more tolerant position towards Nazarbayev.

Beginning in 2002, the government began pushing back on the independent media and freedom of expression in response to the growing influence of the oppositionist camp. According to Western observers, a more moderate group led by Dzhandosov and Abilov split off from the DVK and founded the Ak Zhol [Bright Path] Party with a more centrist course reaching out to Nazarbayev’s regime in early 2002. Ak Zhol offered mild criticism of some policies, including the 2004 amendments to the election law and suppression of journalists’ rights. The Kazakh judiciary arrested the two DVK leaders, Ablyazov and Zhakiyanov, who allegedly threatened to disclose sensitive information on large-scale corruption among the top authorities. The charges against Ablyazov and Zhakiyanov included abuse of power during their government tenure.

**Controversial party reform.** In July 2002, Kazakhstan’s political party and election laws were amended to require that political parties have nationwide representation and a documented membership of at least 50,000 (as compared to the previously required 3,000) to be eligible for mandatory re-registration by the Justice Ministry. Opposition figures and outside observers have heavily criticized this regulation as favoring pro-government parties while placing an unjustified burden on smaller parties, and inhibiting the development of vibrant party politics in Kazakhstan. The new rules, however, did not cause the elimination of a single major political force. Nine political parties, which took part in elections to the Majilis, the lower house of the Kazakh Parliament, met the legal requirements and registered for the elections.

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15 Ibid.
The September 19, 2004 elections to the Majilis brought a convincing victory to the President’s Otan [Fatherland] party and his close supporters—the Civic Party, the Agrarian Party and Asar [All together] Party, headed by the president’s daughter, Dariga Nazarbayeva.\(^9\) The only seat in the parliament gained by an opposition party, Ak Zhol, through proportional party-lists voting remained vacant until 2006. The party initially refused to take the seat in protest of alleged election violations. Ak Zhol’s leader, Alikhan Baimenov, decided to end the boycott and fill the seat a year later, after an unsuccessful campaign in the 2005 presidential election.\(^20\)

The gradual introduction of local elections for regional governors (akims) has been another important feature of Kazakhstan’s administrative reforms. In fact, it is a forward-looking democratic experiment in the country, which previously lacked a tradition of local electoral politics. Historically, local leadership used to be hereditary, and in the Soviet era, Moscow nominated the local party bosses.

As these elected officials managed to achieve effective improvements in their districts, the State Commission for Democratization recommended the local government reform so that all leaders at the regional and city levels are elected. In August 2005, the country held its first pilot elections of akims for rural areas, and in October 2006, it elected akims in 49 counties and 10 cities. By 2008, one third of the akims in cities and rural counties, except Almaty and Astana, were elected. The Democratization Commission completed its work in February 2007.

**Engaging the opposition in the mid-2000s.** The January 2005 ban on the Democratic Choice of Kazakhstan (DVK), as well as a split in the Ak Zhol opposition party, weakened the Kazakh opposition forces. The authorities accused the DVK of “public protests, including civil-disobedience campaigns” and of calling the Kazakh authorities “anti-people.” The Almaty city court then proceeded to ban the DVK.\(^21\)

A new opposition party Alga! [“Forward!”], set up in 2005 to succeed the banned DVK, repeatedly failed to secure official registration. Meanwhile, after the 2005 split in Ak Zhol, triggered by personal conflict and an internal party leadership struggle, the former Ak Zhol co-chairmen, Altynbek Sarsebayev and Bolat Abilov, created Naghyz Ak Zhol [“The True Bright Path”] party. As is discussed later, Sarsebayev was assassinated in 2006.

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\(^{21}\) “Kazakhstan Votes 2005.”
Currently, the main opposition movements in Kazakhstan enjoy access to funding from influential supporters that could help sustain them in a prolonged struggle against the incumbent authority.\(^{22}\)

In March 2005, the leaders of the major opposition forces, including Ak Zhol, the Communist Party, the DVK, and the Republican People's Party of Kazakhstan, formed the For a Just Kazakhstan (FJK) Coalition, intended “to nominate a unified candidate for the 2005 presidential elections and lead the country out of the crisis.”\(^{23}\) The FJK cleared state registration in August 2005 and became the only official opposition force in Kazakhstan.\(^{24}\) However, a bid by FJK’s leader, former Prosecutor General Zharmahan Tuyakbai, for the presidency turned out to be unsuccessful.

In September 2006, Nazarbayev held a meeting with Tuyakbai in Ak-Orda, the impressive Kazakh presidential residence in Astana. To ensure proper dialogue with the opposition, the President invited the leaders of the FJK movement to take part in the State Commission for Democratization.

In 2002, a local court sentenced Galimzhan Zhakiyanov, founder of the Democratic Choice of Kazakhstan opposition movement, to seven years in prison for the embezzlement of budgetary funds and abuse of office while serving as governor of the Pavlodar region. Zhakiyanov’s supporters and international human-rights watchdogs, including Amnesty International, declared that his imprisonment was politically motivated.\(^{25}\) In February 2006, the authorities released him from prison prior to completing his sentence under a provision permitting parole after a one has served half of the sentence. In 2004, the authorities also pardoned and released another DVK founder, Mukhtar Ablyazov, sentenced in 2002 to six years in jail for illegal enterprise and abuse of power. Since 2005, he has been heading one of the largest banks in Kazakhstan, Turan Alem.

Deaths of prominent opposition activists. In 2005-2006, the deaths of two opposition politicians, Zamanbek Nurkadilov and Altynbek Sarsenbayev, soured what appeared to have been a thaw in presidential relations with the Kazakh opposition.

\(^{22}\) Kusainov, “Kazakhstan’s Critical Choice.”


Nurkadilov was found dead at his family home in Almaty with a revolver by his side in November 2005, during the run-up to the 2005 presidential vote. The official investigation determined his death was a suicide. Yet Western observers, along with his family lawyer, found it suspicious that the former emergencies minister and mayor of Almaty somehow managed to shoot himself in the chest twice before delivering a final shot to the head. The Kazakh state leadership had sacked Nurkadilov after making accusations of corruption as part of the so-called “Kazakhgate” scandal, which involved massive bribes to Kazakh officials in exchange for access for Western oil companies to Kazakhstan’s giant hydrocarbon fields.

Altynbek Sarsenbayev was kidnapped and found dead in February 2006 near Almaty in his car, with his driver and bodyguard shot. The police apprehended his paid assassins. Sarsenbayev had served as Secretary of the National Security Council, information minister and ambassador to Russia before joining the opposition in 2003. He co-chaired the Naghyz Ak Zhol opposition party and was a fierce critic of the authorities over the “Kazakhgate” corruption scandal and other issues.

A Kazakhstan judiciary convicted Erzhan Utembayev, a senior parliamentary official and chief of administration of the Senate, of ordering Sarsenbayev’s murder. The appeals courts commuted his death sentence to life in prison. The courts also convicted a former police officer, Rustam Ibragimov, of carrying out the execution, and eight other defendants, some of them members of an elite unit from the National Security Committee (KNB), were given sentences of between three and 20 years. The prosecution concluded that the assassins acted in revenge for an article penned by Sarsenbayev attacking Utembayev. The opposition contends that the convicted offenders were mere scapegoats, and that the story of the real instigators was being covered up. While from a legal perspective the police and the prosecutors solved both cases, some critics join the Kazakh opposition in expressing doubts about the conclusions of the investigations.

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27 Ibid.
Top-Down Political Reforms

During the first half of the current decade, the notion of “managed democracy” emerged in Russia. Some argue that Kazakhstan followed the same route. This concept implies strong executive powers based on good macroeconomic indicators, control of major media outlets, especially television, and the use of “administrative resources” by pro-government politicians. This type of power structure, bolstered by popular support, theoretically allows for control over both the reform process and the country’s political agenda.

By delivering on economic changes and increasing the standard of living, Nazarbayev positioned his regime to initiate reforms in the political sphere. According to his view, these reforms have to be gradual and come from the top. In November 2002, the Kazakh government established The Standing Council on Proposals for Further Democratization and Development of Civil Society (PDS), a commission to develop democratic reform programs in the country. However, the opposition largely ignored the body, which lacked a constitutional status, and was advisory in nature.

In November 2004, the President set up the National Commission for Democratization and Civil Society (known by the Russian acronym NKVD). Unfortunately, this was also the acronym for Stalin’s dreaded secret police in the 1930s and 1940s. This body included members of the Ak Zhol opposition party, public organizations, and members of the parliament. The commission initially focused on drafting policy papers for the development of civil society, an electoral system, and local self-government. The rest of the opposition objected to the fact that the Commission had no constitutional base and that pro-government NGOs and individuals predominated.

In March 2006, President Nazarbayev established the State Commission on Democratic Reform, which he chairs. The Commission is a consultative body to...
the President and acts as an official forum for dialogue between the authorities and various political forces on further political and legal reform as well as the country’s political modernization and development strategy. It consists of the leaders of Kazakhstan’s political parties, including the opposition, and several state officials. Its major political project to date has been the National Democratic Reform Program, scheduled for two-stage implementation in 2006-2008 and 2009-2011. Although some parts of this program are still under development, its adoption and implementation could move the Kazakh national legislation closer to international democratic standards.

In 2005, Nazarbayev announced an initiative to enhance the role of political parties in legislative activity, Cabinet formation, and control of the government. Kazakhstan began to examine the feasibility of increasing the number of members of Parliament, both in the Senate and the Majilis, and introducing a party list voting system. Constitutional amendments approved in 2007 reflected these political reforms.

Kazakhstan has also been working on improving its election laws. The lack of election campaign transparency and an underdeveloped electoral system are both features of “managed democracy.” Thus, in the 2005 presidential elections, according to independent polls, Nazarbayev was confidently leading with 70-80 percent of the vote. Later on, the Central Election Commission (CEC) announced the nationwide result with a whopping 91 percent for Nazarbayev, surprising many Western observers. Nevertheless, the world has generally recognized the outcome of the December 2005 Kazakh Presidential elections as legitimate, although the OSCE reported that the elections fell “short of meeting a number of democratic standards.” After the CEC announced the results, Nazarbayev commented that the victory was in recognition of his achievements as founder and the head of state. Nevertheless, some in the West considered the results of both the 2005 presidential elections and the 2007 parliamentary elections insufficient. For example, the Organization for Security and Cooperation in Europe (OSCE) Office

of Democratic Institutions and Human Rights (ODIHR) has written: “While the 2007 elections reflected welcome progress, a number of international standards were not met.”38

**Political consolidation.** In 2006, Nazarbayev moved towards consolidating political life in the country. The Otan ruling party was renamed Nur Otan [The Light of the Fatherland] after absorbing the leading pro-presidential political forces, including the Asar Party, into its ranks.39 The total membership of the consolidated party amounted to some 700,000. Bakhytzhan Zhumagulov, a high-ranking party official, said, “World experience shows that when a country is faced with massive economic and social tasks only a very strong party can provide an effective strategy of development,” citing the examples of Japan, Switzerland, and Singapore.40

Consolidation among the pro-government and opposition forces during the latest presidential election indicates that Kazakhstan, as many post-Soviet states, has begun a movement towards a political system with fewer parties. However, none of Kazakhstan’s opposition parties has reached sufficient membership to compete effectively with the new pro-presidential mega-party.

In 2007, Kazakhstan underwent a major constitutional reform and parliamentary elections, which may define the country’s political system for the rest of President Nazarbayev’s rule. The constitutional amendment that granted Nazarbayev the ability to run for a third41 presidential term surprised most Western capitals. The Parliament passed this provision as part of a broader reform package that promises to expand the powers of the parliament and bring about other changes to the Kazakh political system. The August parliamentary election, however, resulted in a one-party legislature, since no other political party besides the President’s Nur Otan was able to overcome the high seven-percent threshold.

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The 2007 Constitutional Reform

In 2007, Nazarbayev initiated a major constitutional reform aimed at enhancing the country’s stability while developing political institutions, including the parliament and political parties. In May, the Kazakh Parliament, dominated by pro-presidential forces, passed legislation On the Introduction of Changes and Addenda to the Constitution of the Republic of Kazakhstan. The bill followed the recommendations of the State Democratization Commission and envisaged a shift from a presidential to a presidential-parliamentary republic by significantly increasing the role of the legislature. Nazarbayev signed the bill into law on May 21, 2007.

One of the constitutional amendments that drew criticism from the expert community, opposition figures, and foreign observers, was a special dispensation for Nazarbayev to seek re-election to the presidency, if he so chooses, as the state’s founder. This provision could mean that Nazarbayev will be the head of state well beyond 2012, when his current term expires. With the duration of presidential tenure decreased from seven to five years, he could remain in power until 2017, when he will turn 77, if his health permits. The constitutional limitation of two consecutive 5-year presidential terms will still apply to future presidents of Kazakhstan.42

Allowing Nazarbayev an additional term in office opens the door to certain pitfalls of which he, as an experienced politician, is no doubt well aware. His potential challengers will certainly be on the lookout for opportunities to grab some power. If he chooses to stay beyond 2012, his options range from the example set by Lee Kwan Yu, the “inventor” and founding father of Singapore, whom Nazarbayev is known to admire, and who gradually faded into the background, to Deng Xiaoping, one of the greatest Chinese rulers of the last few centuries, who secured his succession and legacy. On the other hand, Nazarbayev would not want to experience the tragic decline of authoritarian rulers such as Indonesia’s Sukharto.43

The majority of the Kazakh mass media, loyal to the president, appeared to focus on aspects of the constitutional amendments that enhanced parliamentary power while deflecting attention away from the probable prolongation of his tenure. Other amendments, widely emphasized as encouraging Kazakhstan’s evolution

into a more stable democracy, changed the make-up and functions of the parliament. The Upper House (Senate) and the Lower House (Majilis) gained additional seats. After the reform, the Senate consists of 47 members; while the number of seats in the Majilis increased to 107 from the pre-reform 77, with representatives elected for five years (up from the pre-reform four years). Voters elect ninety-eight of the Majilis lawmak ers via a proportional political party representation system with a heightened threshold of seven percent. The Assembly of Peoples of Kazakhstan (APK), a nationwide ethnic minority representation body, elects the nine remaining legislators.

Thus, the reforms increased the APK's role as a unique instrument to preserve the religious and ethnic peace and promote mutual tolerance within the multi-ethnic and multi-confessional society of Kazakhstan. However, some critics argue that the body lacks democratic legitimacy, with its top members being presidential appointees.\textsuperscript{44} Election analysts from the Organization for Security and Cooperation in Europe, Office for Democratic Institutions and Human Rights (OSCE/ODIHR) have pointed out that a general electoral vote does not determine the full membership of either house of Kazakhstan's parliament. The election of nine of the Majilis members by the APK falls short of meeting the OSCE's provision, which states that the popular vote should determine all seats in at least one chamber of the national legislature.\textsuperscript{45} In response to these criticisms, officials from Kazakhstan's CEC have referred to the OSCE's provisions permitting member states to implement special measures to guarantee full equality to persons belonging to ethnic minorities—which is what the APK quota purportedly aspires to achieve.

Under the terms of the constitutional reform, the new parliament will have a greater role in the formation of the cabinet. For the first time in the country's sovereign history, the process will require parliamentary approval of the prime minister, who will represent the parliament's majority party, and of the cabinet. Specifically, the president will submit the prime minister's nomination for approval by the majority of the Majilis, and will make the official appointment only after the parliament approves the nominee. The government will therefore be accountable not only to the head of state but also to the entire parliament. At the


same time, the parliament will be able to pass a vote of no confidence by vote of a simple majority of the deputies (as opposed to the previously required two thirds).

Kazakhstani experts believe that the new cabinet formation procedures will boost the government’s professionalism, accountability and “political neutrality” since it will have to seek support from key parliamentary factions. The reform also strengthens parliamentary control over the budget, and gives the Majilis more authority in forming an Audit Committee (equivalent to the U.S. Government Accountability Office, or GAO) and Constitutional Council. Under the reforms, political parties have also gained the right to nominate members of Kazakhstan’s CEC.

The Government of Kazakhstan announced that the reforms aim to invigorate Kazakhstan’s civil society by abolishing the constitutional prohibition against state funding of public associations, and permitting partial state financing of political parties. International observers of Kazakh politics have noted that the new funding rules aim at preempting “moves by business groups to buy influence in the legislature.” Kazakhstan political scientists, on the other hand, believe the reforms may help the country’s political parties overcome their rather marginal status and turn them into a core element of the political system, capable of representing the interests of the society. Others point out that the newly envisaged state financing of political parties may simply allow the executive branch to increase its level of control over them.

Finally, the constitutional amendments abolished the death penalty in Kazakhstan, limiting it to exceptional cases, such as punishment for those guilty of terrorist acts resulting in death, which amount to serious war crimes. In a genuine achievement for a post-communist country, the courts will be the only competent body to sanction arrest (as opposed to the national prosecutor’s office prior to the reform).

The amendments are likely to enhance the stability of the elected local councils (Maslikhats) by increasing their term in office to five years and giving them more authority over akims (mayors and governors). The respective Maslikhats will have to approve the nominees for the akim offices before the appointment can proceed.

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48 Shomanov and Konovalov, “Constitutional Reform is Promoting the Country’s Competitiveness.”
Maslikhats will also be able to express no confidence in akims through a simple majority vote (as compared to the previously required two-thirds majority).

The 2007 Parliamentary Elections

In order for the constitutional amendments to take effect, President Nazarbayev called an early parliamentary election on August 18, 2007, after having dissolved the parliament on June 20, 2007. In the elections, the pro-presidential Nur Otan [Light of the Fatherland] party gained a landslide victory, with 88.5 percent of the votes and all 98 elected seats. No opposition party succeeded in clearing the seven percent electoral threshold.

Vast administrative and financial resources and, most importantly, Nazarbayev’s genuinely high personal popularity, backed Nur Otan. Independent surveys, commissioned by the International Republican Institute in 2005, showed 82 percent of the citizens supported Nazarbayev. Since then, the country’s growing economy, backed by vast hydrocarbon exports, has helped keep Nazarbayev’s approval ratings high.

Many analysts conclude that, given the lack of solidarity and the seemingly endless infighting in the ranks of the opposition, Nur Otan’s massive victory was predictable. Nevertheless, as in the 2005 presidential elections, questions remain among Western observers as to the extent to which the CEC and regional commissions “assisted” in the vote count, and whether perhaps the opposition might have been capable of winning at least a few seats in the parliament. This would have been more likely if the opposition forces could have united. Some also believe that the political development of Kazakhstan would benefit from hearing constructive criticism from the opposition and alternative voices in the nation’s parliament. Analysts also say that Nur Otan’s one-party rule may hurt the Nazarbayev regime in the long run if the party fails to meet its pre-election promises and sticks to a rigid domestic agenda.

Additionally, the August 2007 elections drew relatively low voter turnout, which some interpreted as a lack of confidence in the political system. While the Kazakh CEC indicated that voter turnout was just below 65 percent nationwide,

51 Sharip, “Kazakh Parliamentary Elections Resurrect Communist-Style One-Party Rule.”
independent sources reported extremely low turnouts in the major urban areas, with up to 60 percent of the electorate staying away from the polling stations in Almaty and up to 77 percent failing to cast ballots in Astana.\footnote{Ibid.} While stability is laudable, popular buy-in in the political process and genuine grass root participation in politics, based on the availability of a variety of opinions and platforms, would keep Kazakhstan’s political system competitive and alive.

**Evaluation of the reform.** International and domestic reaction to the 2007 Kazakhstani constitutional reform ranged from harsh criticism to effusive praise. The Kazakhstani opposition parties issued a statement decrying the measures as “further worsen[ing] the situation around the political rights of citizens,”\footnote{“Statement by the Democratic Forces Regarding Kazakhstan’s Chairmanship in the OSCE,” True Ak Zhol, October 11, 2007 at http://eng.akzhol-party.info/activity/statements/2007/10/11/statements_2380.html (March 18, 2008)} echoing the concerns of international human rights groups over Kazakhstan’s management of internal politics.

The conduct of the 2007 elections also drew criticism from the domestic opposition as well as international organizations, including the OSCE and international human rights groups. The ODIHR division of the OSCE engaged in monitoring the August 2007 elections and published its final report in October 2007. Although the OSCE characterized the elections as a step forward towards democracy, it pointed out that shortcomings remained. In particular, the report praised the CEC for working “transparently,” further noting that it had cooperated with all political parties and 16,000 local and foreign observers. The ODIHR election observation mission noted the calm electoral atmosphere and well organized voting, as well as media access for all political parties during the campaigning period.

Media access prior to the elections included televised debates between the parties on the state-owned Khabar TV, as well as on privately owned Channel 31. The print media provided a broad spectrum of opinion, with two government-owned papers favoring Nur Otan, while some of the private newspapers pressed the case of the two leading opposition parties, the National Social Democratic Party (NSDP) and Ak Zhol.

On the negative side, The ODIHR report noted that the state-owned media gave particularly favorable coverage to the Nur Otan party and that the vote count lacked transparency, with serious irregularities occurring in some 25 percent of the
polling stations monitored during the count. The OSCE report also criticized the

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government for placing barriers in the way of a pluralistic party system. Specifically, the report focused on preferential treatment of Nur Otan in the local electoral commissions, on preventing independents from running for parliament, and banning the parties from uniting in electoral coalitions to run for seats jointly.

Kazakh officials rebutted international criticism of the elected one-party parliament, stating that they believed Nur Otan deserved its victory, which reflected broad public satisfaction with the country’s economic growth and the rise in per-capita income. Kazakhstani political scientists also praised the constitutional reform as promoting “Kazakhstan’s regional leadership as a state committed to coherent adaptation of recognized democratic institutions and processes.” In their opinion, Kazakhstan—a non-Western and Eurasian country—had taken another successful step toward adapting democracy to the realities of post-Soviet Central Asia.

Nazarbayev underscored the significance of the reform in the following statement:

We have been approaching this moment of political change consistently and gradually. All views and proposals, including the most radical, have been studied and worked on. We consulted with political parties, scientists, experts, with people representing diverse ethnic groups of Kazakhstan. I am sure that it is the right time to introduce changes to the Constitution of the Republic of Kazakhstan and to begin a new distinctive stage... of Kazakhstan’s democratization.

While some human rights groups and pro-democracy NGOs persisted in criticizing the reforms, the US government’s reaction to the constitutional changes was low-key, if not mildly positive. During a May 22, 2007 press briefing, State Department spokesperson Sean McCormack said:

There is an amendment that would effectively allow the president... to stay in office for quite some time, but there are also a number of other

55 Shomanov and Konovalov, “Constitutional Reform is Promoting the Country’s Competitiveness.”
political reforms that, we believe, move the country in the right direction. It is a step, ultimately, when you look at the balance of these things, in the right direction... Is it all that the rest of the world would like to see? No, it is not. But, again, this is a country that... we have high hopes for, that we are working closely with, they have a lot of potential.57

The constitutional changes and the August 2007 elections can be seen as a stage in the process of political modernization. Democracy development is not an exact science. The Kazakhstani government’s rhetoric claims that the country’s path may serve as a model for other states in post-communist transition that choose gradual political reform. In developing a meaningful democracy, elections should come during or even after the build-up of political institutions.58 History and recent events have shown that when elections come prematurely, counterproductive, and at times even dangerous results can ensue. Examples of this include Germany in 1933 and the West Bank and Gaza in 2006. While they are important, elections are not an exclusive part of political development. At the end of the day, the proof of democratic development is neither rhetoric nor empty ceremony. It is action. The eyes of foreign governments, the expert community, and international organizations will remain focused on Kazakhstan’s political development for years to come.

The opposition’s electoral defeat. During the August 2007 Kazakh parliamentary elections, the voters had real choices, with seven competing parties ranging from left-leaning social democrats to free market advocates and right-wing nationalist movements in the running. Some regional analysts had predicted the opposition would gain more seats in the parliament than ever before. However, the opposition, unfortunately, shot itself in the foot. Given Kazakhstan’s new high electoral threshold of seven percent, it would have made sense for the Social Democrats (NSDP) and Ak Zhol to unite. Their platforms are rather similar, and are not very different from the positions taken by the ruling Nur Otan party. This is not surprising, as the leaders of the opposition are former senior officials who served under President Nazarbayev, including an ex-prosecutor general, a former finance minister, and Nazarbayev’s former chief of staff. Separately, however, the two leading opposition parties failed to clear the barrier: the NSDP, the main opposition force, received 4.62 percent of the vote, followed by the Ak Zhol party, a

58 Cohen, “Kazakhstan’s Political Challenge.”
more moderate group, with 3.27 percent. Combined, they could have won seats in the Majilis.

After the vote, the opposition criticized the election and emphasized the negative findings published by the OSCE/ODIHR, including procedural problems and lack of transparency in the vote count. Despite their protests, however, the legitimacy of the new parliament appears to have been widely accepted, both in Kazakhstan and abroad, as demonstrated by the consensus among OSCE members to elect Kazakhstan as its chair for 2010. In Astana's bid for this highly prestigious role in the Euro-Atlantic community, the conduct of an at least relatively transparent election was indeed crucial.

In the meanwhile, locked out of the new parliament, the opposition finds itself in a “multiparty system coexisting with a one-party parliament as peacefully as the Communist regime and free enterprise do in China.”

Christopher Walker, Director of Studies at Freedom House, stated in an August 2007 interview with Radio Free Europe/Radio Liberty following the elections that it has become increasingly difficult for the opposition to participate in Kazakhstan’s political life outside the parliament:

> The opposition in Kazakhstan should be playing a meaningful role in scrutinizing the performance and the activities of the ruling powers in the country. This becomes increasingly difficult under the current circumstances. I think, at this point, they have to find whatever space is possible there to play this rightful role. But there is no question that has become increasingly difficult and, naturally, to the detriment of ordinary Kazakh citizens. I think to the extent that Kazakhstan has been looked to as a leader in the region by the outside world, this is a disappointment in terms of having no voice whatsoever in the new parliament for any opposition parties.

The opposition would very much like to contribute to a public debate on such acute issues as fighting corruption, enhancing the rule of law, and promoting civil

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59 Lillis, “Kazakhstan Set to Have One-party Parliament.”


liberties. However, in practice, lacking formal participation, they have little influence on policymaking in Astana and are weak and fragmented. The numerous factions, torn by personal disagreements and by ties to competing interest groups, fail to offer a comprehensive alternative vision for the nation. Ultimately, in many respects, their views are often not fundamentally different from those of the authorities they criticize. Nevertheless, the opposition parties may still reap some political hay if people begin searching for alternative solutions to the country’s recent economic downturn, which resulted from the international credit crunch and governmental overregulation.

Many observers hope that Kazakhstan’s 2010 chairmanship of the OSCE, approved in November 2007, will boost pro-democracy reforms, accelerate the amendments of the media law to make it more permissive, and bolster governmental transparency and accountability. The leadership of the OSCE, as well as American diplomats, have expressed hopes that the Kazakhstani government will keep promises it has made in relation to the OSCE chairmanship, including promulgating the legislative agenda.

The Realignment of Political Forces

Despite the realignment of some powers in favor of the parliament on paper, experts in Kazakhstan and the West believe that Nazarbayev will continue to wield supreme authority in Astana. However, it is also evident that the president harbors no illusions about the need to diminish his daily involvement in management minutiae and prepare for an orderly transition. The constitutional reform was a vital step in paving the way for Kazakhstan to keep functioning after his eventual departure from the political scene. The rifts within Kazakhstan’s elite have, in part, dictated the emphasis on the institutions, political parties, and a functional state bureaucracy. Although the president enjoys high personal popularity, he faces a difficult task in maintaining a balance among the ruling groups (clans) and broader elites. Vast riches are at stake.

Factional maneuvering and tensions over Kazakhstan’s internal balance of power and its effect on succession, whenever it comes, intensified throughout 2007. Several influential groups associated with the Kazakhstani political parties seem already to be strategizing for the post-Nazarbayev era. Individuals who were originally close to the president and held high political posts head the Republican

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63 Cohen, “Kazakhstan: President Nazarbayev Makes a Power Play.”
People’s Party of Kazakhstan and several of the other opposition groups. Nazarbayev’s former son-in-law, Rakhat Aliyev, also challenged the President’s leadership.

The defection of Rakhat Aliyev. The case of Rakhat Aliyev illustrates personal and factional power struggles among the Kazakh elite at the highest level. In 2007, Nazarbayev moved to reduce the political powers of potential rivals for succession, including those of his two sons-in-law. Aliyev had served as deputy chief of the Committee for National Security (known as the KNB), and as Nazarbayev’s ambassador to Austria and the OSCE, as well as holding the office of Deputy Foreign Minister. Nazarbayev sent Aliyev off to Vienna in February 2006 to isolate him and prevent him from making any moves on the domestic front. After a return visit to Kazakhstan in May 2007, Aliyev fell further from grace by harshly attacking the regime and his father-in-law personally, threatening to reveal alleged information on massive corruption, including the “Kazakhgate” affair (see below). Later, in October 2007, he attempted to implicate Nazarbayev in personal involvement in the 2006 assassination of opposition leader Altynbek Sarsenbayev.

Several independent media outlets, online publications, and weekly printed newspapers faced pressure from the Kazakh authorities after publishing materials related to Aliyev’s case. The controversy was of such magnitude that it could not have stayed low profile even in Kazakhstan’s domestic media.

According to Aliyev, he fell out of favor after making his aspirations to become the next president of Kazakhstan known to Nazarbayev. However, as the unpopular former de facto chief of the Kazakh security services, Aliyev would have been an unlikely winner in a presidential election, as many in the elite vehemently opposed him.

The Kazakh Prosecutor Office issued a warrant for Aliyev’s arrest on charges including fraud and the kidnapping of two officials from the Nurbank bank, where he then owned a majority share. Since being charged, Aliyev has remained in Vienna, fighting extradition. Kazakhstan even sent a planeload of officials, headed by the Prosecutor General, to bring the fugitive home. However, the Austrian authorities, who briefly detained Aliyev in June 2007, have to date refused to extradite him, fearing that he would not receive a fair trial. Dariga Nazarbayeva, the President’s eldest daughter, has divorced her renegade husband.

Aliyev’s trial in absentia opened in Kazakhstan in November 2007, with a Kazakh military court taking over the case in January 2008. The court found that he had

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65 Gorst, “Politics: Preoccupied by a Need to Hold on to Power.”
funded the training of mercenaries in Israel and Egypt, with the aim of toppling the Kazakh government.\textsuperscript{66} In March 2008, the court sentenced Aliyev to 20 years in jail on charges ranging from embezzlement and kidnapping to plotting to overthrow the president. Along with him, the court convicted the former head of the KNB, Alnur Musayev, of crimes committed during his time in office, including abuse of power, embezzlement of state property, unauthorized acquisition of state secrets, and theft of firearms and ammunition.

According to Western sources, although the authorities have stripped Aliyev of his wealth, the Nurbank financial group is still under control of the president’s family. Dariga Nazarbayeva has become Nurbank’s largest shareholder, with an over 36 percent stake, while Nurali Aliyev, the son of Rakhat Aliyev and Dariga Nazarbayeva, has been chairing the board of Nurbank since October 2007.\textsuperscript{67}

Nazarbayev also dismissed his second son-in-law, Timur Kulibayev, from his post as deputy chairman of the Samruk State Holding Company in September 2007. Nevertheless, some believe that Kulibayev controls Kazkommertzbanks (KKB), and sits on KazMunayGaz’s Board of Directors. Although generally staying low profile and not overtly engaged in politics, his family and business connections still make him a powerful insider who could potentially contend for power.

**Political rebalancing.** Following the downfall of Rakhat Aliyev, Nazarbayev moved to restore the balance of power between Kazakhstan’s competing political clans. A 2007 investigation into illegal construction in protected areas around Almaty was part of the political power shift.

Imangali Tasmagambetov, the former mayor of Almaty and former head of the presidential administration, is an influential figure loyal to Nazarbayev, with a broad power base and a breadth of experience in state management, who also enjoys particular support among Kazakh-speaking intellectuals. Some at times mention him as a potential presidential successor.

Some observers viewed the investigation into Almaty construction as targeting Tasmagambetov, yet he emerged with his power base intact after the state commission completed its inquiry and found no abuse of office on his part. However, several officials lost their posts in connection with land misallocation, including deputy mayors Yakov Zayats and Kayrat Bukenov; deputy governor of


the Almaty region Alikhan Toybayev; and three district officials. Viktor Khrapunov, another former mayor of Almaty, also lost his post as emergencies minister because of irregularities in land allocation during his tenure.

The personnel reshuffling carried out in late 2007 appeared to indicate a desire on Nazarbayev’s part to strengthen his position in the face of a likely slowdown in economic growth and potential political difficulties in the wake of Rakhat Aliyev’s trial. However, he may have secured a tighter grip on power at the expense of increasing the level of dissatisfaction among entrepreneurs and Kazakhstan’s growing middle class over abuses on the part of the bureaucracy, the rise in corruption, and excessive state regulation of the economy.

The business community and Western policymakers hope the Kazakh political system will evolve toward an institutions- and rules-based polity. Many experts agree that Kazakhstan should allow for a broader political space and the greater participation of opposition groups and parties in strengthening the rule-of-law and fighting corruption in the country.

The Kazakhgate Corruption Scandal

Allegations of massive corruption at the highest level in Kazakhstan during and after the negotiation of major oil investment agreements in the 1990s erupted in the Western media and led to the indictment of two oil-industry players with close ties to the Kazakh leadership. In April 2003, the US judiciary indicted James Giffen, a former consultant to President Nazarbayev, and J. Bryan Williams III, a former senior executive at Mobil in charge of overseas crude-oil transactions in Kazakhstan, in connection with bribing Kazakh authorities during the 1990s. The scandal, known as Kazakhgate, was centered around payments of some $78 million in bribes, allegedly on behalf of major oil companies—Mobil (now ExxonMobil), Texaco (now ChevronTexaco), Phillips Petroleum (now ConocoPhillips), and Amoco (now BP)—to high-level Kazakh officials in return for lucrative oil contracts.

68 Ibid.
69 Ibid.
70 Cohen, “Kazakhstan: President Nazarbayev Makes a Power Play.”
71 The judiciary charged Williams with tax evasion on illegal payments connected to Mobil’s joining the Tengiz investment consortium in Kazakhstan. He pleaded guilty and was sentenced to three years and ten months in prison and a fine. Source: “Kazakhgate Corruption Scandal Dogs the Government,” Country Profile Select, September 20, 2007, accessed via LexisNexis (March 10, 2008).
Giffen, a prominent player in East-West relations for over 40 years and CEO of the New York-based merchant bank Mercator Corp., was charged with 13 counts of violating the Foreign Corrupt Practices Act (FCPA) and 33 counts of money laundering. His trial is still pending in New York’s Southern Federal District in Manhattan. Since 1984, as a member and later the head of the American Trade Consortium, Giffen began to cultivate relationships with the Soviet elite, including Mikhail Gorbachev and Nursultan Nazarbayev. By the late 1980s, he was involved in consulting Western companies on doing business in the former USSR, including in the oil and gas sector. Giffen was instrumental in promoting Chevron’s acquisition of the Tengiz oil field.\textsuperscript{73}

In 1992, Giffen arranged for Nazarbayev’s first official visit to Washington after the Kazakh Embassy opened in the United States.\textsuperscript{74} He soon became Nazarbayev’s advisor on doing business with the West, and was part of the negotiations on some major Kazakh energy projects, including development of the Tengiz and Karachaganak oil fields and development of the Caspian Pipeline Consortium.

Ironically, the case originated as a Swiss money-laundering investigation initiated by the government of Kazakhstan, reportedly aiming at former Prime Minister Akezhan Kazhegeldin and his alleged holdings in Europe. The FBI subsequently followed up on the case when it led the Swiss authorities to note irregularities in payments by US oil companies to Kazakhstani officials.\textsuperscript{75} Later, the investigation uncovered a complex scheme of accounts in Switzerland and the British Virgin Islands with links to Kazakh officials.\textsuperscript{76}

The 2003 indictments in the Giffen case were a diplomatic embarrassment. Kazakhstan had been a key regional partner in the US-led anti-terrorism campaign in Afghanistan, granting over-flight and emergency landings rights to the American combat aircraft. Reid Weingarten, a prominent Washington-based defense lawyer who represented Nazarbayev, pressed for assurances that the U.S. would not indict him, referring to the importance of preserving strategic relations with Astana at a time when the U.S. was involved in military operations in the region.

\textsuperscript{73} Steve LeVine, “The Oil and the Glory. The Pursuit of Empire and Fortune of the Caspian Sea,” Random House, pp. 54-67.


\textsuperscript{75} Telvick, “Indictments Allege Bribes were Paid for Kazakhstan Oil.”

\textsuperscript{76} Telvick, “Kazakhstan: United States vs. James H. Giffen.”
Such an assurance would be of significance to Kazakhstan and have no impact on the investigation... [while] any indictment naming a Kazakh official as an unindicted co-conspirator or the recipient of a bribe would be viewed as an affront to Kazakhstan, [and] could have a destabilizing political effect in Kazakhstan, and deteriorate the US [relations with Kazakhstan] - an important ally in the war on terror with significant oil and gas reserves in an unstable geographical region.  

Kazakhstan indicated that it would maintain a “respectful distance” from the trial, which Kazakh officials said they viewed as a US matter involving a US citizen. Nevertheless, in March 2004, the US prosecution named two top Kazakh officials linked to the Giffen case as unindicted co-conspirators: President Nursultan Nazarbayev, and his former prime minister and energy minister, Nurlan Balgimbayev.

Nazarbayev has denied any personal involvement in the affair. In May 2004, when Giffen’s court hearings were to begin in New York, Nazarbayev stated in a widely televised speech that he found it inappropriate to comment on a trial being held in the U.S. and involving a US citizen. He also added that “the [oil contracts facilitated by Giffen] were executed on a high level; they completely met the interests of Kazakhstan.”

The Foreign Corrupt Practices Act (FCPA). Kazakhgate may be one of the most important cases in the history of the FCPA. The Act, passed in the post-Watergate period (1977), holds US companies liable for corrupt payments made to foreign officials, directly or through third parties, with the intent of benefiting their business. Amendments to the FCPA passed in 1988 also hold US companies liable for “willing ignorance,” or turning a blind eye to an intermediary bribing a foreign official on their behalf. However, in the oil and gas industry in general and in the emerging markets in particular, where kinships and “facilitation” payments are widespread and tolerated on the highest levels, “playing clean” may simply put American companies at a disadvantage when others agree to play by the local rules.

77 Telvick, “Kazakhstan: United States vs. James H. Giffen” and Telvick, “Indictments Allege Bribes were Paid for Kazakhstan Oil.”
79 “Kazakhgate Corruption Scandal Dogs the Government.”
80 Telvick, “Kazakhstan: United States vs. James H. Giffen.”
According to Donald Zarin, author of *Doing Business Under the Foreign Corrupt Practices Act*, the FCPA does not criminalize the receipt of a bribe by a foreign official, but only the provision of incentive payments by a US-based firm or intermediaries. However, the political repercussions of Kazakhgate could certainly prove politically problematic for the Nazarbayev administration.

Giffen’s attorney, William Schwartz, stated that the US government was aware of and approved of Giffen’s actions. In March 2004, Schwartz requested access to classified data to collect evidence of his client’s purported links to top CIA, FBI, and State Department officials at the time of the alleged violations. The authorities denied access, leaving it unclear whether the contacts that Giffen’s defense team claims he made were part of top-level networking he needed to do as an international oil consultant and whether the US government approved his allegedly corrupt actions for operational reasons.

The trial gained some momentum in 2007, when another US firm, Baker Hughes, an oil services company, pleaded guilty of violating the FCPA. The firm agreed to pay a $44 million fine for the charge of having transferred $4.1 million in bribes to receive a services contract for the Karachaganak field, which generated $219 million in revenues for the company from 2001 to 2006. The judiciary did not name any Kazakh officials in the proceedings. Nevertheless, this development may have pushed the government of Kazakhstan to pursue a forfeiture agreement with the US judiciary.

**Forfeiture.** Kazakhstan and the U.S. made a peace of sorts in May 2007 when the Kazakh government admitted the existence of a Swiss bank account in its name and agreed to transfer the funds to a children’s charity, while the American side agreed to cease further probing into the Kazakh side of the case. From a legal perspective, the funds are subject to civil forfeiture. Although the Kazakh government denies the receipt of bribes, some experts say that participation in the forfeiture agreement may imply an admission of guilt.

The World Bank will monitor the distribution of the forfeited money between the newly established Bota Kazakhstan Child and Youth Development Foundation to help the country’s poor children and two programs to improve financial

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82 Telvick, “Kazakhstan: United States vs. James H. Giffen.”
83 Ibid.
management and transparency in Kazakhstan’s oil, gas, and mining industries.\textsuperscript{86}

John Ordway, the US Ambassador to Kazakhstan, told a press briefing in Almaty on May 22, 2007:

Though the positions of the USA and Kazakhstan do not coincide as regards the belonging of 84 million dollars that has been frozen in bank accounts in Switzerland, the sides have agreed that the money should be used for the good of the country. ...The Kazakh government’s position is that the money...in the account... belongs to the Kazakh government. The position of the US government is that the money [resulted from] officials’ corrupt actions in the case instituted against [US] citizen [James] Giffen. We are of different opinions as regards the [origin of the money]. But, to avoid further disputes, we have agreed that the money should be used to the good of the Kazakh people.\textsuperscript{87}

Since the first disclosure of Kazakhgate in 1999, Kazakhstan has launched a public-relations campaign to improve its image in the West. Following the spring 2007 agreements, as well as a number of successful legal moves by Giffen’s attorneys, the case began cooling down.

As part of the 2007 political reshuffling, Nazarbayev appointed Nurlan Balgimbayev, whose name appears in the Kazakhgate materials, as his adviser on energy, reportedly in connection with Kazakhstan’s more assertive economic policy, particularly in the energy sector.\textsuperscript{88}

\textsuperscript{86} Ibid.
\textsuperscript{87} “Kazakhstan, USA Agree to Use Corruption Case Money for Children,” BBC Monitoring Central Asia Unit, May 22, 2007, from Interfax-Kazakhstan news agency, accessed via LexisNexis (March 20, 2008).
Investing in Development

Kazakhstan has succeeded in creating a favorable environment for private sector growth since the 1990s. Over the 17 years of its sovereign development, Kazakhstan has undergone an impressive transformation from a centrally planned and managed Soviet republic to a predominantly market economy. Kazakhstan was the first CIS country to be recognized by the EU (2001) and the U.S. (2002) as having a market economy.

Modern Kazakhstan’s economic growth stands out among the CIS countries. The country may be Eurasia’s strongest candidate to join the “Asian tigers,” which include South Korea, Taiwan, and Singapore in the first wave, and Malaysia and China in the second. All of these states have managed to achieve significant leaps in wealth creation by drastic transformations of their economic systems.

Kazakhstan’s GDP exceeds the combined GDPs of the other countries of Central Asia and the Caucasus, although it is still below the annual turnover of such transnational corporations as British Petroleum and ExxonMobil. Measured in current prices, Kazakhstan’s GDP has almost quadrupled, from $21.8 billion in 2000, to $80.4 billion in 2006, and it exceeded $102 billion in 2007 (with an 8.5 percent real GDP annual growth rate). In 1994, the GDP per capita in the country was as low as $600, whereas by 2007 it was above the $6,600 mark. Economists have estimated Kazakhstan’s 2007 GDP per capita measured in terms of purchasing power parity (PPP) at $10,428.

3 Economist Intelligence Unit, “Kazakhstan: Country Report,” February, 2008; and Nazarbayev, Address at the ceremonial meeting dedicated to the 15th Anniversary of Kazakhstan’s independence.
The structure of the GDP has also been changing. Between 2000 and 2004, the share of manufacturing in the total GDP decreased from 45.9 to 42.5 percent while the percentage of services grew from 48.4 to 53.3 percent,\(^5\) taking Kazakhstan closer to the figures of industrially developed nations.

**Figure 2: Kazakhstan’s current GDP and real GDP growth rate (2003-2007)**

The country’s real GDP grew at a high 9-10 percent annually since 2001, although the international credit crisis has slowed it down somewhat. Nevertheless, the monetary, taxation, and financial reforms of the 1990s, as well as high world oil prices, have created a solid foundation for continued economic growth in the 21st century. In the near term, the government needs to address the acute challenges of supporting diversified economic growth at a time when the country’s banks have lost access to international borrowing, and while energy production costs are rising at home.

Still, the 2006 average monthly salary in Kazakhstan was $334, compared with Russia’s $550.\(^6\) Since 1991, the state has raised the wages of civil servants, doctors, teachers, and other state employees numerous times. After his re-election in 2005, Nazarbayev pledged to double salaries and pensions during his next term and to raise the per capita income to the level of Eastern European countries.\(^7\) Barring a major global economic recession, these are feasible targets.

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In the early 2000s, Kazakhstan repaid its international debts, including to the International Monetary Fund and the World Bank, seven years ahead of schedule. Afterwards, the country launched a massive social investment program to support sectors strategically important to the state.

Healthcare funding grew to $1.2 billion between 2005 and 2007. The government plans to increase public housing by at least four percent in the coming years, while the rate of private residential construction remained high until 2007. Funding for culture, sport, and tourism in the next few years is likely to reach a high mark of $500 million.

*Training the future elite.* In 2006, nationwide education funding reached $2.5 billion. Kazakhstan is investing its oil windfall in boosting the national education system and training high-quality professional personnel overseas. The country stands out in its neighborhood for the value it places on leveraging top-quality Western education to help make the transition to a modern market economy in place of the centrally planned Soviet model a success.

A major overseas academic training program—the presidential Bolashak [The Future] scholarship, launched in 1993—provides governmental stipends for approximately 3,000 students per year to study abroad. Grantees from around the country pass competitive selection. Many of Bolashak’s students have received undergraduate and graduate degrees in the best US, UK and other Western colleges and universities, and are now working back home. To avoid the risk of brain drain because of graduates remaining overseas, families of grantees are obliged to pledge property to the government to guarantee that their scholars will return to Kazakhstan for a minimum of five years’ employment. The goal is to prepare a bright generation of professional leaders “to transform Kazakhstan into a competitive, world class economy” say education ministry officials.

The best and brightest alumni occupy positions of high authority, including deputy ministerial posts. The scope of the Bolashak program has broadened to include more than 60 academic disciplines, while funding increased six-fold in the past two years and will top $96.5 million in 2007. Large Kazakh companies satisfy the demand for skilled professionals by funding overseas business education for their employees.

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8 Nazarbayev, Address at the ceremonial meeting dedicated to the 15th Anniversary of Kazakhstan’s independence.


10 Ibid.
Kazakhstan also recognizes the value of access to the World Wide Web. According to the International Telecommunication Union (ITU)—the United Nations agency for information and communication technologies—the number of Internet users in Kazakhstan has almost doubled since 2000 and has reached 1.25 million people (or over 8 percent of the country’s total population). Eighty-two percent of Kazakhstani secondary schools have Internet connections.

In order to give further impetus to the economy, the government has invested in developing Kazakhstan’s homegrown business education capacity. The country’s two leading colleges—the Kazakhstan Institute of Management, Economics and Forecasting (KIMEP) and Kazakh-British Technical University (KBTU) — specialize in economics and business. Leading British universities supported the establishment of KBTU with an eye toward training experts for the oil and gas industry.

The Kazakh leadership understands that good education is expensive everywhere. Accordingly, the government spends more than $2 million on resident foreign instructors to Kazakh universities, particularly to the Kazakh State National University (KSNU) and the Eurasian University.

**Through Energy to Global Competitiveness**

The Asian financial crisis of 1997-1998 resulted in low commodity prices and economic stagnation. Kazakhstan was in dire need of investments to create new jobs and boost economic growth, and the government went about the business of creating a favorable climate for foreign investment. In 2002, Kazakhstan became the first CIS country recognized as a market economy by the US Department of Commerce. As of September 2007, the National Bank of Kazakhstan reported that the total inflow of foreign direct investment (FDI) had reached $39.3 billion and was likely to exceed $40 billion by the end of the year, while the 2006 gross FDI reached over $50 billion. In Southeast Europe and the CIS, only Russia and Romania attract more investment, and only Hungary has a higher per capita FDI. The United Nations Conference on Trade and Development (UNCTAD) reported Kazakhstan’s 2006 yearly FDI inflows to be more than three times the 2005

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level.\textsuperscript{14} Moody’s, Standard & Poor’s, and Fitch Ratings Ltd. have confirmed Kazakhstan’s investment attractiveness by providing investment grade ratings for the country’s bonds.\textsuperscript{15}

The energy sector has fueled Kazakhstan’s economic growth. Since 1985, the production of hydrocarbons in the country increased by 225.4 percent, as compared with a worldwide growth of 30 percent.\textsuperscript{16}

On the regulatory side, market liberalization reforms launched in 1994 have facilitated Kazakhstan’s economic growth. At that time, after the voluntary dissolution of the Supreme Soviet, Nazarbayev supported the centralization of power to facilitate the implementation of urgent social and economic reforms.

In 1995, presidential decrees On Taxation and On Privatization created the preconditions for higher rates of internal capital investment and the inflow of foreign investment, which Kazakhstan desperately needed to revive its large enterprises, just as it needed revenue to further social programs. Opening the country to foreign capital and implementing tax cuts boosted the major export-oriented industries while replenishing the nation’s foreign exchange reserves. Sensing significant economic improvement, Nazarbayev was able to implement a series of painful reforms, including housing and utility management privatization, the introduction of an accumulative pension system, and overhauls of the education, agriculture, and banking sectors.

\textit{“State-of-the-art” pension reform.}\textsuperscript{17} In 1998, Kazakhstan launched an ambitious pension reform, transitioning from the Soviet-era pay-as-you-go pension system to the three-pillar system promoted by the World Bank, in which pensions contain pay-as-you-go, mandatory, and voluntary components.\textsuperscript{18} The government privatized the state-owned State Accumulating Pension Fund in 2006. Today, 16


savings and pension fund management companies are operating in the Kazakh market under the supervision of the state financial regulator.

According to the 1998 Kazakhstani pension law, all employed citizens must transfer 10 percent of their income into personal pension accounts in a saving pension fund, and may opt to make additional voluntary pension contributions. The fund invests these savings in the economy and pays money out to the retirees. The pension funds invest their assets almost exclusively in corporate and government bonds, including Eurobonds.

**Openness to Western best practices.** Partnerships with international oil companies such as Chevron, Total, ExxonMobil, and Eni brought modern technology and Western know-how to Kazakhstan, promoted the efficiency of hydrocarbon reserves usage, and facilitated the revival of Kazakhstan’s large enterprises in hydrocarbon, non-ferrous metal, coal, and other mineral extraction industries.

Through their business in Kazakhstan, MittalSteel, JP Morgan, Credit Suisse Group, Deutsche Bank and others introduced advanced management methods in other sectors of the national economy, most notably metallurgy and the financial services. For example, MittalSteel, working in Kazakhstan since 1995, successfully turned a stagnant integrated steel plant [Mittal Steel Temirtau (MST), Karaganda] into a vibrant enterprise with up-to-date equipment and a high production capacity. MST also operates eight coalmines. In 2006, a string of mining accidents occurred in Central Kazakhstan’s Karaganda region, which drew public attention to the poor state of mining safety. In 2007, MST launched a project on improving health and safety practices at its coalmines to bring them into line with international best practices.

In the finance sector, Deutsche Bank (DB) Securities Kazakhstan, established in 1998, acted as a joint lead-manager for two of Kazakhstan’s Eurobond placements. In the country, DB pioneered the first-ever hedging transaction, merger and acquisition cross-border transaction, and municipal bond and municipal credit issue.
Kazakhstan’s government viewed each sector as a potential base for entrepreneurial development, applying Norway’s oil-revenue based development experience. This approach gave a significant boost to non-hydrocarbon sectors of the economy and laid the foundations for an oil-services cluster model of development.

At the same time, the state has retained strategic control of the economy. National monopolies dominate the oil and gas industries (KazMunayGaz), the power generation sector (Kazakhstan Electricity Grid Operating Company, KEGOC), telecommunications (Kazakhtelecom), railways (Kazakhstan Temir Zholy) and some other industries.

In early 2006, Nazarbayev initiated the establishment of two national development agencies—Kazyna Sustainable Development Fund and Samruk State Holding Company and the Regional Financial Center of Almaty (RFCA)—in an effort to advance Kazakhstan’s financial market development (see Part Three). These agencies aim at developing strategic national projects to boost innovative high-tech industries and help create a sustainable basis for the country’s development beyond the natural resource sectors.

**Challenges and Threats.** The economy of Kazakhstan has been growing rapidly due to high global commodity prices combined with effective government-led economic reforms. These developments, however, still require the leadership to consider the kinds of challenges that can come with rapid growth and prepare for potential economic crises. The country’s dependence on its minerals and raw materials sectors, and specifically on the oil and gas sector, will remain a serious concern for several years to come.

International experience has demonstrated that when prices for oil and other natural resources are high, premium wages and profits paid in the commodities sectors can lead to suppression of the non-raw material industries and as well as to inflation and excessive appreciation of the national currency. This phenomenon, known as the Dutch disease, crowds out non-commodity sectors of the economy, spreads corruption, and can cause political instability. Considerable distortions in

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23 The term “Dutch Disease” originates from the economic crisis that ensued after the discovery of vast natural gas deposits in the Dutch sector of the North Sea in the late 1950s-early 1960s. It is also known as “the Groningen effect” named after Groningen province in the Netherlands, where a rich gas field was discovered in 1959. “The Dutch Disease” refers to a rapid growth of the real national currency exchange rate due to surging raw-material exports. This makes non-resource exports less competitive in the international market and suppresses other tradable industries, with negative ramifications on the country’s economy as a whole. Source: [www.investopedia.com](http://www.investopedia.com) (February 15, 2008)
the economy in favor of the extractive industries, according to many experts, raise
the issue of diversification.

In the framework of its economic diversification and competitiveness programs,
the Kazakh government is attempting to place special emphasis on policies aimed at
preserving current economic growth rates while reducing the role of the extractive
sector. In 2000, Nazarbayev initiated the creation of the National Fund for the
Republic of Kazakhstan (NFRK).24 Modeled on the Norwegian Petroleum Fund,25 it
accumulates taxes on companies in the oil and gas sector and income from
privatization in the mineral resource industries, both extractive and processing.
This policy has enabled the accumulation of energy revenues outside the state
budget and the projection of a budget based on revenues from the non-raw material
sectors.

The goal of Kazakhstan’s national oil fund is to preserve the country’s energy
wealth for future generations and to reduce excessive pressure on the domestic
economy stemming from windfall revenues. It also serves as a contingency fund
for energy market volatility or economic recession. The Kazakh National Bank
manages the Fund, while a governing board under the president’s leadership
exercises oversight.

The Fund designated 75 percent of its assets for long-term investment and 25
percent for short-term stabilization needs.26 The nine largest oil companies and
three largest metallurgical companies contribute to the stabilization fund based on
the “reference prices” for gas, oil, and four metals (chrome, zinc, lead, and copper).
When commodities exceed target prices, the companies transfer windfall tax
payments to the Fund. At the same time, if market prices fall below the targets,
NFRK supplies revenue to the government.27 The National Fund has built its
investment strategy on the rules for the foreign exchange reserves of the National
Bank of Kazakhstan. It may invest in low-risk interest-bearing securities. By

24 Interview with Natalia Korzhova, Finance Minister of Kazakhstan, CentralAsia.ru, October
25 Norway is a success story as an oil-rich country avoiding the “Dutch Disease” and energy
revenue driven corruption through the establishment of the Norwegian Government
Norway/Background.html (November 2, 2007). In January 2006, the Fund was renamed The
Government Pension Fund – Global. Similarly, in January 2004, the Russian Federation
established a Stabilization Fund, split into Reserve and National Welfare Funds as of February
2008.
26 Elena Kalyuzhnova, “Overcoming the Curse of Hydrocarbons: Goats and Governance in the
Oil Funds of Kazakhstan and Azerbaijan,” Comparative Economic Studies, December, 2006, at
27 Ibid.
January 2008, the Oil Fund had accumulated over $21.5 billion, having nearly doubled its reserves since 2006 due to high oil prices.\(^28\)

The government has taken another important step aimed at mitigating the existing risk of corruption linked to the extractive industries. This was Kazakhstan’s 2005 accession to the Extractive Industry Transparency Initiative (EITI) launched by then-British Prime Minister Tony Blair.\(^29\) Ninety-two companies, the government of Kazakhstan and a number of non-governmental organizations have joined the Initiative on a voluntary basis.\(^30\) Under the EITI, participating oil companies and state agencies publish regular reports on taxes and other budgetary transfers.

To increase its economic efficiency, Kazakhstan needs to address the following challenges:

- Limit state intervention in the economy;
- Ensure proper implementation of the terms of contracts by foreign investors;
- Modernize the infrastructure and industrial sectors;
- Boost anti-corruption efforts;
- Increase the proportion of Kazakhstani workers adequately trained and employed in the industrial sectors;
- Attract foreign investment in the non-raw material industries;
- Strengthen environmental monitoring and control.

The Development of Kazakhstan’s Financial Sector

The rapid development of the energy sector has boosted other sectors of the Kazakh economy. The establishment of an independent financial sector regulatory body, the Agency on Regulation and Supervision of Financial Markets and Financial Institutions, in 2004, was an important step toward bringing Kazakhstan’s financial architecture closer to international standards. In 2004, the International Monetary Fund and the World Bank concluded that the core legal framework for banking, the

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securities market, and insurance was in place. The Kazakh authorities still need to focus on implementation and enforcement.

Kazakhstan’s three largest banks out of approximately 35 (Halyk Bank, Kazkommertsbank and Turan Alem Bank) dominate the banking sector. A number of major foreign banks have entered the market via acquisitions and set up branches, including HSBC, UniCredit, Citibank, and Raiffeisen. As part of the effort to invigorate the sector, the National Bank of Kazakhstan introduced deposit insurance procedures. As early as the late 1990s, several privately owned Kazakh banks acquired stable credit ratings and became active borrowers in the international credit market.

Striving for capital and international presence, a growing number of Kazakhstan’s companies trade their shares on the international stock exchanges. In mid-2007, the Financial Times noted that Kazakhstan’s initial public offerings (IPOs) have expanded beyond the energy and mining companies to include the country’s thriving banking and industrial sectors. In 2006, Kazkommertsbank and the People’s Bank of Kazakhstan successfully conducted IPOs of their minority shares in the form of Global Depository Receipts (GDR) on the London Stock Exchange. Later in 2006, Halyk Savings Bank, Kazakhstan’s third-biggest asset holder, raised $680 million in an IPO, beating even the most optimistic expectations.

The Economist Intelligence Unit reported in early 2006:

Kazakhstan has managed to avoid the financial crises that have dogged other former Soviet republics thanks to a well thought out and consistently implemented program of banking sector reform in the 1990s. The danger for the authorities now is that, with liquidity increasing on the back of the oil boom, banks may not be making wise lending decisions... and there are inflationary and bad-credit dangers looming.

33 Ibid.
The boost in the banking sector initiated the entrance of Kazakh capital into the foreign markets. Turan Alem Bank (formerly the state-owned construction bank Promstroibank) led the expansion trend with operations directly or through partners in Armenia, Ukraine, Belarus, Russia, Kyrgyzstan, Armenia, Georgia, Tajikistan, the United Arab Emirates, and China.\textsuperscript{35}

**The Regional Financial Center of Almaty (RFCA).** The government established the Regional Financial Center of Almaty (RFCA) in 2006 to boost Kazakhstan’s financial market development. The RFCA is a flagship project intended to create a competitive stock market operating by internationally recognized standards and best practices. The RFCA provides a preferential legal and taxation regime for registered market participants and strives to attract major domestic and foreign financial institutions into credit, insurance, and financial services, as well as the implementation of large-scale regional projects.\textsuperscript{36} Beyond broker-dealer companies, the RFCA is attracting pension funds, share funds, insurance companies, banks, and private investment funds.

Nazarbayev has ambitions to capitalize on Almaty’s already developed financial infrastructure and turn it into a “Hong Kong of Central Asia” through legal incentives and the development of supporting infrastructure.\textsuperscript{37} In January 2007, the Kazakhstan Stock Exchange (KASE) became an RFCA special trading floor, entitling RFCA registered participants to trade securities at this stock exchange.

The Boston Consulting Group, jointly with the three interdepartmental working groups composed of representatives of state agencies and financial market participants, developed the concept and model of the financial center. The government established RFCA as an internationally competitive financial center operating in three languages—English, Kazakh, and Russian. The RFCA has authority to provide simplified registration, tax filing, and visa support to its foreign participants, as well as independent court and alternative dispute resolution.\textsuperscript{38} A special regulation agency in cooperation with an international advisory council monitors RFCA activities to ensure reliability.


\textsuperscript{38} Embassy of Kazakhstan in the UK, “Efficient corporate governance.”
International financial analysts have ranked Kazakhstan's quickly modernizing banking system the best in the CIS. On the downside, the relatively high level of integration into international finance rendered the country vulnerable to the international repercussions of the 2007 sub-prime credit market collapse in the U.S.

The global liquidity crisis hits Kazakhstan. As energy windfall revenues started to spread through the economy, the expansion of the middle class and businesses drove the demand for credit. Kazakhstan's banks became heavy international borrowers and, in the process, exposed themselves to the 2007 global financial market credit crunch.

The low domestic deposit base and low public confidence in the banking sector led Kazakh financial institutions to rely on external borrowing to raise funds for credit. Borrowing on the international capital markets helped Kazakhstan's banks double their assets in 2005 and again in 2006, leading to an overall 10-fold growth in assets since 2002, reaching $94.7 billion as of November 1, 2007. About one-third of these assets came from foreign banks, making the external liabilities of the Kazakh lending institutions high. Despite efforts by the National Bank of Kazakhstan to regulate the borrowing of the country's commercial banks, the external debt of the sector doubled annually since 2002. By the end of June 2007, it stood at $45.9 billion (around 45 percent of the GDP), up from $33 billion in the beginning of 2007.

Credit growth in Kazakhstan began running out of control as credits to the non-bank and household sectors jumped by 95 and 135 percent correspondingly year-on-year in July 2007 alone. The volume of retail credit in the first five months of 2007 almost equaled the total for 2006. Amid this credit boom, analysts began expressing concerns that the banks' lending decisions, at times, may not have been wise.

The growth in wholesale borrowing by the banks and spectacular consumer and business lending showed no signs of slowing until the global subprime crisis hit in the second half of 2007. Analysts announced that, "the level of indebtedness and its

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43 Ibid.
rapid expansion were not healthy.” Excessive reliance on borrowed funds left the banks vulnerable when investors began restructuring their portfolios by selling what they considered to be the most risky assets.

Bob Kommers, an analyst for Zurich-based UBS AG, Europe’s largest bank by assets, commented to Bloomberg on investor wariness over Kazakhstan:

International credit markets crumbled after the fallout in the US subprime mortgage markets. As the credit crisis unfolded, investors’ risk appetite soured, and the Kazakh banks, heavily relying on foreign capital and with large exposure to the construction sector, were topping investors’ risk screens.

Kazakhstan’s banks abruptly lost access to foreign lending. From August through October 2007, the outflow of foreign currency from the country reached some $6.8 billion, about 28 percent of the National Bank’s reserves. Correspondingly, the sale of Eurobonds and syndicated loans, the primary wholesale lending instrument for Kazakhstan’s banks, dropped from a high mark of $8.63 billion in January-August 2007 to a low point of $300 million in September-November 2007, according to Bloomberg. However, while Kazakhstan may be largely shut out from opportunities for external borrowing for some time into the future, the global demand for natural resources will keep capital flowing for export-oriented projects.

Amid concerns over Kazakhstan’s liquidity and difficulties in the debt refinancing being experienced by its banks, international rating agencies, including Standard & Poor’s, Moody’s and Fitch Ratings, downgraded Kazakhstan’s sovereign credit rating, its long-term foreign currency rating and foreign currency-denominated debt. This caused the shares of the leading Kazakh banks listed on London Stock Exchange to fall by a further 10 percent.

Since the banking sector is central to Kazakhstan’s economy, the authorities stepped in fast to stabilize the situation. The National Bank of Kazakhstan eased short-term lending rules for the banks to inject liquidity into the market. In addition, the state indicated its intent to buy shares of the major banks listed abroad.

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45 Aris, “Banking: A Breakneck Pace of Expansion.”
46 Smith, “Kazakhstan’s Bank Lending Frozen in Subprime Squeeze.”
47 Ibid.
48 Ibid.
49 Ibid.
in an attempt to boost investor confidence. The government reportedly provided some $4 billion to support the ailing banking sector.

The Economist Intelligence Unit projected that if the stabilization plan now in place succeeds, the banking sector will slow down credit growth and move towards more sustainable lending policies, having only moderate effects on long-term economic growth. At the same time, continued investor wariness concerning Kazakh banks and the spillover effect into other economic sectors may pose severe risks in the near and medium term.

Gulnur Rakhmatulina, Senior Fellow at Kazakhstan's Institute for Strategic Studies, said in an interview to Kazinform that “it is essential for Kazakhstan’s banking system to provide more funding to the real sectors of the economy so that we earn money by expanding our export capacity” and protect the country from overexposure to international financial crises.

**Construction and the real estate market slump.** Construction and financial services are important drivers of Kazakhstan’s economy, accounting for some 45 percent of GDP growth in January-September 2007, according to the Kazakh Economic Ministry. The condition of these sectors is therefore crucial to the long-term economic health of the country.

Prior to the 2007 credit crunch, Kazakhstan had been experiencing a housing construction boom, fueled by the ample availability of mortgage credit. The enormous influx of credit into the real estate market left it particularly exposed to the global liquidity problem. Approximately 25 percent of all bank loans were reportedly going to the real estate market, which was growing by over 30 percent year-on-year in 2007. After several years of double- and triple-digit growth in real estate prices in Kazakhstan’s metropolitan areas, the value of real estate, particularly residential property, began falling in August 2007. By November 2007, construction had appreciably slowed.

In an attempt to cushion the fall of the real estate sector, the Kazakh government announced plans to acquire residential real estate from construction companies to house the staff of some of the national companies and for rental properties.

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51 “Kazakhstan’s Own Economic Development Model has been Formed Over 17 years,” Kazinform, October 25 2007 (Russian) at www.kazinform.kz (January 12, 2008).
52 Ibid.
this program, the government pays a price slightly below the primary market price as calculated by the Kazakh national statistics agency. The near and mid-term outlook of the construction industry depends upon whether the government succeeds in its stabilization efforts, which also include enforcement of mortgage rate caps and a moratorium on bank foreclosures.\footnote{Economist Intelligence Unit, “Kazakhstan: Country Report,” February, 2008.}

Government activism in trying to resolve the problems may lead to unnecessary waste of taxpayers’ money and to the moral hazard of paying for reckless lending decisions by those financial executives who should have known better. Nevertheless, as the global subprime credit crisis runs its course, it is likely that the construction and mortgage difficulties in Kazakhstan will eventually ease.

\textbf{A rise in inflation.} Although Kazakhstan’s economy has been demonstrating strong overall growth, inflation has also reached levels not seen since 2000. The government estimated the 2007 year-on-year inflation rate at a high of 10.8 percent, driven mainly by increased food, retail, and services prices. As is the case in many other countries, increases in fuel prices and grain shortages on the domestic markets are triggering rising food prices. In Kazakhstan, the likely reason for domestic grain price increases is the export of wheat by private producers and traders, attracted by high world prices. Food price inflation usually has particularly adverse affects on the low-income population in emerging markets, as their consumer basket remains predominantly composed of foodstuffs. In Kazakhstan, food accounts for almost half of the consumer basket (as compared to around 15 percent in the developed economies). In an effort to address the short-term effects of food price inflation, the Kazakh authorities have enforced emergency price controls on key foodstuffs and imposed food export controls while lowering import duties. Seeking to contain growing public discontent over surging inflation, Nazarbayev recently dismissed his finance minister, Natalya Korzhova. However, observers doubt the sustainability of the administrative intervention policies put in place to date, since rising world agricultural prices appear to be a structural shift, pushed by growing demand, mainly from China and India, as well as higher production costs driven by expensive energy, especially rising oil prices.\footnote{\textit{Ibid.}}

\textbf{State Participation in the Economy}

Kazakhstan’s economic success since the 1990s was largely due to its pro-market economic policies, which favored private sector growth. Nazarbayev praised the outcome of privatization in his book \textit{Kazakhstan’s Path}:
Our privatization brought about the expected results. By now, the private sector is in place in Kazakhstan’s economy, and it produces around 90 percent of the industrial output. Further development of the private sector requires clearly established rules of the game, an adequate legal and regulatory framework, not burdened by Soviet trends... Today, such important sectors as catering, trade, processing and food industry, services and agricultural production are completely out of the public domain. Energy, mineral resource and other industries have also moved towards private ownership. The competitive environment is rapidly evolving in the areas of healthcare and education, particularly higher education.57

Yet, with the international markets suffering a credit crisis and inflation growing worldwide, the Kazakh government returned to playing a stronger role in the economy. As of 2007, the Finance Ministry reported that the state held a stake in 129 public joint stock companies and 26 limited liability partnerships; and with privatization still underway, it increased its involvement in the national economy.

In addition to the economic factors, the presence of foreign investment and expertise in the Kazakh private sector has made some in Kazakhstan feel that foreign capital dominates the most attractive economic sectors. Several Kazakh scholars have even blamed slow domestic capital development in Kazakhstan on the rapid growth of foreign investment since the 1990s, and called for the protection of national capital, including measures such as higher levels of internal investment to replace foreign funds.58 In discussing such measures, they particularly refer to steps that several European states have taken, most notably Germany, to restrict strategic investment on their territory by foreign investors or foreign sovereign funds.

Possibly taking such sentiments into account, the government of Kazakhstan began undertaking action to strengthen homegrown capital, such as setting up state investment funds supporting innovative public-private partnership projects. Russia, which often serves as a bell-weather for Kazakhstan, has promulgated a natural resources law that severely limits foreign investment in its natural resource sectors.59

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58 Ibid.
Investment policy is on the agenda at the highest levels. Nazarbayev met with President George W. Bush during his September 2006 visit to Washington. The two leaders committed to a strategic dialogue and development of a US-Kazakhstani Public-Private Economic Partnership. This initiative promotes the involvement of the public and private sectors in building a shared vision of stability, prosperity, and reform in Kazakhstan and the surrounding region. The partnership aims to expand joint activities in such areas as:

- Economic diversification and regulatory reform;
- Small and medium business development;
- Business training and wider application of market economy principles;
- Advancement of rule of law and robust anti-corruption measures.

In his 2007 State of the Nation address, Nazarbayev emphasized the need for greater economic diversification of the Kazakhstani economy away from the current commodity focus. The government's white paper, *Strategy of Kazakhstan’s Industrial-Innovative Development Until 2015* and the broad participation of large domestic businesses in the *Thirty Corporate Leaders Program* (see Part Three) are considered essential for achieving this target. These programs aim at boosting value-added processing, manufacturing, and high tech industries to supply competitive products on the world markets. Their purpose is to sustain economic growth beyond this decade. The growth in the non-resources sector will define the success or failure of Kazakhstan’s development beyond 2020.

Nazarbayev has also called for enhanced regional and local development through “social entrepreneurial corporations” and public-private partnerships. State-owned sustainable development fund Kazyna will play an important role in these ventures, as will be demonstrated below. Social entrepreneurial corporations will reinvest business profits into socially significant and breakthrough projects in the communities where these companies are located. 60 In this context, local authorities will get involved in forming portfolios of promising projects that can boost socio-economic development and improve the quality of life for the citizens. These projects may include the provision of drinking water, housing, construction of schools and hospitals, or modernization of the utility services and local infrastructure.

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Joining the “50 most competitive nations.” Since the start of 2006, Nazarbayev has spoken repeatedly about his interest in transforming Kazakhstan into one of the “50 most competitive, dynamically developing nations in the world” within the next decade. He articulated this goal for the first time in March 2006 during his annual address to the nation, and formalized policy around it a month later in the government’s economic development program for 2006-2008. The objective is to “create favorable institutional and economic conditions in order to raise Kazakhstan’s competitiveness in the international arena, as well as living standards.”


The main components of the strategy to boost Kazakhstan’s competitiveness include:

- Accession to the WTO and successful integration into the world economy through diversification and development of internationally interconnected service sectors;
- Implementation of “breakthrough” projects of international significance, boosting the production of goods and services that can compete in the world market;
- Global political integration via active participation in regional and international political and economic institutions, including OSCE Chairmanship in 2010;
- Increasing the efficiency, profitability and transparency of the energy and mining sectors;
- Human capital development through further improvements in healthcare, education, and civil service professionalism; as well as conducting a comprehensive demographic policy aimed at the return of emigrants;
- Financial market development in line with modern international standards.

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62 Ibid.
Kazakhstan has widely publicized its ambitions to join the ranks of the 50 world’s most competitive nations as its flagship national project. Maintaining a favorable geopolitical environment is also crucial for the country’s successful development.

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Kazakhstan’s confident position as an important supplier of oil to the international markets has enabled it to develop an assertive foreign policy. The country is capable of defending and promoting its strategic national interests from the standpoint of a stable and independent regional player.

Nazarbayev described Kazakhstan’s approach and principles in the hydrocarbon sector in the following 2006 statement:

At this time, our country is among world’s top-ten countries by recoverable oil reserves. Kazakhstan holds the second largest oil reserves outside OPEC... Apparently, such resources potentially place Kazakhstan among the world oil powers. We must become aware of our new geo-strategic role in the global energy market, and develop our energy policy accordingly over the next ten to fifteen years.

We find it essential to conduct an optimal, balanced, and transparent foreign policy. In the future, we are going to strengthen the reputation of Kazakhstan as a forward-looking, reliable international partner that contributes to global energy security with due consideration to its national interests.¹

In practice, this statement underlines that the Kazakh leadership strives for consistency and predictability in its geostrategic posture in general and in the oil and gas sector in particular. Since the early 1990s, Kazakhstan put a great deal of effort into developing an international policy that ensures its national interests and regional security in all four principal directions: North, South, East, and West. The foreign policy course followed by the country’s leadership has thus far allowed Kazakhstan to develop foreign economic ties and maintain high GDP growth rates despite the unfavorable geopolitical situation in Central Asia and especially in the neighboring Middle East.

¹ Nazarbayev, Address at the ceremonial meeting dedicated to the 15th Anniversary of Kazakhstan’s independence.
The New Great Game: Multi-Vector Energy Geopolitics

Competition among the global actors in the Caspian and Central Asian regions has prompted many analysts to compare the situation with the “Great Game”—a confrontation between the Russian and British empires for influence in Central Asia in the 19th century. In the 21st century, however, more players are competing for presence in the region.

In order to maintain a balance of external interests, Kazakhstan has chosen a path of transparency concerning the country’s foreign policy. Over the years Nazarbayev, regardless of the geopolitical climate at the time, has undertaken Eurasian integration initiatives, as well as consulting with the political leadership in Moscow, Washington and Beijing on all important projects in the oil and gas sector. This multi-vector policy course has thus far prevented a single global political player from achieving complete hegemony over Central Asia.

The following quote from an interview with Kasym-Zhomart Tokayev illustrates the logic of the republic’s foreign policy:

Several years ago, a blunt attitude to our relationship with Russia and China prevailed in some circles of the American establishment. They framed the issue this way “You are either with us or with them.” We kept explaining that as a key Central Asian state, Kazakhstan could not afford having tense relations with its neighbors. This would not only contradict the country’s long-term national interests, but could also undermine regional security and stability... For us, relations with Russia, China, and the Central Asian countries are strategically important. Another policy course is simply not possible; it would be contrary to the national interests of Kazakhstan.2

Four key powers dominate the geopolitical landscape around Kazakhstan’s sector of the Caspian Sea—Russia, China, the U.S., and Europe.

The Russian Vector

Kazakhstan’s cooperation with the CIS states, and primarily with Russia, is a top priority for Astana. Nazarbayev has often said that Russia is Kazakhstan’s major foreign policy partner. On July 6, 1998, the two countries signed a Declaration of

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Eternal Friendship and Cooperation for the 21st Century, a unique diplomatic document. In 2006, Kazakhstani-Russian bilateral trade reached $13 billion (compared to Kazakhstan’s bilateral trade with China—$8 billion in 2006, with the European Union—$2.8 billion in 2005, and with the U.S.—$1.6 billion in 2006.

Russia’s phantom pains of empire. Many in the Russian post-Soviet elite, however, never fully relinquished the notion that Kazakhstan is “ours” or at least that it falls within Russia’s “sphere of influence”—a special relationship that the majority of Russian foreign and security policy decision-makers believe the rest of the world should recognize. This concept is still prevalent among the military top brass, security officials, and the Kremlin administration. Russian officials have even stated to their US counterparts that they do not object to US-CIS member relations, as long as these go through Moscow. Many in the West, however, think that the path of clearly demarcated spheres of influence is an obsolete, 19th century geopolitical notion.

Kazakhstan’s czarist and Soviet-era development fell within a center-periphery analytical framework. Out of 89 Russian regions, 72 have economic links with Kazakhstan. The governors of the neighboring Novosibirsk and Orenburg oblasts of the Russian Federation have been vocal supporters of Kazakh-Russian cooperation. Russia was the final destination of $7 billion in Kazakhstani exports in 2004 (25 percent of the total). Due to distortions created by Soviet era central planning, energy rich Kazakhstan remains a top consumer of Russian electricity, while Kazakhstan ships its coal to Siberia to fuel Russian power stations.

The Kazakhs, on the other hand, value their independence as a source of power, prestige, careers, and wealth. Those non-Kazakhs in the nomenclatura who were attached to their allegiance to “Mother Russia,” such as the Soviet-era “red director” and later Deputy Prime Minister of the Russian Federation, Oleg Sokovets, departed for Moscow. Others, such as Vladimir Shkolnik, the current Deputy Head of the Presidential Administration, and Alexander Tereshchenko, the former Prime Minister of Kazakhstan (1991-1994), remained in the republic.

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5 Numerous interviews by author with senior Russian officials, intellectuals, experts, and journalists, Moscow, 1992-2005.
Considering Kazakhstan’s rapid economic growth, Russia has apparently decided not to play some of the geopolitical trump cards it holds. The ethnic card is certainly one of them. Moscow-based experts and politicians of the more nationalist persuasion often complain that the Russian government tends to neglect the “cultural heritage” and the status of ethnic Russians and Russian-speaking minorities in the CIS in favor of economic interests. Nevertheless, recently Russian Deputy Prime Minister Sergey Ivanov announced that Moscow would protect the 30 million ethnic Russians living abroad.7

As Russian speakers dominated northern Kazakhstan in the period immediately following independence, it would have been easy to create a movement for autonomy and reunification with Russia. Such a move would have been similar to the Nazis playing the ethnic card in the Czech Sudetenland before 1938, or to what some in Russia advocated for the Russian diasporas in the Baltic States, Eastern and Southern Ukraine, and the Crimea. However, Moscow has thus far refrained from attempts to destabilize Kazakhstan’s internal situation by instigating tension between the large Russian-speaking community in the country and the Kazakhs. Pragmatism and caution on the part of the Kazakh leadership have also been essential in maintaining calm.

Kazakhstani-Russian bilateral ties. Despite some of the serious issues at stake during the first years of independence, the leaders of Russia and Kazakhstan have managed to maintain a close partnership, which later served as the basis for settling many conflict situations. Throughout most of the 1990s, economic cooperation between the two countries remained high on the agenda. Kazakhstan and Russia based their bilateral relations on the May 1992 Treaty on Friendship, Cooperation, and Mutual Assistance, and later, the July 1998 Declaration of Eternal Friendship and Cooperation for the 21st Century,8 as well as several other documents aimed at facilitating the acquisition of citizenship.

A major economic dispute arose in the 1990s between the two countries focused on the legal status and the rental fee to be paid for the Baikonur spaceport (the “cosmodrome” in Russian). After negotiations, which took some two years, both parties agreed that the cosmodrome is the property of independent Kazakhstan and that Russia would rent it until 2014 for $115 million a year. Some experts on both

sides were critical about the terms of the agreement. However, compared to the acrimonious Russian-Ukrainian dispute over the Black Sea fleet (based at the Russian naval base of Sevastopol in the Crimea, Ukraine), Russia and Kazakhstan successfully reached a resolution. According to Tokayev, the Baikonur agreement was an extremely important step, setting the tone for subsequent friendly relations between the two states.

Moscow and Astana, bound by their long common border and close cultural ties, as well as by the Caspian oil and gas infrastructure, have thus far chosen a policy that best meets their mutual needs. The two countries opted for close coordination of their activities in the international arena and in the domestic policy spheres. Vladimir Putin, having inherited friendly relations with the Kazakh leader from his predecessor Boris Yeltsin, continued to move towards integration with Kazakhstan through a number of regional organizations. Friendship between the two leaders (Putin and Nazarbayev met 13 times in 2006) possibly enabled Russia to restrain its imperial ambitions—or at least direct them elsewhere. Russia tends not to interfere in Kazakhstan’s domestic policy matters, and Moscow is an active supporter of Astana on the world stage.

During a celebration dedicated to the 60th anniversary of the victory in World War II, Putin placed Nazarbayev in the forefront of the ceremonial procession, together with the American and French leaders. In July 2006, Nazarbayev was invited as an observer and Putin’s personal guest to the St. Petersburg summit of the Group of Eight (G8). During the summit, the two presidents created a joint venture to process and export natural gas from the Karachaganak oil field in Kazakhstan. More importantly, Russia was a key supporter of Kazakhstan in the long struggle to win a turn at chairmanship of the Organization for Security and Cooperation in Europe (OSCE). As Moscow is actively lobbying for reform of the OSCE, the Western countries were for a time reluctant to embrace Kazakhstan, which some saw as a key Moscow ally.9

The good relations between Russia and Kazakhstan stand out even more when compared to Moscow’s continuing problems with other CIS capitals: Kyiv, Chisinau, Minsk, and Tbilisi. As Nazarbayev noted in his 2008 annual address to the nation:

The Russian vector is Kazakhstan’s most important foreign policy priority. There are no disagreements between the two countries, which

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they cannot settle through dialogue and consideration of mutual interests.10

In the early 1990s, Russia served as the main development model for Kazakhstan, but the roles had reversed by the end of the decade. Nobody in Moscow expected such a twist. Astana managed to implement a number of painful social reforms even before the hike in oil prices in the first decade of the 21st century. As part of these reforms, the Kazakh authorities successfully abolished certain wasteful social security benefits, privatized municipal housing management, and introduced a cumulative pension system. In Russia, on the other hand, many similar transformations triggered social protests, or are still at the initial stages of implementation.

The Russian economic elite, including former presidential economic advisor Andrey Illarionov, former Minister of Economic Development and Trade and current Sberbank chairman, German Gref, Deputy Prime Minister and Finance Minister Alexey Kudrin, Deputy Director General of Rusal and former Deputy Prime Minister Alexander Livshits and others have studied and praised Kazakhstan's reform experience.

The personal friendship between Presidents Putin and Nazarbayev also helped to synchronize a number of policy initiatives. In 2006, the two countries introduced similar bans on certain second hand Japanese cars and implemented similar gambling reforms, moving casinos outside of the major city centers. They also attempted to encourage public participation in the securities markets by making shares of flagship national companies Kazakhtelecom (in Kazakhstan) and Sberbank (in Russia) available for acquisition by their citizens.

As joint oil and gas projects in the Caspian and greater trans-border trade flourished in the early 2000s, Kazakhstan and Russia expanded their bilateral economic ties and cooperation. In a relatively short period, the second wave of large Russian telecommunications, retail, and food producing companies entered Kazakhstan's market.11 Russian private investment funds such as Renaissance

11 The first wave of Russian companies, including TransAer air carrier, the KamAZ machine-building company, the LUKoil oil company, and the ORT and MIR television channels have been operating in Kazakhstan either since the Soviet era, or from the first years of independence. As a rule, special intergovernmental agreements regulate their activity. This is a key distinction from the second-wave companies, which entered the market independently.
Capital, Troika Dialog, and Kit-Finance announced the establishment of major joint ventures in 2007. Turan Alem and Kazkommertsbank are successfully representing the Kazakhstani financial sector in Russia. According to preliminary calculations, Kazakhstan has invested some $8 billion in the Russian economy over the last 15 years.\(^{12}\)

As Russia remains Kazakhstan’s major military partner, Astana’s interest in a higher level of political and economic integration between the two states has an even greater basis. The Kazakh infantry, air force, and navy largely rely on Russian armaments and training. Over 60 agreements between the Kazakh and Russian Defense Ministries regulate military cooperation, arms and technology sales, air defense coordination, and joint actions to combat drug trafficking, terrorism, and poaching in the Caspian Sea. Kazakhstan and Russia also cooperate in nuclear arms control and joint use of military training grounds. In addition, the two defense ministries have agreed on student exchanges in the military education field that will allow Kazakh citizens to get training in Russian military colleges and academies. This long-term military connection between the two countries would make any NATO or Chinese military ties with Kazakhstan difficult.

In the oil and gas sectors, a number of agreements formalize strategic Russian-Kazakh cooperation, including mutual concessions in oil field boundary delineation and demarcation. Other agreements also stipulate important aspects of the Caspian Pipeline Consortium (CPC) operation, which is a secondary priority for Russia, but a principal export pipeline for Kazakhstan.

Production sharing agreements (PSAs) on the once-disputed Russian-Kazakhstani border fields of Imashevskoe and Kurmangazy in the Northern Caspian similarly reflect cooperation. Both agreements are part of the 1998 Kazakh-Russian intergovernmental agreement on the Caspian seabed delineation. It stipulates that natural resource deposits located along the border area are subject to joint and equal exploration.

The close relations between the two countries suggest that the Government of Kazakhstan may favor giving priority to Russian companies in the development of its largest energy projects in the future.

**Russia-Kazakhstan: pipeline politics.** During the Soviet era, the USSR directed the majority of its oil investments toward developing the Western Siberian fields

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\(^{12}\) Tuymebayev, “Otechestvennyy biznes.”
located in the territory of the Russian Federation. After the collapse of the USSR, Russia attempted to keep strategic control over the oil export flows from the Caspian basin in general and from Kazakhstan in particular. Many in Moscow viewed maintaining a transit pipeline monopoly as a sure-fire way to prevent the energy exporting CIS member-states from developing independence from their former imperial master. However, in the 1990s Russia was deep in a political and economic crisis due to clashes within its post-communist political system and the transition to a market economy, and lacked both the capital and corporate mechanisms for developing natural resources. Major international oil companies (IOCs) entered the market and launched oil field development projects with minimal participation on Russia's part. Despite Moscow's opposition, British Petroleum also took the lead in building the Baku-Tbilisi-Ceyhan (BTC) pipeline that originates in Azerbaijan.

Today, Russia views the U.S. and Great Britain as unwelcome strangers if not outright intruders in the region. Moscow meets Kazakh, Kyrgyz, Georgian, and Azerbaijani ties with Washington and NATO, and to lesser degree with China, with suspicion and at times even hostility. In addition, Moscow and Beijing cooperate against US "hegemony" worldwide and in Central Asia. For example, in 2005, Russia and China persuaded Uzbekistan to terminate NATO's four-year stay at the Karshi-Khanabad airbase. Prior to that, China provided Uzbekistan with a massive loan to develop a gas pipeline, while immediately after NATO's withdrawal, Moscow and Tashkent signed a treaty on military cooperation, and Gazprom entered the Uzbek gas market.

After the 1998 agreements on delimiting the northern Caspian and transporting Kazakh hydrocarbons via the Russian pipeline system, Kazakhstan abandoned its quest for alternative routes, at least temporarily. Meanwhile Russia, concerned by what it saw as a growing American influence in Kazakhstan and the whole Caspian region, began working to increase its share in oil and gas projects in Kazakhstan and other Caspian states. In the early 2000s, the Russian energy giants Gazprom and Lukoil began to show a growing interest in hydrocarbon projects in Central Asia. Moreover, Russia has several aces in its geopolitical deck of cards, including

\[13\] Before World War II, major oil production in Azerbaijan was primarily based on the fields discovered before the 1917 revolution. By the 1970s, the explored Soviet deposits were depleting, thus triggering additional urgency to develop deposits in Western Siberia. The major modern offshore fields in the Caspian were either undiscovered or undeveloped until the 1970s-1990s.


control of the Samara and Novorossiysk export pipelines. However, Russia has not enjoyed unalloyed success in Central Asia. With a less advantageous geopolitical position and fewer historic ties in the region, but with growing economic power and momentum, China has succeeded in quickly (within one and a half decades) gaining influence where it had none before.

**The Chinese Vector**

Historically, Chinese influence in Central Asia goes back at least 1,200 years. Since the collapse of the Soviet Union, China came to see Central Asia as its “strategic rear” in case of a confrontation with Taiwan or the United States or deterioration of relations with Japan. The region’s place on the list of Chinese foreign economic priorities also began moving up as the Chinese economy gained steam.

At the end of the 1990s, the Politburo of the Communist Party of China Central Committee adopted a resolution on the “four strategic materials.” These are oil, gas, grain, and water. Kazakhstan is a world-class supplier of three out of the four commodities, as well as a range of ferrous and non-ferrous metals and uranium. For the first time in three centuries, Beijing decided to expand its strategic, economic, and cultural influence in a region linked to China throughout its millennial history.

In the 1990s, Kazakh-Chinese relations were spontaneous or “project-focused” in nature, limited primarily to the semi-legal flow of Chinese consumer goods into Central Asia and metals in the opposite direction. Nevertheless, Nazarbayev and the Kazakh leadership understood the global role of rising China. Both Senate Chairman Tokayev and the current Prime Minister Karim Massimov are not only native Russian speakers and fluent English speakers; they are also fluent in Chinese.

The Chinese vector has always remained a priority in Kazakhstan’s foreign policy strategy. First, the huge and rapidly growing manufacturing economy of developing China is complimentary to Kazakhstan’s raw materials exporting economy and provides a unique opportunity for expanding trade and cross-border cooperation. Second, a passive policy towards its giant neighbor could gradually lead to the political and economic expansion of China with adverse affects upon Kazakhstan’s strategic interests.

Concerned with the growing Russian and American presence in the region, China has taken a number of steps to elevate its relations with Kazakhstan to the level of a strategic partnership. Turning from a “dark horse” into a fully-fledged regional player, China initiated a number of major infrastructure and energy projects in Central Asia. Thus, Beijing provided political and economic support to
Uzbekistan’s Islam Karimov immediately after the 2005 Andijan events, including signing a multimillion contract to build a gas pipeline to China.

Since the 2000s, after Astana and Beijing had settled all their border disputes, China has followed a well-designed and integrated strategy in its regional policy. Beijing began a rapprochement with Kazakhstan on security cooperation within the SCO; access for oil companies to the Caspian shelf; the construction of the Atasu-Alashankou oil pipeline; the purchase of PetroKazakhstan; and bilateral trade.

Despite growing popular resentment over Chinese economic expansion, Kazakhstan recognizes the vital importance of its economic, political, and military partnership with Beijing. In 1998, the China National Petroleum Corporation (CNPC) proposed the development of a number of oil and gas fields in cooperation with KazMunayGaz. However, the transnational corporations opposed CNPC’s subsequent attempts to expand its presence in Western Kazakhstan. Thus, in 2003, the AgipKCO consortium that develops the Kashagan field blocked the sale of a 16.67 percent stake in the British BG Group to Chinese investors.

The failure to reach a deal did not stop China’s zeal for acquiring oil assets in Kazakhstan. In 2005, the government of Kazakhstan approved the $4.18 billion acquisition of PetroKazakhstan’s assets by CNPC. Canadian-run PetroKazakhstan had been the largest independent oil producer in the former Soviet Union, and this was the largest foreign purchase by a Chinese company and the first major Chinese acquisition in Kazakhstan.

The deal enabled China to become the owner of the Kumkol field in southern Kazakhstan, with 42 million tons of oil reserves. China also acquired the Shymkent oil refinery in co-management with KazMunayGaz.

In 2006, the China International Trust & Investment Corporation (CITIC) acquired the Karazhanbas fields (46.6 million tons of oil reserves) near the city of

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16 On May 13, 2005, Uzbek security forces crushed a crowd of protesters in Andijan, some of them armed, killing hundreds, after they had seized a prison and freed a group of local businessmen charged with “extremism, fundamentalism and separatism.” The jailed men were members of the Akramiya group, a spin-off of the Hizb-ut-Tehrir global Islamist group active in Central Asia and considered a terrorist organization by the Uzbek authorities. The massive use of violence by the Uzbek authorities was heavily criticized by the West. Source: Lionel Beehner, “Documenting Andijan,” Council on Foreign Relations, June 26, 2006, at http://www.cfr.org/publication/10984/documenting_andijan.html#6 (February 12, 2008).
Aktau for $1.9 billion. In that same year, Kazakhstan forced the Chinese company to resell a third of its acquisition to KazMunayGaz,\footnote{Christopher Pala, “China Pays Dearly for Kazakhstan Oil,” The New York Times, March 17, 2006, at www.nytimes.com/2006/03/17/business/worldbusiness/17kazakh.html (February 12, 2008).} warning the Chinese of the state’s desire to maintain a say in its major energy companies. On balance, China has become a leader in terms of its stake in Kazakhstan’s oil exploration, reflecting the high priority that the Chinese place on Kazakh oil assets and their willingness to pay premium prices. These acquisitions also signaled a weakening of the Western competition relative to China in the race for Caspian energy resources.

China’s global energy sector expansion is not accidental. The following quote demonstrates why Chinese companies are successful in promoting oil and gas investment around the world, and why Russian and Western companies sometimes fail to compete effectively against them.

Speaking in Almaty in 2004, CNPC’s Vice President Zhou Jiping expounded his company’s principles when working in Kazakhstan and elsewhere:

First, honesty and faithfulness. Investment in due time and amount is essential for international petroleum cooperation. To date, CNPC has made a total investment of $1.3 billion in Kazakhstan projects, far exceeding the amount specified in the contract, fulfilling our investment commitment.

Second, win-win principle. CNPC commits to create benefits to local people through petroleum cooperation, supports local economic development by investing in power stations, chemical reagent plants, railways and gas pipelines as well as agriculture projects. In addition, CNPC is an active sponsor of cultural, educational, healthcare and public undertakings, with a total sponsorship of more than $15 million... All these actions by CNPC are widely recognized and appreciated by local people and governments.

The third principle is localization. During cooperation, CNPC makes efforts and investments to train both technical and management personnel out of Kazakhstani employees for the sustainable development of the local petroleum industry.\footnote{Zhou Jiping, “Hand in Hand for Brighter Future of China-Kazakhstan Cooperation” at http://www.cnpc.com.cn/english/xwygg/speeches/200507220003.htm (December 20, 2007).}

Kazakhstan’s energy strategy aims at maximum diversification of export channels. With this in mind, China’s greater assertiveness in pursuing oil reserves enabled
Kazakhstan to balance the interests of other global powers represented in the Caspian basin. Moreover, cooperation with China provides additional benefits, such as direct hydrocarbon export without additional tariffs and taxes on transit through third countries.

As China consumes increasing volumes of oil and gas, projects to build energy infrastructure gain in importance. By 2015, China plans to build an oil pipeline from Western Kazakhstan with a capacity of up to 70 million tons per year, as well as a gas pipeline. If implemented, these projects would make China the main consumer of Kazakhstan’s hydrocarbons, and would also signal major power redistribution in the region.

Chinese oil companies have demonstrated that they have more financing, more nimble management, and a greater need than Russian ones to acquire hydrocarbon resources in the Caspian area. It is clear that China has become a global player in the energy market, while Russia, despite its high oil and gas output, is playing catch up. For a while, PetroChina emerged as the leading world energy company in terms of market valuation, overtaking ExxonMobil and Gazprom.21 Once again, as was the case with the industrialization and gradual transition to a market economy, the Chinese dragon is overtaking the Russian bear.

The American Vector

US interests in Kazakhstan rest on three pillars: security (including counter-terrorism), energy, and democracy. During the late 1980s -1990s, American companies became pioneers in developing the Caspian’s oil and gas resources with the active support of the US government. Today, US-based companies have a stake in the largest shares in the most important fields, including Tengiz, Karachaganak, and Kashagan, as well as in key pipeline systems, such as the CPC and BTC. In the period from 1993 to 2005, US companies invested some $12 billion in Kazakhstan’s energy projects, making America the main investor in the country.22 The two countries also cooperate in the political sphere.

Following the events of September 11, 2001, bilateral US-Kazakhstani relations gained a qualitatively new dimension. Though the U.S. has not established any

military bases in Kazakhstan, the country has provided over-flight and emergency landing rights for US Air Force aircraft engaged in operations in Afghanistan. The U.S. increasingly views Kazakhstan as a key state for ensuring regional stability, combating terrorism, and providing energy security. Kazakhstan has sent a 30-strong, largely symbolic contingent of its army engineers to the multinational military force in Iraq, while the US government provides strong support to Kazakh civil society. In some instances, the Kazakh authorities, however, take this assistance as meddling in the internal affairs of a sovereign state, as the gap in political values and customs remains wide.

In 2005 and 2006, a number of high-ranking US delegations visited Kazakhstan, led by Vice President Richard Cheney, US Secretary of State Condoleezza Rice, and former US President Bill Clinton, as well as some distinguished American policy-makers and experts. US-Kazakh relations got a new spin with the introduction of a Central Asian regional strategy known in the White House and the US Congress as the Great Central Asia Strategy. Among its key objectives are providing security in Afghanistan and balancing, in a peaceful manner, Russia’s, Iran’s, and China’s respective regional influences. The United States seeks to diminish Russia’s control over the region’s oil and gas transit, while keeping China from strengthening its regional presence, as well as encouraging export options bypassing Iran, another contender for a greater regional role.23

The United States promotes greater integration and cross-border cooperation within so-called Greater Central Asia. Washington wants to facilitate regional trade flows and give impetus to a “corridor of reform” extending from Kazakhstan southward to Afghanistan and the Indian Ocean, even as the region’s ties expand eastward to China, Japan, Korea, and the Pacific Rim.24 The U.S. wants to “help create a Central Asian region comprised of independent, sovereign pluralistic states that are territorially secure, free from external political domination, and economically engaged with international markets.”25

Former US Deputy Assistant Secretary of State for South and Central Asian Affairs, Evan A. Feigenbaum, summarized the logic of the official US policy in the wider Central Asian region:

Since 1991, the ability to cross borders—from Central Asia to points in Afghanistan, China, and beyond—represents an unprecedented opportunity to tap into the extraordinary economic dynamism that now surrounds the greater Central Asian region. For Central Asia, the governments and peoples thinking and acting as an integrated region can best achieve this promise. Reducing barriers... will benefit consumers, make this region more attractive to foreign investors, and forge new patterns of cooperation. This is the core of American policy in this region: to support Central Asian states as fully sovereign, democratic, stable, and prosperous nations, contributing to regional stability and the global war on terrorism and potentially serving as models of ethnic and religious tolerance.26

This approach, of course, needs to take into account the negative side of porous borders: the spread of thugs, drugs, and religious extremists. If the borders from Pakistan to Poland remain permeable, organized crime, drug trafficking and Islamist terrorists can move through with ease, taking advantage of post-Soviet chaos, poverty, corruption, deficiencies in or absence of working law enforcement institutions, and illicit economic opportunities and jobs. While the U.S. would like Kazakhstan to influence, say, Afghanistan, the reality may be more complicated, with mutual influence and permeation negatively affecting relatively secular Central Asian societies.

An equally important factor for the White House’s increased attention to Astana is the ongoing realignment of the global powers in the Caspian region as the U.S., Russia, and China jockey for power. Several energy deals reached with China in recent years will soon lead the country to be the second largest producer and consumer of Caspian oil, while a resurgent Russia may eventually view the Chinese presence in the region as being almost as undesirable as America’s.

For Kazakhstan, the U.S. has always been a strategic partner who made a significant contribution to creating the foundations for the country’s economic

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development. In the early 1990s, the U.S. seemed to be the only country capable of providing the most effective exploration of the Caspian resources. At that time, Russia was preoccupied with its domestic economic problems, the EU was following a wait-and-see policy, and China was meeting its energy demands via domestic resources.

The 2000s have seen a rebalancing of this equation. In the new geopolitical context, Nazarbayev assigns the West a new role. While the development of trade and energy connections will increasingly shift to the major regional powers (primarily Russia and China), the U.S. may play a more active part in his economic diversification strategy for the Kazakh economy.

According to Kasym-Zhomart Tokayev, the United States positively received Kazakhstan’s new regional strategy:

> It is conventional to believe that the U.S. is interested in Kazakhstan only as an energy supplier. This is not entirely true. During the talks in the Oval Office [of the White House – A.C.] President Bush made it clear that, despite Washington’s interest in further energy cooperation with Kazakhstan, it is not the main factor in the bilateral relationship. The main thing is to understand the commonality of purposes. First and foremost, these include the fight against international terrorism, nuclear proliferation and other threats to peace and security.27

The government of Kazakhstan is willing to add several new items to this agenda. During his visits to the U.S. and the UK in September and November of 2006, Nazarbayev appealed to the governments of both countries to assist Kazakhstan in becoming the “economic dynamo of Central Asia.”28 As part of its economic recovery agenda, the country is interested in introducing international accounting standards to improve the quality and transparency of existing large industrial and financial enterprises. The U.S. has done much to develop Kazakhstan’s energy potential, and still has plenty to offer, especially in macroeconomic policy development. The primary areas of mutual interest include American expertise in developing innovative educational and anti-corruption programs. Astana will also need US assistance and investment to diversify its natural resources-based economy and develop its high tech, financial services, and agricultural sectors.

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27 Tokayev, “Vektory politiki i sosedstva.”
Kazakhstan is interested in attracting foreign direct investment to its natural resources and non-extractive industries, especially from Europe.

The European Vector

Almost immediately after becoming independent, Kazakhstan invited European energy companies to develop the Caspian oil fields. However, the Old World investors cautiously entered Kazakhstan only after the more ambitious Americans had paved the way. Nevertheless, the EU’s oil giants, especially Agip/Eni, Shell Development B.V., British Petroleum, and TotalFinaElf, managed to join the prospective projects, including the development of the Karachaganak and Kashagan fields. In 2002, for the first time, the EU overtook the U.S. in the amount of foreign direct investment in Kazakhstan. Kazakhstan is also Europe’s largest trading partner in Central Asia.

The governments in the region often treat European and American energy companies as a unified Western lobby. However, the U.S. and its European allies often view things differently. The most significant disagreements between the Western European and North American policies in the region are Europe’s more cooperative posture towards Moscow and its flexible policy towards Iran. European and US companies have also become involved in serious competition with the Russian and Chinese state-controlled oil giants.

Until recently, for the European Union, Kazakhstan was relevant only as part of Europe’s regional strategy and energy security in the Caspian region and Central Asia. The EU and Kazakhstan framed their bilateral relations within the Partnership and Cooperation Agreement (PCA), signed in 1995 and effective since early 1999. In 2002, the parties expanded the dialogue to include energy and transport issues. In 2004, the Europeans initiated additional interregional dialogue in the EU-Central Asian Troika format, which includes representatives of current and future EU presiding members and the European Commission on one side, and the Central Asian states on the other.

Kazakhstan, for its part, continued to insist on its “special role” in the region’s economic and political development. With this in mind, during his December 2006 visit to Brussels, Nazarbayev managed to convince the European Commission to hold a ministerial level meeting in March 2007 in Astana. This visit concluded with the first Astana-Brussels joint statement in the history of their bilateral relations,

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saying that “Kazakhstan is a key player in regional and economic stability and... will continue play its role in the Central Asian regional cooperation.”

The European Commission then summarized the mutual benefits of the EU-Kazakhstani cooperation:

The EU has a vital role to play from Astana's perspective as a balancer between the rival energy and geopolitical interests that Russia, China and the U.S. have in Kazakhstan and the surrounding sub-region... From the European Union’s perspective, Kazakhstan represents not only an important source of energy outside of the Middle East, but equally a guarantor of stability in Central Asia, and a potentially long-term strategic partner in the region.

Astana will advance its role within the European region with the landmark award of the OSCE 2010 Chairmanship to Kazakhstan.

Kazakhstan’s Regional Role

Two important factors affected the region’s geopolitics and development in the 1990s: First, the emergence of a number of political organizations dominated by Russia. Secondly, China’s appearance on the scene as a major economic and geopolitical player in Central Asia. In line with its multi-vectored foreign policy, Kazakhstan works to cultivate dialogue within the Moscow-dominated CIS and the Beijing and Moscow-backed Shanghai Cooperation Organization (SCO), as well as with the Washington-backed North Atlantic Treaty Organization (NATO). It is also an active participant in the forum of the Caspian littoral states.

Kazakhstan has been an active advocate of political and economic integration in the post-Soviet space. In 1994, Nazarbayev proposed the creation of a Eurasian Union of States—a conceptually new organization that would facilitate joint efforts toward economic reforms as well as improvement and harmonization of national laws in the former Soviet Union. At that time, Russia was experiencing a number of severe internal political and economic problems, including a constitutional crisis, dismissal of the Supreme Council, and the war in Chechnya. Moreover, while keeping a monopoly on CIS integration initiatives, Moscow was busy
reconstructing economic ties with its former allies. As President Nazarbayev noted, the Russian leadership initiated the withdrawal of the Central Asian countries from the ruble zone.\textsuperscript{32} Despite the obvious long-term potential for the proposed integration project, it failed to gain sufficient support at that time.

Nevertheless, Nazarbayev remained enthusiastic about integrating Central Asia based on “market principles, mutual respect, and mutual benefit.”\textsuperscript{33} During an official visit to Moscow on March 18-19, 2007, he told the press that certain CIS countries are “ripe” for the establishment of a Eurasian Economic Union and “taking the road Europe has been following [for the past 50 years].”\textsuperscript{34} Although the ultimate degree of success for this approach has yet to become clear, Kazakhstan’s continuous diplomacy towards integration has resulted in a gradual restoration of economic ties within the CIS. Through these efforts, Nazarbayev earned a reputation for being the “chief CIS integrator.”\textsuperscript{35}

At the November 2006 Minsk CIS Summit officially dedicated to “issues of the effectiveness and improvement of the Commonwealth,” Nazarbayev presented a new concept for CIS development drafted up by the Kazakh Ministry of Foreign Affairs under Tokayev’s leadership.\textsuperscript{36} However, the document failed to engender consensus due to the divergent interests of a number of the member states. The CIS summit held in Dushanbe the following year finally adopted, under Astana’s leadership, a new development concept for the Commonwealth.\textsuperscript{37}

Despite Kazakhstan’s consistent efforts, differing viewpoints among the leaders of the CIS concerning further integration are apparent. Some CIS member states, most notably Georgia and Ukraine, backed out of major integration initiatives, such as the Common Economic Space. Tbilisi and Kyiv prefer a different integration model altogether, and have tended to focus on EU and NATO

\textsuperscript{32} Nazarbayev, “Na poroge 21-go veza [On the verge of the 21st century].”
\textsuperscript{37} “The CIS Summit has Adopted the Development Concept and Renewed the Organization’s Leadership,” Prime-Tass.
integration. In reality, it is difficult to impossible to integrate such divergent players as Slavic Orthodox authoritarian Belarus, Muslim Turkic Azerbaijan, democratic Ukraine, harshly authoritarian Uzbekistan and oil rich Turkmenistan. Many observers question the effectiveness of the CIS beyond serving merely as a forum of communication for the leaders of post-Soviet states.38

The Shanghai Cooperation Organization (SCO). The roots of the SCO go back to the China-Russia rapprochement of the 1990s. The organization serves as a basis for cooperation in border protection, strengthening regional security and defense, as well as in the economic field. After Beijing and Moscow signed a Treaty of Friendship and Cooperation in 2001, China initiated the launch of the SCO as a “joint venture” with Russia. Today it also includes the five Central Asian states as full members, with Mongolia, Iran, India, and Pakistan holding observer status. Iran and Pakistan are formally applying for membership.

While the SCO was also conceived as an economic cooperation organization, in the last decade, Russia has been attempting to boost its security and defense potential.

Russia agreed to allow China to increase its profile in Central Asia because, during the doldrums of the 1990s, Moscow felt it could not deal with regional security challenges alone. Prior to September 11, 2001, the U.S. demonstrated little abiding interest in the region, despite desperate calls for help from Tashkent, Moscow, or the Northern Alliance in Afghanistan. Central Asian states found themselves facing Islamist terrorist entities, such as the Islamic Movement of Uzbekistan, which had links to Al Qaeda and the Afghan Taliban.

As the level of radical Islamist propaganda and the threat of terrorist attacks were on the rise, Russia and China offered protection to the Central Asian leaders, taking advantage of the insecurity of their regimes. Both the SCO and the Russian-dominated Collective Security Treaty Organization (CSTO) developed as politico-military tools. SCO includes a Secretariat in Beijing, yearly summits for the heads of participating states, and rapid reaction forces headquartered in Bishkek, which the member-states can use to combat terrorism (or to quell domestic unrest).

In addition to enhancing regional security, the SCO also aims to balance US influence in Central Asia. A SCO declaration signed at the fifth summit in Astana held in July 2005, calling for the U.S. to decrease its military presence in Central Asia, in particular in Uzbekistan and Kyrgyzstan, was a major political victory for China and Russia. As noted previously, this declaration proved to be more than a

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matter of words – in October 2005, Uzbekistan evicted the US air force base located in the former Soviet Karshi-Khanabad airbase.

In 2007, an experienced Kazakhstani diplomat, Ambassador Bolat K. Nurgaliyev, assumed the post of the first SCO Secretary General. In his inaugural speech, he praised the organization’s successful fight against common security threats, including terrorism, extremism, and separatism. He also said that the countries need to adopt a “comprehensive approach and continuous synthesis of political, diplomatic, social, economic, and humanitarian measures” to combat regional security challenges.39

The SCO also focuses on regional energy policies. As a major hydrocarbon producer, Kazakhstan is interested in coordinating regional energy trade. Astana backs the Russian idea of creating an OPEC-style natural gas “coordinating organization,” despite the relatively weak position it would occupy in that association. With a total population of 1.5 billion people, the SCO may spin off an “energy club,” given the vast energy resources of active members Russia, Kazakhstan, and Uzbekistan, and observer member Iran, while China and observer member India are among the world's largest energy consumers.

At the August 2007 SCO summit in Bishkek, Nazarbayev proposed the formation of an “Asian energy club” to extend energy ties between the member-states, including the creation of unified energy infrastructure to serve as the basis for a common SCO energy market.40 This energy market would build upon the network of gas and oil pipelines left over from the Soviet period and extend them, presumably to China. If such a club becomes functional, it would further enhance Russia’s geopolitical role as the linchpin of energy supply and transportation in Europe and Eurasia. However, energy exporters and importers recognize that dependence on Russian control over the pipelines may contribute to Gazprom’s and Transneft’s monopolistic positions and put other energy market participants at a disadvantage.

Thus far, no major initiative has come to fruition in this area. The SCO may fail to develop into a viable energy cooperation organization, as this could involve Russia and Kazakhstan selling Central Asia’s energy resources to China below market prices. This is something that Moscow would reject, as it seeks to control the

export outlets of the region’s gas and oil. Russia would not favor sharing pipelines with China to ship oil and gas to foreign markets, including China.

The August 2007 Summit of the SCO also attracted international attention due to the unprecedented maneuvers of the SCO militaries, in which Chinese troops for the first time exercised on foreign (Russian) territory. Nazarbayev attended the exercise together with China’s President Hu Jintao and then-Russian President Vladimir Putin. Observers compared the strengthening of the SCO military component with the creation of the Warsaw Pact half a century ago. Others were more circumspect in their assessments, as the two militaries exercised separately, with no real interoperability.

Russia has been flexing its oil-fed muscles from the Arctic to the Indian Ocean. Putin initiated a $300 billion military modernization, and ordered Russian strategic bombers to resume worldwide patrols, clearly aimed at challenging American military superiority. He welcomed Iranian President Mahmoud Ahmadinejad to the SCO summits and has supported Iran’s bid to join SCO as a full member, something China may oppose. All this leaves Kazakhstan in a tight spot, engaged in a three-way balancing act between its two powerful neighbors and the world’s superpower, while seeking to play a greater role in regional security arrangements.

Military modernization and cooperation. Beyond its position as the region’s economic and energy heavyweight, Astana has become more active in military reform, security and defense cooperation. Kazakhstan’s ambitious military modernization plan requires an increase in defense funding. In 2000, for the first time in ten years, the government made a real increase in defense spending, which reached one percent of the GDP at the time. In 2007, it grew further by around 74 percent to reach an overall budget of $1.17 billion (around 1.2 percent of GDP). An anticipated transition to contract-based military recruitment as opposed to conscription, common in the Eurasian region, would increase military professionalism. As of 2007, some 70 percent of the Kazakh troops were volunteers serving under contract.

43 Ibid.
In 2003, President Nazarbayev issued a decree that launched the country’s ambitious defense modernization program. This decree restructured the military into four services: the army, the navy, the air force, and the airborne troops. The reform also established four regional commands: Astana, East, West, and South, which is typical of NATO members. Today, the 6,000 strong airborne forces are considered the elite of Kazakhstan’s military.

Nazarbayev approved a new Military Doctrine of Kazakhstan in a March 21, 2007 decree. In line with the military modernization priorities, the state plans to complete the formation of the new troop units by the end of 2008, and concentrate on qualitative improvements of the military in 2009-2010. The concept of interoperability, including inter-agency synergy and interoperability with foreign forces—Russian, CSTO’s, or NATO’s—is in the center of Kazakhstan’s defense planning, according to Roger McDermott of the US-based Jamestown Foundation.

According to the new doctrine, Russia remains a principal military partner of Kazakhstan. Defense Minister Daniyal Akhmetov stated that Astana attaches special significance to its relations with Russia (including enhanced CSTO participation) and with China. He also noted, however, that Kazakhstan’s new military doctrine, published in April 2007, highlights the need to improve cooperation with the U.S. and NATO.

As a member of NATO’s Partnership for Peace and Euro-Atlantic Partnership Council, Kazakhstan hosts the Central Asian battalion exercises (CENTRAZBAT) with the United States and neighboring Kyrgyzstan and Uzbekistan. Astana maintains its ties with NATO despite Russia’s opposition to the Alliance’s possible expansion into CIS territory, which Putin reiterated at the, April 2008, NATO summit in Bucharest, Romania.

Astana is willing to participate in international peace support missions with KAZBRIG, the brigade-level peacekeeping formation, and looks to the West to

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enhance the level of their professionalism. In October 2007, the Kazakh parliament passed a law allowing the German military transit through Kazakhstan when shipping humanitarian aid to Afghanistan—months before Russia came out with a similar initiative vis-à-vis NATO. It is possible that the two capitals had coordinated their policies.

In its attempt to bolster regional security, Kazakhstan is setting up a naval force on the Caspian Sea. Russia, Ukraine, Turkey, and France are bidding on contracts to supply naval hardware. NATO officials have offered consultations, planning, and overall technical assistance. However, for Astana a political decision to accept NATO’s involvement would be an extremely sensitive matter as Moscow might object. The Kazakh defense officials also discussed the issues of security cooperation with Miguel Angel Moratinos, Spain’s foreign minister and 2007 OSCE chairman-in-office, during his visit to Astana in April 2007.

In Kazakhstan, with its vast territory and scattered transport and communications infrastructure, the air force is vital for the proper protection of the country’s national security. In 2007, Kazakhstan allocated some $450 million for military modernization, the bulk of which was assigned to the air force. Overall, the defense planners allocated some 48 percent of the 2007 defense budget (and up to 60 percent of the 2008 budget) for the modernization of weapons systems and capital investment.

Astana also seeks cross-border cooperation to reduce crimes with implications for national security, such as terrorist and extremist activities or drug trafficking across its borders.

The Euro-Asian Economic Community (EurAsEC) and the Common Economic Space (CES). Kazakhstan is an active participant of another Russian-dominated regional organization—the Euro-Asian Economic Community (EurAsEC) that serves as a vehicle to promote Eurasian economic integration. EurAsEC is, to a degree, a

50 Ibid.
Russia-centered imitation of the European Union and its process of European integration. Russia, Belarus, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan signed the founding treaty in October 2000, with Armenia, Moldova, and Ukraine having observer status. By its mere size and economic power, when compared to the other members of EurAsEC, Russia is clearly the dominant member of the organization.

In September 2003, Russia, Belarus, Kazakhstan, and Ukraine established the Common Economic Space (CES)—an international integrative body created under Moscow’s auspices. The member countries signed the founding agreement in a symbolic location—Yalta. Consolidation and bureaucratic development have been taking place in earnest since 2004. Russia aspires to dominate the post-Soviet space; and the CES is supposed to be more than a customs union and a free-trade zone. The participants envision it will eventually include a common economic area with unlimited movement of labor and a common currency along the lines of the EU.

However, as noted earlier, divergent interests among the member states may ultimately impede or stop the forward motion of the CES. Four years after the “orange revolution,” Ukraine joined the WTO (in 2008) and attempted, albeit clumsily, to pursue a rapprochement with the EU, making Ukraine under the leadership of President Victor Yushchenko and Prime Minister Yulia Tymoshenko a problematic member for the CES. At the same time, authoritarian Belarus has even more statist economic policies than Russia. Moreover, as far as Moscow is concerned, this body is now on the back burner vis-à-vis the EurAsEC. It also seems that both organizations have their limits when it comes to energy cooperation. When in 2007 the Ukrainian Foreign Minister expressed his country’s interest in pursuing economic projects as part of the CES, he also regretted that there was no energy cooperation agreement in either EurAsEC or the CES.

While Kazakhstan retains and strengthens its independence, the pull towards integration with Russia is also on the rise. While the two countries are cooperating within EurAsEC and the CSTO, the influence of the two organizations has thus far been rather limited. However, Western experts believe that Russia, poised to

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54 Nurlan Organbayev, “Rossiya i Kazakhstan lidiruyut v integratsii v Edinoye Economicheskoye Prostranstvo” [Russia and Kazakhstan are Leaders in Integration in Common Economic Space], RusEdina.org, December 15, 2003 (Russian), at www.rusedina.org/print/?id=5058 (December 20, 2007).
limit American influence as much as possible, will slowly but steadily increase its meddling in regional affairs.

At the June 2005 EurAsEC summit, the states promoted an agenda that included a regional free trade zone and customs alliance. During the summit, Kazakhstan and Russia devoted particular attention to strengthening their economic ties. The two countries agreed to create a regional investment bank with initial capitalization of $1.5 billion, and Moscow supplied the bulk of it. The Eurasian Development Bank, headquartered in Almaty, Kazakhstan, became operational in 2005. “This is not a closed bank, it will remain open to shareholders from other CIS countries,” then-President Putin noted.

In line with their commitments to economic cooperation, in January 2008, Russia, Kazakhstan, and Belarus signed documents to create a EurAsEC Customs Union. The Customs Union will become operational in 2010. Three other members of EurAsEC—Kyrgyzstan, Tajikistan, and Uzbekistan—are observers to the process.

However, the economic integration set in motion by EurAsEC will only gain momentum if the most important member of the association, Russia, agrees to full participation in the customs union plan. In the words of the former President of Moldova, Petr Luchinsky, “international practice shows that the success of any organization uniting different states depends on its leader, the strongest member with the greatest economic potential, which is able to throw more than the rest into the common pot.”

In the coming years, both China and Russia are likely to continue boosting their political, economic, and military influence in Central Asia. Since the launch of the NATO military operation in Afghanistan, Moscow and Beijing have been conducting their regional policy on the premise that “the Americans are here temporarily, while we are in the region forever.” Yet, this cooperation is not seamless, and contradictions between these two great powers may develop into fissures and geopolitical competition down the road.

China aimed for the SCO to become a common market, but it appears that the other members of the organization are so concerned about China’s size, power, and

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economic prowess, that they are wary of allowing Chinese capital and imports free access into their markets. This is particularly true in the case of Russia, which is attempting to transform its natural resources based economy to one founded on a strong manufacturing and services sector. Thus, a customs union between Russia, the Central Asian states, and China would imperil Russia’s manufacturing sector and those of its EurAsEC partners. It might be significant, though, that Russia instead favors the creation of a common market through the EurAsEC, an organization from which Moscow may attempt to exclude Beijing.

**Caspian Sea Demarcation**

Currently, Kazakhstan, Russia, and Azerbaijan have agreements on the delineation and demarcation of the Caspian Sea. In particular, the legal regime is based on Kazakhstan’s bilateral agreements on delimitation of the Caspian Seabed signed with Russia in July 1998 and with Azerbaijan in November 2001. On May 14, 2003, Kazakhstan, Azerbaijan, and Russia agreed on the junction point of lines delimiting adjacent zones of the seabed and subsoil of the Caspian Sea, which finalized the process of legal registration of the national sea bottom sectors for the three states. These agreements have increased certainty for foreign investors and national oil companies regarding the prospects of developing new energy reserves. Demarcation problems remain primarily in the southern Caspian Sea, where disputes continue between Iran, Azerbaijan, and Turkmenistan.

Moscow, however, has an interest in maintaining some low-level diplomatic tension in its relations with the Caspian states. On February 17, 2004, a round-table dedicated to the implementation of a common international security system in the Caspian Sea basin took place in Moscow. The conference included Russian Ministry of Foreign Affairs officials, members of the State Duma, and invited experts. According to one keynote speaker, Ambassador Alexander Golovin, a Special Representative of the Russian Foreign Ministry and chief of the Caspian Sea working group, Russia’s position regarding the Caspian boils down to the principle of non-interference of “third states.” Golovin specifically emphasized Russia’s concern that in 1999 the U.S. had declared the Caspian an area of interest. Other Moscow representatives also supported the position that only Caspian littoral countries have rights concerning the Caspian and its vast oil and gas resources. Vyacheslav Skvortsov, Representative of the Russian Federal Security Service (FSB), stressed that it is important for Russia not to tolerate the presence of

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59 Embassy of Kazakhstan to the United Kingdom, “Oil and Caspian Off-shore Development Strategy and Pipeline Policy,” at [http://www.kazakhstanembassy.org.uk/cgi-bin/index/66](http://www.kazakhstanembassy.org.uk/cgi-bin/index/66) (February 27, 2008).
military forces of non-Caspian countries in the Caspian region, “primarily meaning the United States... which had set the task of interfering with—according to their view—Russia's transportation monopoly in the Caspian region.” Moreover, Russia values its overwhelming naval superiority in the Caspian and intends to maintain it in the coming years.

Later, a conference of the Special Working Group (SWG) on preparing the Caspian Sea Convention held in January 2005 in Ashgabat failed to produce any specific agreement among the Caspian states. The concluding communiqué noted that:

In the spirit of constructive and mutually advantageous understanding... the parties completed the discussion of the draft Convention on the status of the Caspian... and agreed to continue the settlement of the issues that need further resolution.61

Previously, unsuccessful rounds of negotiations on border delineation and demarcation prompted Caspian countries to revise their military posture. Since 1997, Russia has doubled its military presence in the Caspian. Iran is building up its naval forces, which are currently second only to Russia. In 2002, Iran's navy was involved in an attack forcing a BP-chartered geo-seismic vessel to abandon prospecting in disputed waters.62 Yet, Iranian and Russian shows of force have not intimidated Kazakhstan. It opened a military naval academy in Aktau, signaling that it would build up its naval forces as well.63

Although the Caspian currently remains peaceful, Russian and Iranian resentment of American power projection may further boost Moscow-Teheran policy coordination, and an anti-US arms race in the basin. Teheran has pursued strategic rapprochement with Moscow in recent years, largely due to its distaste for America's perceived superpower status and domination of the Gulf, and because of its own aspirations to dominate the area. The leaders of the two states have promoted an overall strengthening of bilateral ties, including in the military,

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nuclear, diplomatic, and economic arenas. Russia’s arms sales to Iran and assistance in constructing the Bushehr nuclear power plant is the result of this rapprochement and a source of increasing concern for the U.S. and its allies. As China is increasing its energy holdings in the Caspian, it is possible that it too will attempt to project power in the region.

The October 2007 summit of the heads of the Caspian littoral states held in Teheran, once again illustrated the conflict between Russian-Iranian shared views on the status of the Caspian Sea and the perspectives of the other states. Presidents Putin and Ahmadinejad issued a joint statement saying that all five littoral states must approve any pipeline construction projects in the Caspian Sea (which would enable Russia and Iran to veto any trans-Caspian projects that could connect Central Asian exporters to their European customers.) Azerbaijan, Kazakhstan, and Turkmenistan opposed this position, and it was ultimately left out of the summit’s joint declaration.

During this same meeting, Nazarbayev made unambiguous statements to the effect that only the countries controlling the specific Caspian seabed areas involved need to agree on pipeline projects. Together with Azerbaijan’s President Ilham Aliyev, he called for freedom of transit in the Caspian basin, including export pipelines. At the same time, the conference participants unanimously declared that the Caspian states should not allow an attack or aggression against one another, apparently referring to the debate around US policy towards Iran.

Energy transit routes across the Caspian could provide Kazakhstan with the opportunity to export hydrocarbons westwards, outside of Russian control. However, some argue that the five littoral states must agree on the demarcation of their respective national sectors of the seabed before any new pipeline projects can commence. The Caspian states have thus far failed to produce and sign a multilateral convention on the Caspian Sea status. Therefore, to this day, individual agreements regulate delineation and demarcation, as well as hydrocarbon exploitation and infrastructure development.

While Iran has stalled the demarcation of the Caspian, largely over the rights of each littoral state to veto proposed undersea pipelines, the countries are also at odds with each other as to the method of dividing the sea. Iran, which possesses only 13 percent of the coastline, has advocated an approach in which all countries would

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equally share the mineral wealth of the sea. If the states refuse this approach, Iran advocates an even split, awarding each Caspian state 20 percent of the seabed, and thus giving itself an unjustifiably disproportionate advantage.\textsuperscript{66}

The Iranian position contradicts those of Azerbaijan, Kazakhstan, and Russia, which advocate a “modified median line” approach to demarcation.\textsuperscript{67} This would offer resolution of the territorial dispute between Azerbaijan and Turkmenistan over the Kyapaz/Serdar field in the middle of the southern Caspian Sea, which the median line would have divided between the two states.\textsuperscript{68} Turkmenistan has occasionally backed Iran’s position, mainly because the modified median line approach would split its own principal oil fields (still under contested ownership) with Azerbaijan. Kazakhstan, in its turn, is a strong supporter of Russia’s modified median line approach. With 28 percent of the coastline, Astana would have the most to lose under the Iranian terms.\textsuperscript{69}

Iran’s demarcation model would also affect the Caspian legal regime by limiting the free movement of Caspian state naval forces and interfering with industrial fishing beyond assigned national sectors.\textsuperscript{70} However, Teheran’s rapprochement with Moscow and growing international isolation makes it unlikely that the Iranians can push their Caspian claims against Russia’s interest.

The head of the foreign policy department at Kazakhstan’s Institute for Strategic Studies, Askar Nursha summarized the situation among the Caspian states and the possible regional role for Kazakhstan, in a \textit{Central Asian Monitor} interview:

\begin{quote}
In the recent years, three issues have emerged to the forefront from the overall package of Caspian issues: the challenge of laying pipelines on the
\end{quote}

\begin{itemize}
\item \textsuperscript{67} In international law, the “median line” principle (or “equidistance method”) involves drawing a line equidistant from the closest mainland points of each of two adjacent countries. The “modified median line” principle allows small adjustments in this equidistant line to account for \textit{de facto} boundaries or for practical reasons such as to avoid splitting a single oil field between two states. International law provides two other methods to divide the seabed – drawing of lines perpendicular to the general direction of the coast, and the bisection of an angle formed by the coastline of the two states. Source: Robert M. Cutler, “Putin’s Caspian Diplomacy,” \textit{Alexander’s Gas and Oil Connections}, Vol. 6, Issue 4, February 22, 2001, at http://www.gasandoil.com/goc/news/ntco882.htm (February 27, 2008.); and Robert M. Cutler, “New Chance for Trans-Caspian pipeline,” Asia Times Online, February 28, 2007, at http://www.atimes.com/atimes/Central_Asia/IBz8Ago1.html (February 20, 2008).
\item \textsuperscript{68} Robert M. Cutler, “New Chance for Trans-Caspian pipeline.”
\item \textsuperscript{70} Ibid.
\end{itemize}
Caspian seabed, the ratio of military capacities in the Caspian littoral countries, and the likelihood of the presence of the third country military forces in the Caspian. Russia and Iran continue to be natural allies on the two of the issues—both aspire to preclude a breakthrough on the issue of Western investors laying trans-Caspian oil and gas pipelines, and prevent the emergence of extra-regional armed forces in the Caspian, especially those of the U.S. and NATO... [In this context,] the task of Kazakhstan’s diplomacy in the near future is to contribute to a compromise agreement on the South Caspian seabed delimitation, especially between Azerbaijan and Turkmenistan.71

The demarcation of the Caspian Sea is vitally important to the future of regional hydrocarbon development and energy security.

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Part Two:
The Energy Policy of Independent Kazakhstan
Kazakhstan’s Energy Strategy

Kazakhstan’s principal geo-economic value and role is that of a major oil and gas producing economy (Figures 3 and 4). Exports are projected to rise from 1 million barrels /day (mbd) in 2005 to an anticipated 3 mbd in 2015 (from 50 million tons/year to 150 million tons), putting Kazakhstan in the same category of oil exporters as Kuwait, Iran, and Iraq.

Figure 3: Oil Production and Consumption in Kazakhstan


1 Crude oil measurement units conversion: 1 million barrels per day = 49.8 million tons per year; 1 metric ton = 7.33 barrels; 1 barrel = 0.133 metric tons. Natural gas measurement units conversion: 1 billion cubic meters (bcm) = 35.3 billion cubic feet (bcf) = 0.9 million tons oil equivalent (mtoe); 1 billion cubic feet (bcf) = 0.028 billion cubic meters (bcm). Source: British Petroleum, “Conversion calculator,” at http://www.bp.com/conversionCalculator.do?&contentId=7033429&categoryId=9017919 (May 25, 2008)
Despite its large reserves of coal, uranium, gold and other precious metals, the newly established country faced a deep economic crisis when the Soviet Union disappeared from the world political map. Though Kazakhstan was a potential global hydrocarbon supplier, with the collapse of the USSR it faced energy shortages and for several years was unable to meet its domestic demands for oil, gas, fuel, electricity, and even water.

In the late 1990s, oil prices were low, and the benefits of having oil and gas fields for exploitation were limited. With crude prices falling to a minimum ($10/barrel) in the wake of the Asian economic crisis, the landlocked republic’s energy industry remained on the edge of self-sufficiency. By 1998, oil production in neighboring Russia fell to its lowest point at 250-300 million tons a year, which at that time was less than 10 percent of global production.2

Since the 1970s, Kazakhstan had served as the Soviet strategic petroleum reserve, and the Moscow-run Ministry of Geology had not explored its fields properly. Although Soviet geologists had confirmed the presence of vast oil deposits in the giant Tengiz field as early as the 1970s-1980s, the Soviet leadership had not implemented industrial-scale drilling and pipeline construction, giving priority to West Siberian fields located in Russia proper. After the collapse of the USSR, the extraction of hydrocarbons collapsed as well, with many fields standing idle. Kazakhstan’s declared policy of openness to foreign investment, and its assurances of political support for pipeline routes did not have an instant effect. International

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oil companies wanted firm guarantees for their investments, demanded protection from nationalization and introduced taxation stability clauses into their contracts.

During the first years of Kazakhstan’s independence, the country worked to establish a balance between its geopolitical vectors with the aim of protecting its national interests. At the same time, Kazakhstan was implementing an integrated development strategy, which at times may have deviated from its strategic partners’ agendas. The Kazakh government sought to ensure the proper pace of development of the country’s Caspian hydrocarbon reserves, while simultaneously implementing tax reforms and claiming preferential rights to the largest fields.

**Early Energy Policymaking**

The newly independent state faced several alternatives in the energy policy field. Kazakhstan could take the road of full nationalization of the extractive industry, as has been customary in the Middle East and other oil provinces, or it could transfer some energy assets to the private sector, which is what happened in Russia in the 1990s. Both scenarios implied turning Kazakhstan’s oil resources into a geopolitical tool. In particular, privatization involved identifying potential partners based on the geostrategic balance of the era. At the time, Kazakhstan was in a position to seek partnerships from among the global and regional players, including the American, Russian, European, Chinese, and Middle Eastern energy companies.

However, all scenarios included risks—Kazakhstan could become a “banana republic” —a raw material appendage of Russia or the West. It could also become internationally isolated and squander its energy potential.

In his 1997 annual State of the Nation address, Nazarbayev emphasized that the opportunities offered by Caspian mineral wealth included potential dangers:

> Our natural resources are an enormous wealth. Ironically, world experience shows that many countries with natural resources were not able to dispose of them properly and never came out of poverty. The East Asian countries, poor in natural resources, have demonstrated the most dynamic development. These examples highlight that the people, their will, motivation, persistence and wisdom, primarily determine the development outcome.³

³ Nazarbayev, Annual Address to the People of Kazakhstan, 2008.
Ultimately, Kazakhstan opted for a balanced approach, with proper consideration for the interests of all the world powers involved in the region, by opening access to the international oil companies. The Kazakhstani leadership considered this strategy to be consistent with the country’s foreign policy priorities, believing that Kazakhstan would be able to maintain partnerships with key players in the region and utilize oil revenues towards achieving sustainable economic development.

Russian historian Roy Medvedev described the Kazakh president’s logic most vividly:

[While] preserving reasonable state control over the economy, [Nursultan Nazarbayev] opened up many enterprises to foreign corporations. [Russian President Boris] Yeltsin has not done this—he gave out valuable assets to Berezovsky, Gusinsky, Potanin, Khodorkovsky—those who were later called oligarchs. Nazarbayev, on the contrary, was more open to foreign investment—Japanese, Korean, American, British... In return, Kazakhstan gradually began to receive quality management, new technologies, bonuses for the transactions, money from the privatization, increased salaries for the workers... Kazakhstan avoided illicit accountancy and insane oligarch wars. Russia implemented an alternative strategy of economic development based on its own forces and on international financial centers, but without their diktat. Moreover, Yeltsin pushed to destroy the foundations of the old Soviet system. Nazarbayev, in his turn, was in favor of retaining the most viable Soviet habits while thoughtfully reforming the rest.⁴

In deciding in favor of foreign direct investment, according to the Financial Times, “Kazakhstan was becoming one of the few oil-rich countries that are open to foreign companies.”⁵ In a short time, Kazakhstan undertook a series of legislative initiatives and became the most attractive CIS country for foreign investment.⁶ Interestingly, the country did not apply the model it used in opening the energy sector to foreign capital to other sectors of the economy. Thus, protectionism and

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⁵ Gorst, “Kazakh President to Visit UK”.
reliance on internal resources dominated the financial sector, the media, and other markets.7

Despite its declared policy of limiting government interference in the economy, transnational corporations contending for a slice of the “Caspian cake” had to undergo rigid screening. The Kazakh government gave preference to internationally recognized companies interested in developing long-term projects and ready to take into account the country’s domestic interests. They had to emphasize environmental safety programs, train local staff, and exercise corporate social responsibility. Transnational companies, such as ChevronTexaco, ExxonMobil, Agip/Eni, Royal Dutch Shell, British Group, TotalFinaElf, Impex and others emerged as the winners in this race.

Second-wave investors—Canadian, Middle Eastern, and Russian companies—have been rapidly establishing their presence in the Caspian region. China’s desire to strengthen its role became more obvious in 2005 and 2006, with Russia’s presence on the increase and American influence on the wane. With Chinese and Indian extractive and financial corporations entering the scene, the interests of all major world players were represented in the Caspian region.

The arrival of foreign corporations demanded the construction of a system of export oil and gas pipelines. Kazakhstan had gained independence, but it lacked a sufficient hydrocarbon infrastructure to develop the giant fields and connect it to the international oil markets. The Soviet-era oil and gas infrastructure tied it to Russia for access to ports and external markets, especially in Europe. Russia, in turn, insisted on maintaining control over the energy transportation routes and opposed any project that could provide Central Asian producers with alternative export channels. This underdevelopment of the petroleum transportation system still limits the exploration and production of the largest Caspian fields.

In order to realize the full potential of its oil fields, Kazakhstan had to assure export routes that would guarantee its ability to fill the demand for “black gold,” particularly to the West and China. Nazarbayev was also aware that respecting the interests of all the major players in the Caspian region, namely the West, Russia, and China would enhance the stability of the energy sector in Kazakhstan. This approach would facilitate a balance of power in the region, keeping major players in check.

7 Kazakhstan’s law allows foreign investment in any sector of the economy. However, the foreign capital share is limited to 25 percent in the banking sector, and to 20 percent in the mass media. Source: The Heritage Foundation, “Index of Economic Freedom,” at http://www.heritage.org/research/features/index/country.cfm?id=Kazakhstan (January 12, 2008).
Despite its strategic partnership with Russia, Kazakhstan has actively promoted economic ties with Ukraine, Georgia, and Kyrgyzstan, particularly in the area of energy supply, transit, and investment. Thus, in late 2006, KazTransOil, a subsidiary of the national oil and gas operator KazMunayGaz, signed a joint venture deal with the Batumi oil terminal in Georgia. The newly established Batumi Terminals JV, in which Kazakhstan owns a 50 percent stake, will export Kazakh oil via the Black Sea route.

Considering Washington’s close attention to the Kazakh-Iranian relationship, Astana has taken a wait-and-see position on the development of any large-scale energy projects with Teheran. Currently, Kazakhstan supplies small amounts of oil to Iran under the “swap” scheme. Kazakhstan ships some 100,000 barrels of oil a day by barge to Iranian South Caspian coast ports such as Neka, where Iran refines and uses it in the country’s northern regions. In exchange, Iran exports equivalent amounts through the Persian Gulf to the Asia Pacific region. Astana is also discussing joint construction of oil refineries in Northern Iran and in Atyrau, Kazakhstan.

The role of Kazakhstan as a reliable supplier of hydrocarbons to the global market has greatly increased since the beginning of the decade. The attacks of September 11, 2001, growing destabilization in the Middle East, and increased demand for energy throughout the world, especially in China and India, have all led to an insatiable thirst for oil, especially non-Middle Eastern oil.

**Astana Tightens Its Grip on Natural Resources**

Over the years, as oil prices went up, so did Kazakhstan’s attractiveness as an investment destination. As a result, its perceived need for unrestricted Western investment has declined and the country has started to develop policies to retain its strategic control over oil resources and improve its positions vis-à-vis Western companies. The government aspires to increase its mineral resources revenues, ensure cash flow in the event of a global economic crisis, and diversify sources of investment.

There is a sentiment among Kazakh political and intellectual elites that in the early and mid-1990s, the country entered into agreements with international oil companies that benefited the foreign investors to a much greater degree than they did the people of Kazakhstan. Furthermore, there are allegations that the terms of some of those early agreements may contradict Kazakhstan’s national interests as interpreted

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today. As the country has become stronger economically, the government has moved to changing its oil and gas legislature in ways that boost the role of the state in the vital energy sector. However, those who emphasize sanctity of contract view the issue differently. They stress Kazakhstan’s financial needs that the earlier investors satisfied, and the high degree of political risk international oil companies took on when very few people were willing to invest there on a large scale.

Reasserting the state’s role in the energy sector has taken place gradually. In 2004, the Kazakh Majilis adopted a law giving the state priority rights to acquire fields or shares in various energy projects that are up for sale. Western business interests protested. A managing partner at Denton Wilde Sapte in Almaty, a law firm specializing in oil issues, Marla Valdez, called this legislation “virtually unprecedented in other jurisdictions.”\(^9\) The state-owned KazMunayGaz has already secured its legal right to acquire a 50 percent stake in the Karazhanbas field.

In the same year, Kazakhstan also amended its Tax Code to increase the income tax imposed on oil companies from 25-30 percent to 60-85 percent. This same amendment also precluded the state from freezing tax rates on energy companies for signed deals.\(^10\)

A year later, in 2005, the Kazakh government adopted restrictions on transfers of subsoil use rights and of interests in mining companies. Article 71 of the Subsoil Law gives the state the “the right of first refusal” for the acquisition of energy assets, and prevents investors from transferring their mining rights for two years after signing a contract. In this way, the state attempts to secure its interests in the most profitable energy projects. With the same law, Astana purports to prevent investors from any particular country from dominating the Kazakh market, and to enforce a stronger control of trade in strategic commodities in the interest of the national security.\(^11\)

However, these restrictive regulations generate uncertainty among current and potential investors and may encourage corruption. Under the new rules, the state acquired part of British Gas’s share in the Kashagan project, and bought back a 33-


percent interest in PetroKazakhstan (after it had previously agreed to the China National Petroleum Company’s acquisition of the company).12

In late 2006, the government established a special department to work with major subsoil users. Its main task is to “restore the balance of interests between the state and subsoil users who initially entered into long-term lucrative contracts with substantial preferences for themselves.”13 Although these steps were not even close to the Venezuelan-style radical nationalization program, the most recent round of amendments, put forward in 2007, raised fears of a possible turn toward Russian-style “resource nationalism.”14

In July 2007, the Kazakh parliament adopted legislative amendments to enhance the state’s role in the economy and ensure effective state control over industrial assets deemed vital to national security and other interests. The law defined the types of strategic assets concerned and affirmed the government’s priority right to acquire these assets or properties.15 A special commission on “strategic assets” will issue permits for their acquisition.

In October 2007, Nazarbayev approved changes to Kazakhstan’s Law on Subsoil Resources, allowing the state to reconsider, review and revise contracts with subsoil users in a unilateral manner. Under these amendments, the Kazakh government can revoke any contract considered a threat to the country’s national security or detrimental to its economic interests. The authorities can do this either by forcing the foreign company into renegotiation or by repudiating an agreed-upon contract with two months’ notice.

The business community, unsurprisingly, has opposed these new regulations. The American Chamber of Commerce in Kazakhstan, the Kazakhstan Petroleum Association, and other investors expressed their deep concern over the legislation in a letter to President Nazarbayev. Legal experts, in turn, claim that the amended law, if enforced, would contradict several international investment treaties signed by Kazakhstan.16 This statute, the latest in what is clearly a trend, signals a change in the Kazakh energy investment climate. Astana passed it during the government’s six-month standoff with the Eni-led international consortium developing the Kashagan field, to be discussed in further detail below, in which the

13 Mergaliyeva, “Kazakhstan’s National Capital Development Problems.”
16 Watson, “Kazakhstan Looks In, Out and Shakes it all About.”
Kazakhstan: The Road to Independence

Kazakhstani authorities accused the investors of violating their contractual obligations, understating project costs, and disregarding environmental and health norms.

As a practical step toward bringing subsoil users into better compliance with the terms of their contracts, the Kazakh Ministry of Energy and Mineral Resources (MEMR) has reportedly compiled a list of current hydrocarbon development licenses in the country, ranked according to the degree to which the licensees meet their contract obligations. 17

Prime Minister Karim Massimov is enthusiastic in defending the interests of the state vis-à-vis foreign investors. Just one week after his appointment as head of the government, he made the following statement at a MEMR board meeting:

Contract terms implementation by the natural resource users is generally unsatisfactory...In this matter, we should be more rigorous and clear, and should further advance the national interest within the legal framework...
We, as a state, must carry out our tasks and obligations. 18

Nevertheless, the Caspian energy deposits are still attractive to foreign investors. To date, high demand and high prices for oil have mitigated the recent moves by the Kazakh government. Tighter regulations and increasing state involvement in the oil sector have not stopped the flow of investment. However, if an oil glut develops and energy prices decline, these policies may prompt oil companies to decrease their appetite for Kazakh crude.

The steps by the Kazakh authorities, in a larger context, mean that Astana is attempting to “regain some of its pride by reversing the humiliating production sharing agreements (PSAs) its bankrupt oil sector had to strike with international oil majors during the early 1990s.” 19 Yet, these policy changes are not about pride, but about the sanctity of contract. The PSAs, which have now fallen out of favor, especially in Russia, were about attracting foreign investors at a time when Kazakhstan was a “bridge too far” for the global oil industry. According to the existing PSAs, investors are exempt from paying royalties and some additional

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17 Ibid.
19 Watson, “Kazakhstan Looks in, Out and Shakes it all About.”
payments to the state until they recover the costs of putting the fields they have agreed to develop on stream.

While it may be possible to introduce more stringent conditions for new contracts as the market for oil tightens, it is detrimental to revise existing agreements. As the Roman legal dictum goes, “agreements are there to fulfill.”\(^{20}\) The recent Russian experience shows that overtaxing oil production leads to output declines. Vladimir Putin, in his first act as a Prime Minister, took drastic steps to reduce taxes on oil in order to stem production drops over the first four months of 2008. Kazakhstan could benefit from examining the Russian experience closely.

Foreign energy companies—the main subsoil users in Kazakhstan—oppose the government’s push for consolidating control of the energy sector. According to Robert M. Cutler, the changing investment climate in Kazakhstan has caused “a basic divergence of views... Western investors feel that the playing field has been tilted against them, while Kazakhstani actors feel that it has only been leveled.”\(^{21}\)

The Kazakh case is symbolic of a larger trend—the rise of state power in regulating hydrocarbon wealth and access to it. When markets are tight, it is easier for governments to direct revenue to their own coffers.

The Kazakh Government, however, provides the following commentary on the changes to the Law on Subsoil Use:

> The amendments have been initiated by Kazakh MPs after a substantial debate focusing on the protection of economic interests of Kazakhstan in situations where foreign partners in major deals persistently do not live up to their commitments.

> There were a lot of controversial speculations about the amendments in the energy community implying that the measure would impair the investment climate in Kazakhstan. But Kazakhstan’s Prime Minister and Energy Minister have made it very clear that the main target of the amendments are those foreign operators in Kazakhstan who ignore the legitimate economic interests of the country and do not stick to their contractual obligations. Both officials have unequivocally confirmed that the Government continues to be fully committed to the principle of sanctity of contracts.


\(^{21}\) Cutler, “Kazakhstan’s Foreign Investment Law Changes Again.”
First, the amendments will apply only to a limited number of strategically important oil blocks where subsoil user's malpractice could seriously damage the economic interests and the national security of Kazakhstan. The Government will identify such oil blocks in a special list.

Secondly, the amendments in no way affect one of the main principles and clauses of the Subsoil Law (Article 45-2) which provides for the parties to negotiate situations which affect the balance of economic interests. Should they fail to do so then the court ruling will prevail with full market compensation to the affected party if a contract is ruled as terminated because of malpractice by an operator.

Thirdly, the protecting clause of the Law, which enshrines the right to a court appeal for an operator, remains fully intact.

The Government has made it very clear that by promulgating the amendments, it has switched on the protection mechanism for situations where the nation's strategic economic interests could be seriously endangered. The best way to avoid application of the amendments is to operate and do business as per contract. The amendments will apply only to those who violate undertaken commitments.22

National oil companies (NOCs) currently dominate much of the world’s hydrocarbon market. Seven of the most influential national energy companies control almost one-third of the world’s oil and gas production and over one-third of the global oil and gas reserves.23 In marked contrast, the international oil companies (IOCs, or majors) produce some 10 percent of the world’s hydrocarbons and hold around 3 percent of reserves.24 According to estimates by the International Energy Agency (IEA), in the next four decades, the developing countries will deliver some 90 percent of new energy supplies.25 This setup emerged as a result of extensive competition between the state-owned oil giants and privately owned energy majors over the world’s limited oil and gas resources.

23 Ibid.
24 Ibid.
25 Ibid.
IOCs need to develop a business model that allows them to continue investing in Eurasia. In the near and mid-term, Kazakhstan will need foreign investment and technology, if Central Asian gas and oil providers are to meet the growing demand. For multinational companies willing to continue operating in Eurasia, future success in the region will largely depend on their ability to be more flexible, as government-owned companies are taking a more assertive role in the management of resources. IOCs also need to bring project development costs under control and meet deadlines. Finally, they need to continue leveraging their superior technical expertise to ensure autonomy and long-term staying power. These measures are the best way to achieve win-win situations for all parties.

Oil and Gas Production and Export Challenges

Despite Kazakhstan’s vast hydrocarbon endowment, there are many challenges and limitations to adequate production. For example, Uzakbay Karabalin, President of KazMunayGaz, has expressed concern about bottlenecks affecting Kazakhstan’s oil exports. The main problem is the limited export infrastructure, as Russia is still largely able to control Kazakhstan’s access to its pipeline network. In June 2002, Kazakhstan signed a 15-year oil transit agreement with Russia, under which Kazakhstan undertook to export at least 17.4 million tons per year (350,000 bpd) of crude oil using a pipeline system owned by the Russian state monopoly Transneft.26 Previously, the Russian monopoly had allowed Kazakhstan to transit only 2 million tons of oil per year via the Transneft system, and KazMunayGaz had to fight for any increases in quotas.27 Kazakhstan has been engaged in talks with Russia to expand the CPC capacity to 67-70 million tons a year from the current 28 million, 20 million tons of which comes from Kazakhstan.

Kazakhstan and Western companies have been rather successful in the development of onshore and offshore oil fields. However, several challenges interfere with the continuous growth of Kazakhstan’s oil exports. These include sulfur content, which is uneven in Kazakh oil in comparison with Turkmen oil (see Table 1).

Nevertheless, Kazakhstan’s companies are anxious to get their oil to the market separately from the Russian Urals brand, which has high sulfur content. Currently, this issue is in limbo due to the insufficient capacity of quality banks (these are facilities for separating oil with different chemical parameters, particularly sulfur

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While the Chevron-dominated Caspian Pipeline Consortium (CPC) built a quality bank, thus resolving the issue for its exports, the Russian pipeline monopoly Transneft stubbornly refuses to do so, denying Kazakhstan hundreds of millions of dollars in revenue.

### Table 1: Quality of Kazakh and Turkmen Oils

<table>
<thead>
<tr>
<th>Country</th>
<th>Oil Grade</th>
<th>Density (20°C) kg/m³</th>
<th>Sulfur content (%)</th>
</tr>
</thead>
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<tr>
<td>Kazakhstan</td>
<td>Tengiz</td>
<td>812.3</td>
<td>0.53</td>
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<tr>
<td></td>
<td>Kulsary</td>
<td>790</td>
<td>0.07</td>
</tr>
<tr>
<td></td>
<td>Kalamakas</td>
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</tr>
<tr>
<td></td>
<td>Karazhanbas</td>
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<td>2.1</td>
</tr>
<tr>
<td></td>
<td>Martyshy</td>
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<td>0.27</td>
</tr>
<tr>
<td></td>
<td>Zaburunje</td>
<td>895.8</td>
<td>0.59</td>
</tr>
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<td></td>
<td>Uzen’</td>
<td>855</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td>Zhetybaj</td>
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<tr>
<td></td>
<td>Kumkol</td>
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<td>Turkmenistan</td>
<td>Kotur–Tepe</td>
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<td></td>
<td>Cheleken</td>
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</tr>
<tr>
<td></td>
<td>Nebit–Dag</td>
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<td>0.15</td>
</tr>
<tr>
<td></td>
<td>Barsa–Gelmes</td>
<td>865</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td>Okarem</td>
<td>873.5</td>
<td>0.17</td>
</tr>
</tbody>
</table>


From an environmental point of view, drilling for oil and gas in the Caspian presents particular problems. The Caspian seabed is uneven. In the north, oil fields are located just 15 meters (45 feet) under the seabed; and the sea is only 5-10 meters (15-30 feet) deep, and it freezes in winter. In the southern portion, the depth of the
sea increases quickly to about 500 meters. In addition, there are underwater mud volcanoes—a unique geological phenomenon, which can cause powerful explosions, endangering offshore fields. These volcanoes may also generate methane hydrate—a potential energy source.

While estimated oil reserves in the region rank below the Persian Gulf and Siberia, and despite transportation bottlenecks, oil companies are looking favorably to the Caspian region because of its higher level of political and managerial stability. Another important reason why international oil companies favor the Caspian is that the governments in the region are relatively easy to deal with in comparison with the volatile Middle East, Russia, and parts of Latin America.

28 Sieff, “Interview: Kazakhstan’s Oil Company Chief.”
Kazakhstan’s growing oil exports reach all major markets via the Black Sea and the Persian Gulf, as well as through Russia and to China. Out of some 1.2 million barrels per day in Kazakh oil exports, over 80 percent goes via Russian-controlled pipelines (most importantly the CPC and the Atyrau-Samara pipeline) and by railroad to Russian and Ukrainian ports. Kazakhstan exports another 75 thousand barrels per day from its port of Aktau by small-capacity tankers to several destinations across the Caspian Sea, mainly Baku in Azerbaijan, and Neka in Iran. From Baku, the suppliers deliver oil by railroad to the Georgian terminals of Batumi and Kulevi on the Black Sea.¹

Map 1: Oil Pipelines and Infrastructure of the Caspian Region


¹ Ibid.
Kazakhstan also pumps a growing volume of crude oil (some 4.5 million tons or 85 thousand bbl/day in 2007) via the Atasu-Alashankou pipeline to China. (Map 1 on the preceding page shows the oil transportation infrastructure of the Caspian region, and Figure 5 below shows the distribution of Kazakh oil exports by destination).

**Figure 5: Kazakh oil exports by destination, 2007**

(thousand barrels per day)


In March 2007, Russia and Kazakhstan signed a protocol to maintain 15 million tons per year in Kazakh oil exports via the Atyrau-Samara pipeline, while agreeing to the expansion of the CPC capacity. With shipments expanding as planned, Moscow will largely maintain its control over Kazakh hydrocarbon exports in the years to come.

President Nazarbayev emphasized during his visit to Moscow in 2007 that Russia and Kazakhstan are partners, not competitors. Astana, as a junior partner, is reluctant to engage in head-to-head competition with Russia in terms of oil and gas exports, and continues to rely on its northern neighbor’s pipelines. Some regional experts, however, believe that Moscow is pressuring Astana into over-dependence on the Russian pipelines, rather than allowing it to seek alternative routes. Thus,

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3 Ibid.
Kazakhstan offered only tepid endorsement of extending the Odessa-Brody oil pipeline into Poland, or launching a Western-backed trans-Caspian gas pipeline (TCP). Kazakhstan’s weakened interest in the alternative projects is a product of both Russia’s pressure and lack of clear strategic commitment by the European Union to pipeline projects in Central Asia and Kazakhstan in particular.\(^4\)

In February 2007, US Deputy Assistant Secretary of State Matthew J. Bryza underscored Kazakhstan’s own interest in diversifying export outlets for its oil and gas to end Russia’s transit monopoly. The country’s geo-economic interest is compatible with the West’s imperative to avoid dependence on a Russian energy monopoly.\(^5\) The expansion of the CPC’s capacity and construction of the (gas) TCP—both major westward-oriented export pipelines—are needed to accommodate the growing production of Kazakhstan’s oil and gas fields.

Second-wave investors—Canadian, Middle Eastern, and Russian companies—have been rapidly defining their presence in the Caspian region. China’s desire to strengthen its role became more obvious in 2005 and 2006, with the Russian presence increasing and American influence on the wane. With Chinese and Indian extractive and financial corporations entering the scene, the interests of all major world players were present in the Caspian region.

According to the BP 2007 Statistical Review of World Energy, in 2006, Kazakhstan accounted for 0.8 percent of total world natural gas production with its output of 23.2 billion cubic meters of gas (the equivalent of 21.5 million tons of oil). In oil production, Kazakhstan accounted for 1.7 percent of world output (with its 1,426 million barrels daily or 66.1 million tons).\(^6\) The country estimated its gas production at 29 billion cubic meters of natural gas in 2007, and outlined ambitious hydrocarbon production growth plans for the decade ahead. However, a number of factors, including delays in the development of major fields and insufficient access to ports and the international markets, have limited Kazakh oil production growth.

**Comparison of current export options.** Currently, the cheapest route for Kazakhstan’s oil exports is via the Atyrau-Samara pipeline, which connects to Russia through its oil pipeline network. KazTransOil with Transneft own it. The transit tariff is $0.73/ton /100km, which translates into around $2-3 per barrel excluding the tariff

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through Kazakhstan. However, both the capacity of the Atyrau-Samara pipeline and current agreements between Russia and Kazakhstan limit shipments through this route to 15-17.5 million tons a year. For this reason, government-owned or affiliated oil companies get priority rights to its use.

The second most feasible route is the CPC, with its tariff established at $3.70 per barrel. Use of the CPC’s capacity, however, is restricted to CPC members; and while they may reassign their capacity to third parties, this requires the approval of all members of the Consortium.

Another alternative is for Kazakh producers to ship oil from the port of Aktau in western Kazakhstan across the Caspian Sea to the eastern shore ports (Baku/Makhachkala), and from there onwards by rail to the Russian port of Novorossiysk or the Georgian port of Batumi. The Baku-Novorossiysk oil pipeline has a limited throughput and cannot be a strategic export route. Another lucrative trans-Caspian export pipeline—the Baku-Tbilisi-Ceyhan (BTC)—became available in 2005. The total expense of shipping though the BTC pipeline amounts to $3-4 per barrel, including tanker and offloading costs.

Iran represents a profitable, albeit politically complicated export route. Kazakhstan may export to the South-East Asian markets by conducting oil swaps with Iran. After Iran completes the construction of its domestic pipeline system, the estimated volume of Kazakhstan’s oil transit via the southern ports of Iran could reach 500,000 bpd. However, Russian companies that also use this route will offer stiff competition. At the same time, the U.S. will certainly object to an increase of Kazakhstan’s oil exports to Iran, considering Washington’s current sanctions regime against Iranian oil and gas investment projects, caused by the non-transparent Iranian nuclear program and deep geopolitical disagreements with Teheran. Therefore, whether Kazakhstan can utilize the southern export route via Iran remains an open question.

Oil swaps with Iran are a rather efficient shipment option for the Caspian basin producers. These swaps make a lot of sense for the Iranian side, considering that most of Iran’s refineries and petrochemical complexes are located in the country’s northern and central regions, while the principal oil fields are in the south. Swap deals enable Iran to supply its refineries at a lower cost, while generating income for handling swap operations and transit.

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7 “Kazakhstan planiruyet exportirovat’ svoyu neft cherez yuzhnye porty Irana” [Kazakhstan Planning to Export Oil Via Southern Ports of Iran], Iran News, October 4, 2004, at www.iran.ru (December 20, 2007).
On average, the transportation of oil swapped with Iran costs about $4 per barrel, including a swap fee of approximately $3 per barrel, tanker shipments to Neka, and an offloading fee. Independent oil companies, such as Dragon Oil, Burren Energy, and PetroKazakhstan all utilize these swaps. Moreover, Russia’s Lukoil recently announced plans to build a 3 million-ton-a-year export terminal in Astrakhan, located in the north of the Caspian Sea, with an eye to the Iranian route via the Neka port.

An old pipeline with a capacity of 50,000 bpd connects Neka to Teheran’s oil refinery. In 2004, a Chinese consortium built a new pipeline to the town of Sari with a similar capacity of 50,000 bpd. The Neka-Sari section is the first phase of the new three-phase Neka-Teheran pipeline (392km).8 After several expansions, the capacity of this route reached 170,000 bpd. According to the National Iranian Oil Company (NIOC), the total capacity of the Neka-Teheran pipeline will reach about 500,000 bpd if the company builds additional pumping stations.9

Kazakhstan has launched Kazakhstan Caspian Oil Transport System (KCOTS), which includes building a fleet of five oil tankers for the Caspian Sea, having declared that it will use them to supply the BTC pipeline (see discussion below). However, the Kazakh oil fleet could just as easily supply the Iranian system, if Kazakhstan manages to overcome American opposition. Russia is also eager to maintain its influence over the energy transit routes from the Caspian Basin. The Kremlin has pressed Nazarbayev to agree to a 15-year deal under which Kazakhstan would commit to exporting at least 15 million tons of crude oil per year via the Baku-Novorossiysk pipeline.10

New pipelines for hydrocarbon delivery are essential to ensure Kazakhstan’s political and economic freedom. In the current geopolitical situation, the Kazakh government has focused on developing or integrating the country’s oil exporting system with the three most promising oil transportation routes—the CPC to the port of Novorossiysk on the Black Sea, the BTC pipeline to the Mediterranean via Azerbaijan, Georgia, and Turkey, and the Atasu-Alashankou pipeline to China.

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9 “Caspian ‘Big Three’ with ‘Oil Shield.’ Baku-Tbilisi-Ceyhan is the most strategic Caspian pipeline, think Russian investment companies,” at http://www.caspenergy.com/28/2005_01_10_00e.htm (December 20, 2007).
The interests of the major regional players—Moscow, Washington and Beijing—were behind each of these pipeline projects.

**The Caspian Pipeline Consortium (CPC)**

When production began at the Tengiz and Karachaganak fields, oil exports via Russia were the most cost-effective and politically viable. Focusing on energy cooperation with its northern neighbor allowed the fastest launch of oil deliveries to the world markets. The close Kazakh-Russian integration in the oil and gas sector is a strategic choice made by the two governments, reflecting the most stable relationship in the CIS.

At present, 100 percent of Kazakhstan’s gas exports and 90 percent of its oil exports go to or via Russia.\(^\text{11}\) The 1580 km CPC pipeline runs through the territory of Russia and Kazakhstan, connecting Kazakhstan’s Tengiz and Karachaganak oil fields with the Black Sea port of Novorossiysk. This $2.6 billion pipeline was the largest single US investment in Russia at the time of the project launch in 1999.\(^\text{12}\) (For the composition of the CPC see Table 2; for the route of the pipeline, see Map 2.)

**Map 2: The Caspian Pipeline Consortium**


The CPC has a complex organizational structure. Three governments and ten companies representing seven countries participate in the project. The partners created two joint stock companies—CPC-R (Russia) and CPC-K (Kazakhstan)—to implement the project. In April 2007, the Russian Federal Property Management

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\(^{11}\) Socor, “Discussions Intensify with Kazakhstan on Trans-Caspian Gas Pipeline.”.

Agency transferred the management of its 24 percent stake in the CPC to Transneft.\(^{13}\) The oil companies funded the initial construction of the pipeline, combined with assets provided by the host governments. CPC’s revenues will finance future expansions of the pipeline.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shareholder capital (%)</th>
</tr>
</thead>
<tbody>
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<td>Russia</td>
<td>24%</td>
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<tr>
<td>Kazakhstan</td>
<td>19%</td>
</tr>
<tr>
<td>Oman</td>
<td>7%</td>
</tr>
<tr>
<td>Chevron Caspian Pipeline Consortium Co</td>
<td>15%</td>
</tr>
<tr>
<td>Lukarco B.V.</td>
<td>12.50%</td>
</tr>
<tr>
<td>Mobile Caspian Pipeline Co</td>
<td>7.50%</td>
</tr>
<tr>
<td>Rosneft-Shell Caspian Ventures Ltd.</td>
<td>7.50%</td>
</tr>
<tr>
<td>Agip International (N.A.) N.V.</td>
<td>2%</td>
</tr>
<tr>
<td>Oryx Caspian Pipeline LLC</td>
<td>1.75%</td>
</tr>
<tr>
<td>BG Overseas Holdings Ltd.</td>
<td>2%</td>
</tr>
<tr>
<td>Kazakhstan Pipeline Ventures LLC</td>
<td>1.75%</td>
</tr>
</tbody>
</table>


The CPC is unique to the region, in that it is a producer-owned pipeline—financed and constructed on behalf of a group of shareholders, who have or expect to have oil to transport. This is radically different from the existing regional pipeline systems that are common-use facilities and transport crude oil belonging to third parties. A comprehensive shareholder agreement governs CPC and defines the contractual obligations of all parties. CPC tariffs are set based on agreements among the shareholders and not established by a regulatory authority.

The CPC has substantially benefitted the host governments. For Kazakhstan, the CPC allowed major oil-field developments to proceed, bringing with them substantially increased royalties and taxes, ensuring through a quality bank that Kazakhstan receives full value for its light oil, and reducing the cost of transportation in comparison with rail tariffs. For Russia, the benefits have also been substantial. The project activity has brought multi-million dollar inflows in tax revenues, export duties, fees, and charity donations. CPC participants have rehabilitated and substantially upgraded the Russian oil transport facilities involved in the project. The Russian economy gets some $90 million annually from the CPC’s operational expenditures. Experts estimate that each dollar spent by the CPC on goods and services provided by Russia can generate an additional $2 of incremental GDP, i.e., the total positive impact is three times larger than the direct one.14

On October 13, 2001, the CPC loaded its first tanker of crude oil at its Marine Terminal near the Russian city of Novorossiysk on the Black Sea. This event marked the start of shipping crude oil to the international markets. Moreover, it launched a comprehensive testing and commissioning program for the Marine Terminal. On September 13, 2002, the CPC launched an oil quality bank. In doing so, the CPC established a free market mechanism in the region that allows every supplier to obtain the real market value for their oil, and ultimately provides greater returns for all of the CPC’s shareholders.

In 2003, the first phase of the CPC pipeline system began regular operations. On April 28, 2003, CPC’s management announced the conclusion of the first stage of CPC construction—Project of Initial Construction (PIC), with an estimated capacity of up to 28.2 million tons a year. The State Acceptance Commission (a Kazakhstan government body, which deals with construction quality inspection) verified that the pipeline successfully met all construction, safety, and environmental protection standards. By mid-2004, the CPC pipeline had reached its full initial capacity.

In November 2004, CPC commenced the injection of Russian oil into the system at the town of Kropotkin in Krasnodar Krai (region). Russia expected to inject oil volumes of up to 6 million tons a year in 2005, providing an additional and valuable export outlet for Russian crude, with taxes and export duties paid to the government. The Consortium subsequently experienced revenue losses due to mixing high-quality Kazakh oil with lower-quality Urals oil blend, injected into the

pipeline en route to Novorossiysk;\textsuperscript{15} but Russia has not compensated the Consortium for this loss.

Since the pipeline began operations, it has transported over 1 billion barrels (more than 143 million tons).\textsuperscript{16} However, the CPC’s current capacity will not be able to accommodate the increasing volumes of oil from Kazakhstan’s Tengiz and Karachaganak fields.

\textbf{CPC expansion.} From the outset, CPC shareholders planned that the pipeline would expand 2.5 times above its initial capacity, to be ultimately able to transport up to 67 million tons of oil per year. This expansion would involve the construction of new pump stations, storage facilities, and a tanker-loading buoy at the CPC’s Marine Terminal at Novorossiysk. In fact, for the shareholders—both governments and companies—expansion is vital to the realization of the CPC’s full economic potential. Developing the pipeline to reach its full projected capacity, however, has not been smooth due to Moscow’s lack of support and cooperation in the needed upgrades.

Initially, according to Dr. Sergey Luzyanin of the Moscow State Institute of International Relations (MGIMO), Russia and Kazakhstan reached a compromise, under which Russia received a small part of the (formerly Kazakh) Kostanay region, thus completing the border demarcation agreement. In exchange, Kazakhstan secured Moscow’s endorsement for increasing the capacity of the CPC, which, according to the Russian expert, was not beneficial for Russia.\textsuperscript{17} In practice, the CPC’s expansion would have also considerably increased oil transit benefits to Russia as well as Kazakhstan. Even at the 2005 tariff levels, pumping 67 million tons per year would generate well over $1.5 billion annually in transit revenue, providing both host governments with a high level of secure income.

Nevertheless, Moscow has stalled progress in expanding the CPC, to the great discontent of other Consortium shareholders, including Kazakhstan. Moscow’s pressure on the Western partners concerning issues ranging from increasing tax claims to redistribution of management posts in its favor prevented the parties from moving forward.

Disagreements between Russian companies and their Western partners in the CPC over the terms of the pipeline’s expansion and use across Russian territory intensified in 2007, centering on the following issues:

- Russia advocated increasing the transport tariff (from $24.6 to $38 per ton of oil) on the pipeline’s Russian section.

- Russia demanded lowering the interest rate from 12.66 percent to 6 percent per year on the loans from private companies for the pipeline’s construction.

- Russia requested that the CPC consortium issue $5 billion in Eurobonds to refinance the pipeline’s debts (much of which accumulated due to Russian-imposed terms of use since 2001).

- Russia demanded changes to the CPC charter in order to increase the powers of Russian government-nominated representatives within the Consortium.\(^\text{18}\)

The Russian state monopoly Transneft has also conditioned agreement to expand the pipeline’s capacity upon commitments on the part of the CPC partners to co-finance the new Russian-controlled Bourgas-Alexandroupolis pipeline project and agree to utilize it for their oil exports.\(^\text{19}\)

**The Bourgas-Alexandroupolis pipeline.** The Bourgas-Alexandroupolis oil pipeline, agreed upon by Russia, Bulgaria and Greece in March 2007, will, if realized, be the first Russian-controlled pipeline on EU territory.\(^\text{20}\) With an initial capacity of 15 million tons of oil per year, and 35 million tons in the second stage, the pipeline will bypass the Turkish-controlled, congested Bosphorus Straits. Its projected capacity corresponds to the proposed CPC expansion volumes. This demonstrates Russia’s intent to direct growing volumes of Western-extracted oil from Kazakhstan into Russian-controlled transit routes, thus capturing additional revenue. Moscow wants the new pipeline to become a Russian-controlled extension of Kazakh oil’s route from Novorossiysk westward. The project rivals the US-backed trans-Caspian oil pipeline, which would provide an export route for the oil from the Caspian’s eastern shores to the Baku-Tbilisi-Ceyhan pipeline, bypassing Russia.

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\(^\text{18}\) Socor, “Transneft Squeezing Oil Majors.”


The Western partners in the CPC could commit to Bourgas-Alexandroupolis only if there is simultaneous capacity expansion of the CPC.\textsuperscript{21}

In May 2007, during Putin’s “regional energy diplomacy tour” of Central Asia, he convinced Astana to commit its future oil export to Russian-controlled pipelines, and a deal was struck under which Kazakhstan will pump most of its future oil output through Russian territory and the Bourgas-Alexandroupolis pipeline.\textsuperscript{22}

This paved the way for preliminary agreements on concurrent Bourgas-Alexandroupolis pipeline construction (insisted upon by Russia) and CPC pipeline expansion (insisted upon by Kazakhstan), adding points to Moscow’s scoreboard in the race to build a Bosporus bypass.\textsuperscript{23} For other CPC shareholders, including Chevron, the benefits of the agreement between Putin and Nazarbayev were somewhat dubious. On the one hand, the shareholders see any progress in expanding the CPC’s capacity as a plus in an era of record energy prices. On the other hand, a forced commitment to transport oil via the Bourgas-Alexandroupolis pipeline imposes additional costs on Western oil producers.

Lacking alternative routes, however, the oil exporters are vulnerable to Moscow’s pressures. CPC shareholders reached a major milestone in September 2007 by agreeing to increase oil transit tariffs through the Russian territory, and to reduce loan interest rates (from 12.66 to six percent).\textsuperscript{24} Thus, a debt-restructuring and tariff-raising deal between the owners paved the way for CPC expansion, while solidifying Kazakhstan’s commitment to Bourgas-Alexandroupolis.

In December 2007, Kazakhstan and Russia finally agreed on expanding the CPC’s capacity to 67 million tons of oil per year (or 1.34 million barrels of oil per day). Moscow dropped its opposition to the pipeline expansion after Kazakhstan agreed to take a stake in Bourgas-Alexandroupolis and help supply it.\textsuperscript{25} Kazakhstan also reportedly agreed to double its oil exports through the Atyrau-Samara pipeline, from 10 to 20 million tons per year. Overall, these deals will allow Kazakhstan to unlock its crude output growth potential while increasing Moscow’s revenue.

\textsuperscript{21} Socor, “Transneft Squeezing Oil Majors.”
\textsuperscript{23} \textit{Ibid}.
\textsuperscript{24} “CPC Shareholders Agree to Position on Oil Transport Rate Increase,” Central Asia General Newswire, February 20, 2008 at LexisNexis (February 21, 2008).
Prospects for the CPC. While Russian authorities have doubted the expediency of the CPC project, the Consortium’s projections promise high future profitability. The Consortium originally based CPC’s economic projections on a full build out of the system, with the assumption that the final stage of the project would become operational in 2014. In fact, volume forecasts for the next five years require individual expansion stages to be compressed, so that full system build out is likely to take place much earlier than predicted. This means that the projected rate of return for the CPC may remain robust and exceed original assumptions.26

As the CPC pipeline traverses Russian territory, Moscow views it as a politically significant project in the Caspian. The CPC entrenches Russia’s influence on oil producers and consumers. It also acts as a counterbalance to the BTC oil pipeline, which is favored by Turkey and the United States. Moscow takes a dim view of the BTC, which is located outside Russia’s borders, and thus “deprives” Russia of transit revenues (a fully functional BTC could reduce Russia’s current Caspian oil transit by one-third).27 Moscow has described the BTC project as an American effort to make the Caspian a “Western reservation.”

The Baku-Tbilisi-Ceyhan (BTC) pipeline

The BTC is a major project intended to diversify the regional pipeline network, for which the U.S. has provided key technical and political support. Political maneuvering to ensure the BTC’s launch started in 1994, but construction began only in September 2002, almost immediately after the CPC’s launch. BTC operations began in May 2005. Though the pipeline, connecting the capitals of Azerbaijan and Georgia to the Turkish Mediterranean port of Ceyhan, has no direct access to Kazakhstan’s fields, Kazakhstani oil may fill up to 50 percent of its projected capacity.

On June 16, 2006, approximately one month after a visit by US Vice President Richard Cheney to Kazakhstan, Astana announced a long-awaited decision to join the BTC project, supplying oil via tankers across the Caspian.28 The agreement, signed on January 24, 2007, created the Kazakhstan Caspian Oil Transport System

(KCOTS), discussed below. Kazakhstan’s annual supply volume will reach some 500,000 bpd, or almost half of the BTC’s initial capacity.

According to conservative estimates, a functioning trans-Caspian oil pipeline connecting to the BTC would lower Kazakhstan’s transportation costs by $125 million per year, in addition to increasing revenues due to higher export volume. Until the 800-kilometer pipeline becomes operational, however, tankers will transport the oil across the Caspian Sea to Baku, Azerbaijan. Kazakhstan may be willing to initially ship some 23 million tons of oil per year by tanker, and raise it to some 38 million tons of crude oil a year when the Kazakhstan Caspian Oil Transport System is finished. Oil for the BTC will mainly come from the Kashagan field.

For Astana, participation in the BTC has a clear advantage. With oil from Kazakhstan, the BTC will maintain enough flow to become profitable and will validate the US and UK-led efforts to build a Caspian pipeline bypassing Russia. Participation empowers Kazakhstan as a sovereign petroleum producing country by lessening its dependency on the increasingly monopolistic Russian pipeline system.

Moscow’s acceptance of the BTC’s existence, although late and reluctant, has become a political challenge for Iran, which was hoping for Russia’s support in the construction of another oil pipeline—from Kazakhstan through Iran to the Persian Gulf—a pipeline that the U.S. opposed on political grounds. Moscow, as Teheran’s main civilian nuclear technologies and arms supplier, is in a favorable position to influence Iran and alleviate tensions in Azerbaijani-Iranian relations over maritime borders and oil reserves.

The Atasu-Alashankou pipeline

The Atasu-Alashankou is Kazakhstan’s third export route that goes in an eastward direction towards China. It took only 15 months to build this 1,000 km pipeline from Western Kazakhstan to Southern China—a record time for such a project. While some experts raise safety and environmental concerns over the pipeline, its benefits are certainly compelling. Map 3 shows the route of the pipeline.

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29 Ibid.
The Atasu-Alashankou, which became operational on December 15, 2005, transported 1.8 million tons of Kazakh oil to China within its first year of operations. By the year 2010, the volume of oil supplied to China will rise to 20 million tons annually. Kazakhstan is considering building a second phase of the pipeline linking the Kumkol oilfields with Atasu.31

China has also invested some $800 million into a new pipeline that will take Kazakh oil to the Chinese border. In December 2005, the first section of the new pipeline, built under the terms of an earlier Kazakhstan-CNPC agreement, connected the Kazakh fields to Northwest China (Xinjiang or Atasu, as Kazakhstan calls it). This pipeline, 998 km in length, with a capacity of 250,000 barrels per day, will connect to the trans-China pipeline. Implemented as planned, the project will form the longest oil pipeline on the planet, extending for 4,300 km.32 Much of the oil needed to fill the pipeline will come from the Kumkol fields, and from Chinese-owned oil deposits in the Aktobe region of Western Kazakhstan. However, China needs additional volumes of Russia’s Siberian oil to make the pipeline profitable. The endeavor requires a great deal of diplomatic skill not only

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from Beijing, but also from Astana. This pipeline could eventually redirect a sixth of Kazakhstan’s total oil output to China, and offer an extra oil export route to reduce Kazakh dependence on Russia, Azerbaijan, and Turkey as transit countries.

The geopolitical repercussions of the Atasu-Alashankou pipeline are comparable to those of the BTC. This may be the reason why the Chinese government is financing this $3 billion project ahead of schedule. When completed, Kazakh oil will fill the trans-China pipeline, currently under construction to bring oil to Xinjiang and Shanghai. China and Kazakhstan are also planning to build a gas pipeline from Kazakhstan to Xinjiang (discussed in later sections).

The main advantage of the new line to Xinjiang is that it directly connects the supplier with the consumer, significantly reducing tariff and taxation costs and, more fundamentally, excluding any third party interference. For this reason, the pipeline faced only minimal political resistance from the U.S. and Russia, balancing the energy appetites of the major regional players.

The Trans-Caspian Oil Pipeline (TCP-oil)

The US government and international oil companies are advocating an ambitious and politically sensitive project to build a trans-Caspian oil pipeline linking Baku, Azerbaijan, and Aktau, Kazakhstan, across the Caspian. If implemented, the project will increase the volume of oil pumped west, through Azerbaijan, Georgia, and Turkey, from 30 million to 50 million tons per year. Considering that Kazakhstan’s accession to the BTC, even via a tanker link, has led Moscow to understand that Kazakhstan has a number of export options, the construction of the underwater pipeline would give Astana the necessary balance between Moscow on the one hand, and Brussels and Washington on the other.

The underwater pipeline across the Caspian Sea would meet Kazakhstan’s need to expand its export capacity beyond the partial answers provided by expansion of the CPC and the Atyrau-Samara pipelines. The following statement by KazMunayGaz ex-President Uzakbay Karabalin describes the connection:

KazMunayGaz is examining the possibility of building a trans-Caspian oil or gas pipeline from Aktau to Baku. All littoral states: Azerbaijan, Russia,

Turkmenistan, Iran, and Kazakhstan should agree upon this construction project... However, I cannot agree that this issue hinders the expansion of Kazakhstan's export capacities. As we know, Kazakhstan intends to extract at least 150 million tons of oil per year (3 million bpd) by 2015. The land pipelines could manage the growing export volumes if all the known projects come on stream. These necessary developments include the CPC expansion with the Tengiz-Novorossiysk link, increasing the Atyrau-Samara pipeline capacity, and construction of the second stage of Atasu-Alashankou.35

Understanding the importance of the project, Russia has made a number of statements demanding a decisive voice in future trans-Caspian infrastructure projects—a position the Caspian littoral states reject, at least in theory.

Some analysts have recently suggested that after Kazakhstan’s Senate ratified an energy export treaty with Azerbaijan in April 2008, attention in Astana may be seriously shifting to a trans-Caspian oil transport route.36 The agreement deals with a potential oil export route that would build upon the freshly negotiated Kazakhstan Caspian Transportation System (see discussion to follow).

Other Oil Transport Projects

The marketing prospects for Caspian oil are not limited to the main existing export routes. In the 1990s, Kazakhstan abandoned a potentially lucrative project to build an oil pipeline via Turkmenistan to Iran due to continuous tension in the Middle East, and further destabilization in Iraq.37 Another export route, in the direction of Pakistan and India, is still hypothetical due to the extremely high risks associated with laying a pipeline through war-torn Afghanistan and unstable Pakistan. Moreover, historical tensions between Afghanistan, Pakistan, and India have prevented companies from assuming significant financial and political commitments. A change in the Middle Eastern and Central Asian geopolitics

regarding Iran, Afghanistan and Pakistan respectively could make a difference for these prospective routes.

**The Kazakhstan Caspian Transportation System (KCTS).** Kazakhstan needs to build up the Caspian coastal infrastructure to support its growing oil shipments across the Caspian Sea, especially when the Kashagan field comes on stream. On January 24, 2007, KazMunayGaz, TengizChevroil, and Agip KCO signed a memorandum of understanding in Astana to establish the Kazakhstan Caspian Oil Transport System (KCTS). The parties plan the KCTS as an internal pipeline connecting Eskene, Western Kazakhstan, to the Kuryk terminal, south of Aktau, the main Kazakhstani port on the Caspian. The Kuryk Bay provides a natural shelter that makes possible uninterrupted operations in winter and during storms. The suppliers will transport oil from Kuryk and Aktau by small capacity tankers across the Caspian to Azerbaijani ports and pump it into the Baku-Tbilisi-Ceyhan pipeline.

As part of the project, the parties agreed to build the needed oil tankers and barges, as well as the requisite oil transport infrastructure on Kazakhstan’s Caspian Sea coast, and oil terminals on the Azerbaijani side of the sea. The project may cost up to $3-4 billion. The system’s initial capacity will be 25 million tons a year, with a potential increase to 38 million tons. The parties expect the KCTS to become operational in 2010 or 2011, in time to provide an export route for the Kashagan field’s oil output.\(^38\) The system will primarily transport oil from Tengiz, Kashagan and the adjacent oilfields.\(^39\) According to the KazMunayGaz ex-President Karabalin, KCTS is a significant endeavor for Kazakhstan, as it “will further diversify hydrocarbon export routes.”\(^40\)

Increasing the volume of trans-Caspian oil shipments, even by barge and tankers, may enable Kazakhstan to ship oil to the Georgian Black Sea port of Supsa, and from there, via the Black Sea, eventually through the Odessa-Brody and planned Constanta-Trieste pipelines, in addition to BTC.


The Odessa-Brody pipeline. This route could help Astana sell up to 9 million tons of oil per year in the Polish and Baltic markets, and could allow Kazakhstan to deliver oil to Odessa via Azerbaijani and Georgian Black Sea terminals, outside of the Russian pipeline system. The full capacity of the extended Odessa-Brody-Gdansk pipeline depends heavily on the availability of Kazakh oil. However, some experts doubt that the pipeline can become profitable, even with Kazakh supplies.41 To Poland's great surprise, in 2007, Nazarbayev conditioned his cooperation in Odessa-Brody on Russia's participation in the project.42 Russia, in turn, is interested in reversing the flow of the pipeline, to export Russian oil via the Black Sea to the European markets.

Recent official statements and actions coming from Astana suggest that, when deciding on future pipeline projects, Kazakhstan may be increasingly prioritizing its strategic relations with Moscow above its declared intention to diversify energy export routes. However to date, Kazakhstan’s multi-vector energy policy, including the work it has done to pursue diversified oil export routes, has paid off. Nevertheless, Russia has remained Kazakhstan’s primary partner in energy transit, and Russian dominance of the Central Asian energy routes will increase with CPC’s expansion. As a result, opening a direct trans-Caspian oil export route to ship the growing crude volumes and avoiding Russian control becomes a priority for the West.43

42 Socor, “Moscow Pressuring Kazakhstan to Frustrate Westbound Energy Transport Projects.”
Major Onshore and Offshore Oil Projects

Since the early 1990s, Kazakhstan has led the way in attracting foreign investment in the oil and gas sector. Unfortunately, some Russian politicians and oil industry captains appear to resent the quick pace of development and growing outputs of Kazakhstan’s fields, based on a win-lose zero-sum mindset. Western oil companies, which took great risks by investing in Eurasia while the markets were soft, have reaped profits since oil prices began rising in 2001.

The Tengiz Field

By the end of the 1980s, when perestroika opened the prospects for foreign direct investment, the US-based Chevron Corporation began to pursue opportunities to develop the Tengiz field, which had the potential to double Chevron’s petroleum assets, in earnest. Over five years, beginning in 1988, Chevron re-started negotiations three times—first with the Soviets, then with the Russian government, and finally, with the Kazakhs.

Perseverance paid off. The 1993 agreement between the Government of Kazakhstan and Chevron Corporation marked the entrance of American capital into the post-Soviet space. On April 2-6, 1993, the parties signed statutory documents to establish the TengizChevron joint venture.

Kazakhstan’s legislative framework and business environment were still taking shape during the first years of the country’s independence. Chevron based its Tengiz development contract not only on signed and written agreements, but also on President Nazarbayev’s personal credibility and guarantees. He managed to convince the Western partners that in the future his country would adhere to a consistent and transparent policy on hydrocarbons. This deal laid the first stepping stone in Nazarbayev’s energy strategy, intended to combine the economic development experience of the “Asian tigers” with the high-tech economic sophistication of Norway.
The Tengiz contains some 1.13 billion tons of recoverable oil reserves, which makes it the sixth largest oil field in the world. The field’s development, however, has faced several serious difficulties, including:

- **Infrastructure:** Despite the fact that exploration had already started by the time the parties formalized the deal, Chevron had to rebuild the operation from scratch because the main production facilities and social infrastructure, such as schools and hospitals, at that time, did not meet international safety and environmental standards.

- **Geopolitics and pipelines:** The underdevelopment of the pipeline system and its restriction to the Russia-controlled Atyrau-Samara route has severely constrained oil exports.

- **Climate and geology:** West Kazakhstan’s strongly continental climate, wide seasonal temperature variations and constant powerful winds have complicated oil extraction. Strong flows of natural gas and sour gas have accompanied drilling at a depth of three to five kilometers.

- **Demographics:** An insufficient pool of qualified workers in the immediate area forced the company to organize its 3,600 workers in shifts.

- **Geography:** Kazakhstan’s landlocked position makes oil exportation and transportation more complicated, as it is not possible to deliver large components such as rigs and offshore platforms by ocean going cargo ships.

Initially, Chevron faced all these project challenges alone and, at times, the management considered terminating the venture. However, as Chevron soldiered on, other foreign companies, including ExxonMobil and Lukoil, joined the project (Table 3 on the following page presents the companies involved in the Tengiz field development).

Kasym-Zhomart Tokayev noted in his book, *Perseverance*, that for the United States it was crucial to demonstrate its leadership in the region’s economic and political integration. The Americans were the first to establish a diplomatic mission in Almaty and brought the first major investment to the country, with governments and investors around the world watching closely.

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2 Tokayev, “Preodoleniye.”
Table 3: TengizChevroil stakeholders

<table>
<thead>
<tr>
<th>Company</th>
<th>Role in the project</th>
<th>Share (% of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ChevronTexaco</td>
<td>Operator</td>
<td>50%</td>
</tr>
<tr>
<td>ExxonMobil</td>
<td>Co-owner</td>
<td>25%</td>
</tr>
<tr>
<td>KazMunayGaz</td>
<td>Co-owner</td>
<td>20%</td>
</tr>
<tr>
<td>Lukarco (54% owned by LUKoil; and 46% by British Petroleum)</td>
<td>Co-owner</td>
<td>5%</td>
</tr>
</tbody>
</table>


On August 9, 1994, speaking to leaders of the American oil companies in Irvine, California, then-Vice-President of Chevron Overseas Petroleum Espy P. Price observed:

...Tengiz is more than an oil project. This is the first serious test of whether the former Soviet countries can work successfully with foreign companies in general, and foreign oil developers in particular. Many are aware that the failure of the Tengiz would suppress overall investor enthusiasm in the region. And this is one of the reasons why the US government has made great diplomatic efforts to move our joint venture forward.

The establishment of the TengizChevroil JV had obvious benefits for Kazakhstan – Chevron assumed the obligation to bring some $1.5 billion to the table, including some $50 million in social grants for the Atyrau region during the first five-year period. More importantly, the financial flows from the joint venture provided Kazakhstan with much-needed resources for economic development, as well as demonstrating the country’s openness to foreign investment.

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From a geopolitical viewpoint, the US presence in the region provided an essential balance to Kazakhstan’s relationship with Russia. At the time, Russia was also suffering from serious economic and political problems. With the entrance of a new powerful actor into the Eurasian playground, Russia adapted its Caspian energy policy to a new reality, mainly in the field of hydrocarbon transportation routes, recognizing that its neighbors have options.

This became a win-win situation as Lukarco, a subsidiary of Russian-based Lukoil, joined the TengizChevroil JV, symbolizing Russia’s acceptance of the new rules of the game. This deal increased investor optimism about the expansion of the Atyrau-Samara route and opened the prospects for the Caspian Pipeline Consortium agreement.

The Chevron Corporation’s entry into Kazakhstan through Tengiz also significantly increased the determination of other international energy corporations to get in on the game.

TengizChevroil is the largest oil producer and source of taxable revenue in Kazakhstan. Since the company began production in 1993, output has been consistently growing. Chevron has estimated the Tengiz field’s total recoverable crude oil reserves at 6-9 billion barrels.

In January 2003 the government of Kazakhstan, ChevronTexaco and ExxonMobil signed a Memorandum of Understanding concerning the Tengiz field expansion project. Second Generation Project plans include the construction of extracting, refining, and supporting production complexes with an annual productive capacity of 7 million tons. Construction of these production facilities combined with the introduction of technology to inject sour natural gas into the oil wells will allow the Tengiz field’s extraction to increase to 22 million tons per year.

The injection of natural gas into existing wells is an economically attractive technological solution to expand oil production. Gas injection programs, when fully implemented, preserve geologic pressure while increasing oil output. Current government regulations restricting the flaring of associated sour natural gas have hurt Tengiz production performance in 2005 and 2006.

The field operators tested gas re-injection in Tengiz in 2007, and achieved an increase in the field’s production at the end of the year. In 2007, the Tengiz

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4 In oil production, gas flaring (burning), is used to dispose of unmarketable associated natural gas that dissolves in oil at depth and separates once oil reaches the surface. The gas can also be re-injected into the well to maintain consistent pressure for oil extraction. Source: “PetroKazakhstan Inc. – KazGerMunai Gas Flaring,” PR Newswire Europe Ltd., May 17, 2005, at www.prnewswire.co.uk/cgi/news/release?id=146244 (December 20, 2007).
produced some 14.3 million tons, about 1 million tons higher than in 2006. Full-scale implementation of the second-generation project should result in the field’s oil production reaching up to 540 thousand barrels per day during 2008, which is approximately 15 million tons per year. The delay in the second phase build-up to 2008-2009 was mostly due to Moscow’s obstruction of CPC expansion.

Experts estimate that Tengiz can reach an output level of some 22-25 million tons of oil annually, and yield large quantities of associated gas when it reaches its projected capacity. The field is likely to reach its maximum production level of 1,000,000 barrels of oil per day by 2012. However, Russia’s near-monopoly over export channels due to the prolonged obstruction of expansion of the CPC’s capacity have held oil production at Tengiz to some 13-14 million tons annually for the last three years. For this reason, output increases originally targeted for 2006 are behind schedule.

Until the expansion of the CPC pipeline capacity, TengizChevroil plans to transport additional oil over a thousand miles by rail to the Ukrainian Black Sea port of Odessa. This involves spending more money on transportation than planned: shipping via this route will cost up to $60 per ton, as compared to $38 per ton via the CPC. In the years to come, greater export capacity will enable higher oil outputs at Tengiz.

In addition to the export challenges, the Kazakh government’s insistence on environmental protection and regulation has raised concerns among the members of the Tengiz consortium. In October 2007, the government imposed a $609 million fine (part of which was paid by early 2008) on TengizChevroil for alleged environmental breaches related to the storage of over 9 million tons of sulfur, a byproduct of oil production at the field. Although the authorities later reduced the amount of the fine by half, the Atyrau district court upheld the charges submitted by the regional environmental regulator.

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6 Socor, “Kazakhstan Oil Output and Export Data Dramatize Need for Trans-Caspian Outlets.”
7 Energy Information Administration, “Kazakhstan Country Analysis Brief.”
8 Socor, “Discussions Intensify with Kazakhstan on Trans-Caspian Gas Pipeline.”
9 Ibid.
10 The oil at Tengiz is rich in hydrogen sulfide gas, which is processed into blocks of inert yellow sulphur and stored near the field, and can be marketed. Source: Watson, “Kazakhstan Looks in, Out and Shakes it All About.”
TengizChevroil had to defend its leadership record of bringing the project forward in ways that benefit the country and the local community. Nevertheless, experts believe that the Kazakh government is fully aware of the benefits the consortium’s operations bring to the Atyrau region, and is careful to differentiate between patriotic rhetoric and concrete economic considerations.\(^{12}\) The company has helped the region with the construction of roads, schools and hospitals, and has the best potential to bring the Tengiz oil to the world markets.

The Karachaganak Field

In 1997, Italian Agip joined a consortium with America’s Texaco, the British Gas (BG) Group, and Russia’s Lukoil to develop the giant Karachaganak hydrocarbon deposit. Karachaganak, located 16 kilometers away from the Kazakh city of Aksai, has estimated reserves of 1.2 billion tons of oil and condensate and more than 1.35 trillion cubic meters of gas.\(^{13}\) The size of the field’s reserves is comparable to the enormous Russian fields in Tyumen and Surgut. The Soviets partially developed Karachaganak, but suspended production by the early 1990s.

In November 1997, the Government of Kazakhstan and a group of international energy companies signed a 40-year Final Production Sharing Agreement (FPSA), effective from 1998 to 2038. This agreement established a Karachaganak Petroleum Operating B.V. (KPO). The Consortium includes UK’s BG Group (32.5 percent stake), Italy’s Eni (32.5 percent stake), US’s Chevron (20 percent stake), and Russia’s Lukoil (15 percent stake).\(^{14}\)

The project attracted a massive inflow of foreign capital. At that time, Western companies were willing not only to start production at previously discovered fields, but also to undertake prospecting and exploration in the Caspian shelf, which promised significant benefits. By the mid-1990s, North American, European and Southeast Asian companies had engaged in the quest for Caspian oil. In 1997, a group of international oil companies and the Government of Kazakhstan signed a twenty-year Production Sharing Agreement for the exploration and development of eleven offshore blocks in the Caspian Sea. The members of the consortium included OKIOC (the Offshore Kazakhstan International Operating Company) Agip/Eni (Italy), ExxonMobil (USA), Shell Development BV (Netherlands), TotalFinaElf (France), ConocoPhillips (USA), BG Group (UK) and Inpex (Japan).

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\(^{14}\) *Ibid.*
In 2000, OKIOC announced the discovery of the Kashagan field—the largest field discovered in the last thirty years, with an estimated 2.7 billion tons of oil reserves.\(^{15}\) In August 2001, OKIOC changed its name to Agip Kazakhstan North Caspian Operating Company (AgipKCO) to reflect its leadership in the Kashagan development project.

**The Kashagan Field**

The Kashagan field is located in the shallow area of the northern Caspian Sea, a climatically and geologically challenging area, with estimated recoverable reserves of 13 billion barrels of oil. Experts estimate its peak production will reach 1.5 million barrels per day.\(^{16}\) This giant field is a centerpiece of Kazakhstan’s ambitions to become one of the top 10 oil-producing countries by 2015.

AgipKCO, fully owned by Italian Eni S.p.A. via Agip Caspian Sea B.V., is the sole operator in the Kazakhstan sector of the Caspian Sea on behalf of seven international companies under the North Caspian Sea Production Sharing Agreement (PSA).\(^{17}\) The other partners in the consortium are Royal Dutch Shell Plc, Exxon Mobil Corp, Total, ConocoPhillips, KazMunayGaz, and Japan’s Inpex Holdings Inc.

In 2007, the Kazakh government and the AgipKCO consortium ended up in a standoff that became a center of investor attention. Rising project costs and delays caused the conflict. The consortium had originally planned to put the Kashagan field on stream in 2005, but it subsequently moved the target to 2008, and then announced in June 2007 that the launch was expected to slip further, to 2010. In addition, AgipKCO informed the Kazakh government that project costs would more than double, to some $136 billion (over the initial estimate of $57 billion). This was understandable given the steep rise in worldwide prices of steel, labor, and other inputs. However, the Kazakhstani government laid responsibility for the project slippage and cost overruns at AgipKCO’s doorstep, and ordered the Kashagan operations suspended in late August 2007, evoking environmental concerns.

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concerns. Many experts believed that Astana pressured the consortium to gain a greater stake in the project.\textsuperscript{18}

The Kazakh government, publicly committed to ambitious developmental goals, was also coming under domestic political pressure over the delays and ballooning costs of the project. Astana was concerned that further delays could negatively affect state budget revenues. They could also force the country to downsize its 2015 output targets from 3.2 million barrels to 2.6 million barrels per day. Officials also indicated that the situation could well jeopardize the government’s election-year pledges to reinforce the social infrastructure.\textsuperscript{19} The costs and schedule overruns meant fewer royalty payments to the Kazakh treasury, as under the contract the consortium is exempt from payments until it recovers development costs.\textsuperscript{20}

Speaking to the Second Eurasian Energy Forum, KazEnergy, on September 6, 2007, Prime Minister Karim Massimov accused AgipKCO of “systematic… project mismanagement.”\textsuperscript{21} The consortium, for its part, blamed the cost and schedule overruns on the field’s geological and technological challenges, and further stated that Kashagan’s oil, with its high sulfur content, posed a particular problem, as field operators would have to extract it from a deep high-pressure reservoir in shallow water. Drifting ice during the winter is also a major obstacle. According to the consortium, “the Kashagan project is a unique combination of technical complexity and environmental challenges. The size and variety of operations make it one of the greatest challenges of the petroleum industry worldwide.”\textsuperscript{22} Eni’s intense lobbying as well as a visit by then-Italian Prime Minister Romano Prodi to Kazakhstan in October 2007, helped salvage Eni’s position as the consortium operator.

The Kazakh government, in the meantime, sought to double its stake in the consortium and become a joint operator through KazMunayGaz, a move fiercely opposed by the rest of consortium members. In addition, the government wanted compensation for the revenues lost due to the delays in commercial oil production.

\textsuperscript{18} Ibid.
\textsuperscript{20} “Kazakhstan: Oil Consortium Wrangles with Government Officials Over Kashagan Oil Field.”
\textsuperscript{22} Lillis, “Oil Companies on the Defensive in Kazakhstan.”
On January 13, 2008, the Kazakh government reached a framework agreement with the consortium, valid through 2041. Under its terms, Kazakhstan purchased an extra stake in the project on a proportional basis from all existing shareholders, thus doubling its share to 16.81 percent. With the increased share, Kazakhstan anticipates generating up to $20 billion in additional revenues over the lifespan of the project. Kazakhstan owns a percentage equal to the stakes held by the main Western members of the consortium. KazMunayGaz paid some $1.78 billion to the consortium partners to obtain its increased share in the project, a figure that analysts believe to be below market price. Table 4 below presents the original and revised Kashagan project ownership structure.

Table 4: Shareholders at Kashagan field (2007-2008)

<table>
<thead>
<tr>
<th>Company</th>
<th>Share, %</th>
<th>2007</th>
<th>Jan-08</th>
<th>Jun-08</th>
</tr>
</thead>
<tbody>
<tr>
<td>ConocoPhillips</td>
<td></td>
<td>9.26</td>
<td>8.28</td>
<td>8.4</td>
</tr>
<tr>
<td>ENI</td>
<td></td>
<td>18.52</td>
<td>16.66</td>
<td>16.81</td>
</tr>
<tr>
<td>ExxonMobil</td>
<td></td>
<td>18.52</td>
<td>16.66</td>
<td>16.81</td>
</tr>
<tr>
<td>Inpex</td>
<td></td>
<td>8.33</td>
<td>8.28</td>
<td>7.55</td>
</tr>
<tr>
<td>KazMunayGaz</td>
<td></td>
<td>8.33</td>
<td>16.81</td>
<td>16.81</td>
</tr>
<tr>
<td>Shell</td>
<td></td>
<td>18.52</td>
<td>16.66</td>
<td>16.81</td>
</tr>
<tr>
<td>Total, SA</td>
<td></td>
<td>18.52</td>
<td>16.66</td>
<td>16.81</td>
</tr>
</tbody>
</table>


Under the terms of the January 2008 agreement, the parties set Kashagan's new start date for 2011. Just a few months later, in May 2008, the foreign participants in the AgipKCO consortium proposed to postpone the beginning of commercial production in the field from 2011 to 2012 or 2013. It marked the reopening of the conflict and renegotiations. Kazakhstan’s energy ministry fears that such a delay

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23 Lillis, “Kazakhstan: Officials Jubilant Over Oil-field Renegotiation Deal.”
24 Ibid.
would push off Kazakhstan’s plans to become one of the world’s 10 largest oil producers beyond 2015. Oil experts consider the 2012-2013 timeframe realistic. At the same time, an international oil lawyer of one of the foreign companies, commenting on the Kashagan’s developments, warned that if the launch of production extended to 2013, Kazakhstan might seek a 50 percent stake in the project,\(^{25}\) which thus far has not happened.

After another round of renegotiations in May-June 2008, AgipKCO and the government of Kazakhstan announced the signing of a memorandum of understanding on June 28, 2008. According to KazMunayGaz’s statement, the latest memorandum builds upon the January 2008 framework agreement and involved “important adjustments to the economic terms” as well as “substantial assurances that the project will be implemented in accordance with the approved schedule.”\(^{26}\)

In the new memorandum, Kazakhstan agreed to the proposed delay of the field’s commercial production till 2013, in exchange for the consortium’s commitment to prevent further cost overruns, pay floating royalties linked to the oil price, and have the existing PSA expire in 2041 (despite the consortium’s requests to extend the contract). Analysts say this was the “last delay the Kazakh authorities could tolerate without imposing sanctions,” therefore the new agreement was a good outcome for the investors.\(^{27}\)

Kazakhstan’s Minister of Energy and Mineral Resources Sauat Mynbayev explained the new scheme of floating royalties, linked to the price of oil. The royalties would range from 7.5-8 percent at the $130 a barrel oil price to 12.5 percent at a price of $195 a barrel.\(^{28}\) The energy officials also warned of potential penalties (such as the loss of right to defer the payment of royalties until the recovery of the project costs) if production delays beyond 2013.

Kazakhstan’s leadership believes that the renegotiated Kashagan deal is a just restoration of partnership in relations between the state and the project’s foreign investors, which it holds responsible for production delays. However, some


international experts consider the forced renegotiation of the deal since August 2007 to be “tipping the balance in the Caspian Basin energy game.”

Nevertheless, many observers have remained cautiously optimistic about Kazakhstan’s overall investment climate, and suggested that the international community should not view Kazakhstan the same way as Russia, where the Kremlin’s siloviki (law enforcement and secret services factions in Putin’s entourage) have harassed privately owned energy firms, and in many instances expropriated their assets. The wrangling over Kashagan should not detract from Kazakhstan’s image as a stable country that is still attractive for foreign investors in many sectors. The international community and investors should also remember that Astana has thus far abided by the terms of the production sharing contracts that it signed in the late 1990s. In Kazakhstan, investors enjoy a more orderly and structured pro-business environment. Astana is aware that the country needs foreign investment and expertise to make its oil industry viable and help extract the crude in areas with steep logistical challenges.

**Marine Exploration**

While land exploration is attractive and lucrative, energy experts believe the Caspian Sea hides real hydrocarbon wealth. Kazakhstan’s sector of the Caspian holds the majority of its maritime oil deposits. Russia, however, covets participation in these littoral developments. Moscow is putting pressure on Kazakhstan to be involved in the maximum number of shelf oil and gas exploration projects (see Table 5 on the following page).

Specifically, Kazakhstan is developing the Kurmangazy, Khvalynskoye, and Tsentralnaya projects jointly with Russia, whereby each country secures its sovereign rights over resources.

Lukoil is playing a key role as a conduit for Russian power in the Caspian. Its Chairman, Vagit Alekperov, has described the stability of Kazakhstan’s legislative base as a great asset. Alekperov’s inclusion in the 2004 Russian government delegation to Kazakhstan and his comments mark a meaningful moment for Russia’s new foreign policy. He and others, such as the Gazprom and Russian Unified Energy Systems (RAO EES) chiefs, have promoted Russian business interests in the region more effectively than have officials from the now-defunct Ministry of CIS Affairs.

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29 Lillis, “Kazakhstan: Officials Jubilant Over Oil-field Renegotiation Deal.”
30 Watson, “Kazakhstan Looks in, Out and Shakes it All About.”
### Table 5: Involvement of Lukoil and Rosneft in the Kazakh Energy Sector

<table>
<thead>
<tr>
<th>Company</th>
<th>Project</th>
<th>Stake in the project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lukarco as part of TengizChevron JV</td>
<td>Development of the Tengiz hydrocarbon field</td>
<td>5%</td>
</tr>
<tr>
<td>Lukoil Overseas Karachaganak as part of Karachaganak Petroleum Operating</td>
<td>Development of the Karachaganak hydrocarbon field</td>
<td>15%</td>
</tr>
<tr>
<td>Lukoil Overseas Kumkol as part of Turgay Petroleum</td>
<td>Development of Kyzylkumskoye, Kumkolskoye and Kyzylzharminskoye hydrocarbon fields in Kyzylordinskaya region</td>
<td>50%</td>
</tr>
<tr>
<td>Lukoil Overseas Shelf</td>
<td>Production Sharing Agreement (PSA) on Tyub–Karagan field operated by Tyub–Karagan Operating Company</td>
<td>50%</td>
</tr>
<tr>
<td>Lukoil Overseas Holding Ltd. as part of Atash company</td>
<td>Development of the hydrocarbon field Atash</td>
<td>50%</td>
</tr>
<tr>
<td>Rosneft as part of Aday Petroleum Company</td>
<td>Development of the hydrocarbon field in the Biikzhal Aday bloc in the Atyrau region</td>
<td>50%</td>
</tr>
<tr>
<td>Rosneft with KazMunayTeniz</td>
<td>Development of the Kurmangazy hydrocarbon field</td>
<td>25%</td>
</tr>
</tbody>
</table>

Source: Kazakhstan's Ministry of Energy and Mineral Resources

The May 13, 2002 Protocol to the July 6, 1998 Intergovernmental Agreement between Russia and Kazakhstan on the demarcation of the North Caspian seabed determined the jurisdictions over three trans-border oil fields. According to this Protocol, the Kurmangazy field comes under Kazakhstan’s jurisdiction and the Khvalynskoye and Tsentralnaya fields under Russia’s jurisdiction, while they
should share exploration and development. This protocol determined the fundamental conditions for a PSA for Kurmangazy, and a production agreement based on Russian legislation for Khvalynskoye and Tsentralnaya.

**The Kurmangazy project.** The Kurmangazy (Kulalinsky) structure is located on the northern shelf of the Caspian Sea. Experts estimate its recoverable resources at up to one billion tons. Its productive layers lie at a depth of 300-2000 meters.

Decree No. 1094-r issued on August 8, 2003 by the Government of Russia authorized Rosneft-Kazakhstan LLC, a subsidiary of the Russian state-owned Rosneft Oil Company, to participate in the development of Kurmangazy and to finance the Russian share in the project. The Kazakh side authorized the MNK KazMunayTeniz Oil Company, a subsidiary of KazMunayGaz Oil Company, to participate.

Russia and Kazakhstan agreed that the Consortium would have the following structure:

- KazMunayTeniz Offshore Oil Company JSC (subsidiary of KazMunayGaz)—50 percent
- Rosneft–Kazakhstan LLC (subsidiary of Rosneft)—25 percent (until the Russian party’s right of choice is implemented, the company has rights and obligations in the amount of 50 percent)
- Russian future designee—25 percent (Russia’s Zarubezhneft has an option on 25 percent in the project)

Negotiations between Rosneft and KazMunayGaz on the Kurmangazy project resumed after Kazakhstan passed amendments to its tax code that would improve the profitability for hydrocarbon exploration projects in the Caspian Sea and make them attractive to further investment. The new $23 billion PSA (to be allocated over 55 years) for the estimated 7.33 billion barrels of oil from the Kurmangazy field was signed on July 6, 2005. The first 2000-meter-deep assessment well drilled in April 2006 yielded disappointing results. The field’s operators expect to perform further drilling in 2008 after completing the needed modifications.

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The Khvalynskoye and Tsentralnaya fields. There have been legislative changes in Russia that complicate the implementation of PSAs for the exploration of the Tsentralnaya and Khvalynskoye fields.

While a PSA will govern the Kurmangazy project, routine licensing without PSA guarantees will apply to the other two projects. In 2003, Kazakhstan’s ex-Minister of Energy, Vladimir Shkolnik, accused Lukoil and Gazprom of delaying the development of the Tsentralnaya field and hence, of failing to comply with the intergovernmental agreement on Caspian seabed division. Lack of progress on the Khvalynskoye and Tsentralnaya projects had the potential to complicate Russian-Kazakh relations. Then-Prime Minister of Kazakhstan Daniyal Akhmetov and Minister of Industry and Energy of Russia Viktor Khristenko discussed the issues at a meeting in Astana in February 2005.

In March 2005, KazMunayGaz and Lukoil created a joint venture, the Caspian Oil and Gas Company, to develop the Khvalynskoye field. The joint venture conducted a feasibility study and drafted a production agreement with the Russian government based on the findings. The parties expect to close a deal during 2008. The estimated reserves at the Khvalynskoye field include 400 billion barrels of oil and 12.3 trillion cubic feet of natural gas. The target date for production launch is 2014.

KazMunayGaz, Gazprom, and Lukoil are developing the Tsentralnaya field. They drilled the first deep-water exploration well at the end of 2007. According to Lukoil, the well has shown positive results, and the field may hold recoverable reserves of 521.1 million tones of oil and 91.7 billion cubic meters of gas.

Development of the Caspian fields has not been a top priority for Lukoil and Gazprom. Gazprom is more interested in development projects in Yamal due to their significant financial potential. Lukoil is more interested in oil than in gas (the Tsentralnaya field is 75 percent gas), and therefore finds the Severny and Yalama-Sumur fields in the Caspian more attractive. However, in June 2008, Lukoil’s Vice President Ravil Maganov commented that Lukoil, Gazprom, and KazMunayGaz might set up a joint venture to develop the Tsentralnaya field based on a concession agreement by June-December 2009.

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36 “Lukoil, Gazprom and KazMunaiGas may create Caspian JV,” Business New Europe
The Atash field. The Atash field is located in the central part of Kazakhstan’s sector of the Caspian Sea. KazMunayGaz is carrying out the exploration of Atash according to contract No.1289, dated December 29, 2003, between the Ministry of Energy and Mineral Resources and KazMunayGaz. The operator of the project is Atash JV, established by KazMunayGaz and Lukoil Overseas Shelf B.V. The field’s operator conducted spring and summer ecological and seismic tests (1057 km) in 2004. The shareholders invested $4.78 million in 2004 and $9.24 million in 2005. Seismic data interpretation and preparations for exploratory drilling took place in 2005.\(^{37}\)

The Tyub-Karagan field. The Tyub-Karagan field is located in the central part of Kazakhstan’s sector of the Caspian Sea. The Ministry of Energy and Mineral Resources and KazMunayGaz are developing the field according to a PSA between them, dated December 29, 2003. The operator of the project is the Tyub-Karagan Operating Company, owned 50/50 by Lukoil Overseas Shelf B.V. and Marine Oil Company KazMunayTeniz. The Operating Company carried all costs incurred during the exploration period of the project until commercial discovery. The amount invested for 2004 was some $45 million. The first exploration drilling, geological and geophysical data analysis, geological modeling and operational assessment of the reserves, as well as preparations for comprehensive seismic testing took place in 2004 and 2005. The field’s operator abandoned the first exploration well in August 2005.\(^{38}\) Currently, the developers are conducting seismic prospecting to get more accurate deposit data.

The Imashevskoye field. The Imashevskoye gas condensate field, located in West Kazakhstan in the area adjacent to the Astrakhan oblast (region) of Russia, was the last unsolved frontier problem between Russia and Kazakhstan. Exploration may take six years, and extraction may take 34 years.

On March 16, 2000, the KazMunayGaz Company and the government of Kazakhstan signed a contract on exploration and extraction of hydrocarbons from the Imashevskoye field. An Expert Commission of the Kazakh Ministry of Energy transferred the extraction rights to AtyrauMunayGaz in 2003. Kazakhstan had previously insisted on ownership of this deposit, but the agreement signed by Putin

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and Nazarbayev in January 2005 recognizes both countries as having equal rights to the field (“parity division”).

The Kazakh Ministry of Energy urged the governments of Russia and Kazakhstan to determine which companies would participate in creation of the joint venture. The governments designated Russian energy giant Gazprom and Kazakhstan’s KazMunayGaz. Energy companies have estimated the condensate reserves at Imashevskoye at 172.1 billion cubic meters (bcm), including some 129 bcm of the extractable free gas category C1, and some 43 bcm of free gas category C2.

Since 2006, the parties have negotiated various aspects of the project, including gas transportation and treatment to rid the gas mix of its high sulfur content (reaching up to 20 percent). However, as of 2007, field development has not seen much progress, and Kazakh officials are appealing to the Russian government to speed up the field exploration and determine a company, which will participate in the project on behalf of the Russian side.

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39 “Severo-Kaspiyskiy paritet i vostochnyy dissonans” [North-Caspian Parity and Eastern Dissonance].
40 Blagov, “Nazarbayev and Putin Pledge “God-Given” Friendship.”
In addition to oil, Kazakhstan possesses large quantities of natural gas and condensate. Energy experts estimate land-based reserves to be 1.8 trillion cubic meters, with littoral reserves reaching up to 3.3 trillion cubic meters. Gas production is likely to grow, while exports of gas are stagnant. The bottleneck is Kazakhstan’s lack of export capacity bypassing Russia.

Several years ago, Gazprom used to buy Kazakh gas at about $44 per thousand cubic meters, which was just one quarter of what it was charging its European customers. Over the past few years, the price that Gazprom pays for Kazakh gas has gone up several times, with Russia agreeing to the increases to maintain its control over the regional energy flow. Thus, in May 2006 Gazprom agreed to pay a higher price ($140/tcm) for gas supplies from Kazakhstan. A Russian energy analyst commented that “fair distribution” of incomes from Central Asian gas exports is vital to the preservation of the post-Soviet gas transportation system, which opens the way to creating a new “gas OPEC.” In 2007, the Central Asian countries announced that they would increase their gas export prices to “European” levels.

Russia and Kazakhstan have different approaches to the large-scale development of the hydrocarbon fields in the northern Caspian. While Russia maintains an almost-absolute state monopoly in the gas sector (Gazprom), Kazakhstan allows foreign investors around the world to develop its gas reserves. Total, Royal Dutch and Repsol are already participating in gas projects. Russia, on the other hand, divides the fields among a small group of Russian companies without any assistance from foreigners. Thus, Lukoil, Gazprom, and Rosneft are the only Russian companies operating in the region.

**Kazakhstani-Russian natural gas cooperation.** Kazakhstan and Russia cooperate in the gas sector based on a long-term agreement between the governments of both

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countries signed on November 28, 2001, which outlines bilateral cooperation in the following:

- The transit of Russian and Central Asian gas through Kazakhstan, and
- The purchase and marketing of Kazakhstan’s natural gas, including gas from the Karachaganak field.

On Kazakhstan’s side, the main arm of international gas transport and trade is KazTransGaz JSC. The company controls Kazakhstani underground gas storage, domestic and export gas transportation, and owns more than ten thousand kilometers of gas pipelines.4

Gazprom and KazTransGaz established the KazRosGaz Company, each with a 50 percent stake in ownership, on November 28, 2001. This joint venture is in charge of purchasing and marketing Kazakhstan’s natural gas, including the Karachaganak field gas, and is responsible for supplying gas for processing at the Orenburg Gas Refinery in Russia, close to the Kazakhstani-Russian border.

KazRosGaz purchases gas mainly from the Karachaganak field through Karachaganak Petroleum Operating BV. The purchased volumes have increased every year: 5.5 billion cubic meters (bcm) in 2003; 6.5 bcm in 2004; and 8 bcm in 2005. The volume of gas from Karachaganak shipped to Orenburg has reached 250 billion cubic feet (bcf) per year, or some 8 billion cubic meters, and may eventually reach 530 bcf per year, close to 16 bcm.5 For the longer term, the Karachaganak investor consortium has a 15-year agreement with Gazprom to process annually up to 16 bcm of Karachaganak gas at Russia’s Orenburg processing plant to reduce its sulfur content.

This bilateral gas trade is not transparent due to an absence of reliable reporting concerning the volume of Karachaganak gas refining that takes place at Orenburg. Only estimates are available. In 2006, Kazakhstan got a 50 percent stake in a new unit of the Orenburg gas processing plant that was turned into a Gazprom-operated joint venture.6

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6 Ibid.
After processing at the Orenburg plant, Western Kazakhstan consumes part of the refined gas and the rest goes for export. In 2007, Russia paid Kazakhstan $145 per 1,000 cubic meters of the processed gas, and then sold it in Europe at Gazprom-determined “market” prices averaging $250-$400 and above. With joint ownership of the Orenburg refining unit, windfall profits from this price differential will accrue not only to Russia but also to Kazakhstan, proportionate to its share in the processing plant. The Kazakh side hopes for a price of $160 per 1,000 cubic meters, contingent on boosting the volume of deliveries from Kazakhstan to Orenburg.\(^7\)

While the trans-Caspian export project continues to be a subject of much discussion but little substantive progress, in May 2007, Moscow and Astana announced two joint projects in the field of natural gas. The plan is to expand natural gas transit pipelines to Russia in order to accommodate the growing transit of Turkmen and Uzbek gas via Kazakh territory, and via Russia to the new Nord Stream, Blue Stream, and South Stream pipelines, as well as via Ukraine and Belarus to Central Europe. In 2008, Kazakhstan raised the tariff for shipping Central Asian gas to Gazprom by 27 percent, from $1.10 to $1.40 for transporting 1,000 cubic meters of gas for 100 kilometers.\(^8\)

According to the second agreement, Kazakhstan will supply its growing natural gas output to Russia’s Orenburg processing plant, thus endangering any prospects for trans-Caspian westbound energy exports. Russia may continue selling Kazakh gas to Europe. Analysts have noted that these deals will serve to prevent Kazakhstan from becoming an independent gas exporter to Europe.\(^9\)

Russia already handles almost all of Kazakhstan’s gas exports, with the exception of those going to China. Kazakhstan expects to boost gas production from 27 billion cubic meters in 2006 to 45 billion cubic meters in 2010 and 60 billion cubic meters by 2015. A large share of this output will be available for export. Ironically, Western companies extract Kazakhstan’s oil and gas before they head to Russia.\(^10\) Absent a westbound trans-Caspian pipeline, the new production will go to Russia through overland pipelines, just as it is the case today.\(^11\)

**ITERA and Russian gas policy in the CIS.** In the 1990s, the CIS market was not very attractive for Gazprom due to the liquidity crisis, which led to payment arrears or payments with money surrogates such as promissory notes and bartered goods on

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\(^7\) Socor, “Kazakhstan’s Growing Gas Exports to Go Russia’s Way.”


\(^9\) Socor, “Kazakhstan’s Growing Gas Exports to Go Russia’s Way.”

\(^10\) Ibid.

\(^11\) Ibid.
the part of the main domestic Russian customers and those in the former Soviet republics. Gazprom then reassigned a significant portion of the ex-Soviet republics’ market to ITERA, a company connected to the top tier of its leadership. ITERA, established in 1992 as a commodities trading company, prospered through barter deals, such as trading food for gas in the 1990s. Since 1994, it was involved in marketing Turkmen natural gas, which was part of the country’s payment for food supplies. ITERA transported the Turkmen natural gas via Gazprom’s pipelines.

The management of Gazprom did not grant access to the pipelines to any other company. Gazprom’s control over Russia’s long distance gas pipelines enabled the monopoly to decide the fate of the independent gas producers. For transportation of Turkmen gas via Uzbekistan, Kazakhstan, and Russia, ITERA received 42 percent of the transported gas and sold this in Ukraine at $67 per thousand cubic meters—a price lower than prevailing market rates. Since 1995, ITERA started its own gas production in Russia. Over several years, it turned from a murky intermediary company into one of the leading gas suppliers. In Turkmenistan, officials privately describe ITERA as a “child of Gazprom.”

“Crawling privatization” of the Russian gas business, with assets being gradually transferred outside Gazprom, characterized the company’s development during the 1990s—under Chief Executives Viktor Chernomyrdin and Rem Vyakhirev. Under the patronage of Vyakhirev, ITERA received the most favorable regime. Observers suspected that Gazprom management was using ITERA as a front company for the improper transfer of assets, mostly rich gas fields, either without adequate compensation to Gazprom or through questionable stock deals, subsequently profiting Gazprom top tier managers. Both companies have denied that any cross-ownership exists. Such unauthorized transactions harm Gazprom shareholders who, besides the Russian government, include owners of shares traded in the U.S. as American depositary receipts (ADRs).

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12 Isabel Gorst, “Gazprom Holds the Keys to the Kingdom Russia, but Independents Prosper,” Financial Times, December 5, 2006, accessed via LexisNexis (February 12, 2008).
14 Viktor Chernomyrdin, a one-time Soviet gas minister, became the first chairman of Gazprom when it was privatized, served as Russian prime minister from 1992 to 1998, and later returned to Gazprom as chairman before resigning the post in 2000. Since 2001, he has been serving as Ambassador of the Russian Federation to Ukraine.
16 Ibid.
In the 1990s, with the Kremlin’s blessing, Gazprom’s executives were practically able to run the company as their fiefdom. This changed in 2001, when President Putin ousted Vyakhirev and replaced him with his aide, Alexey Miller, who received a mandate to clean up Gazprom. Dmitry Medvedev, Putin’s confidant and the current Russian president, became Gazprom’s board chairman. ITERA’s business started to decline with the emergence of Gazprom on the CIS market. At first, the monopoly decided to negotiate with gas producers in Turkmenistan, Uzbekistan, and Kazakhstan. However, Gazprom failed to establish control over gas exports from the Tengiz field. ITERA lost most of its assets to Gazprom after Miller took charge. In June 2006, ITERA agreed to sell a majority stake in the Beregovoye gas field in Western Siberia to Gazprom’s subsidiary Gazprombank. In December 2006, Gazprom acquired control shares of Sibneftegaz, ITERA’s last major asset. In 2007, ITERA confirmed its intent to sell off its remaining oil and other non-gas projects.

The Russian Gas Strategy and Gas Transit through Kazakhstan

Russia is increasingly pushing to consolidate control over gas supplies throughout Eurasia. Though possessing the world’s largest gas reserves, Russia seeks to acquire a significant share of exported natural gas from Central Asia and elsewhere, in order to be able to dictate prices, especially in Europe. Central Asian natural gas helps Gazprom to offset stagnant output in Siberia and meet its CIS and European commitments. The Kremlin also says that it is interested in the long-term availability of Central Asian energy so that it can “preserve Russia’s northern gas fields for next generations, avoid boosting investment in their development, and decrease the pressure on the markets presenting strategic interests for Russia itself.”

Russia’s main West Siberian fields have peaked and are now stagnating. It is only a matter of time until they go into decline. At that point, Moscow will face a choice:

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18 Paul Starobin and Catherine Belton, “Gazprom: Russia’s Enron? Gazprom and PricewaterhouseCoopers are Under Fire,” Business Week, February 18, 2002, at http://www.businessweek.com/magazine/content/02_07/b3770079.htm (February 12, 2008); and Gorst, “Gazprom Holds the Keys to the Kingdom Russia.”
invest tens of billions in Arctic, East Siberian, and offshore gas fields, or buy from Central Asia. Currently, Central Asian gas accounts for some 22 percent of Gazprom’s total exports. Based on its long-term contracts, Gazprom purchased 41 bcm of Turkmen gas, 9.3 bcm of Uzbek gas, and 7.2 bcm of gas from Kazakhstan in 2006, and these purchases continue to grow.²³

Table 6: Share of Central Asian Gas in Gazprom’s Exports

<table>
<thead>
<tr>
<th>Volumes of gas received into and distributed through Gazprom’s gas transportation system in the Russian Federation, bcm</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total amount received by the gas transportation system</td>
<td>699.7</td>
<td>717.8</td>
</tr>
<tr>
<td>Amount received by the system</td>
<td>646.9</td>
<td>660.9</td>
</tr>
<tr>
<td>Including Central Asian gas</td>
<td>54.6</td>
<td>57.0</td>
</tr>
<tr>
<td>Gas withdrawn from UGSF in Russia</td>
<td>42.8</td>
<td>48.2</td>
</tr>
<tr>
<td>Decrease in gas reserves within the gas transportation system</td>
<td>10.0</td>
<td>8.7</td>
</tr>
<tr>
<td>Total distribution from the gas transportation system</td>
<td>699.7</td>
<td>717.8</td>
</tr>
<tr>
<td>Supply to Russian consumers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Including Central Asian gas</td>
<td>389.8</td>
<td>352.0</td>
</tr>
<tr>
<td>Supply outside Russia</td>
<td>251.2</td>
<td>254.7</td>
</tr>
<tr>
<td>Including Central Asian gas</td>
<td>54.5</td>
<td>56.8</td>
</tr>
<tr>
<td>Gas pumped into UGSF in Russia</td>
<td>46.3</td>
<td>50.4</td>
</tr>
<tr>
<td>Technological needs of the gas transportation system</td>
<td>51.7</td>
<td>52.0</td>
</tr>
<tr>
<td>Increase in gas reserves within the gas transportation system</td>
<td>10.7</td>
<td>8.7</td>
</tr>
</tbody>
</table>


Kazakhstan is a major transit route for gas from Turkmenistan to Russia and on to other markets across the territory of the former Soviet Union. According to agreements with Gazprom, in 2004, Kazakhstan’s gas pipeline infrastructure carried 43.35 bcm (40.3 bcm in 2003) of Turkmen and Uzbek gas to Russia and 66.05 bcm (65.34 bcm in 2003) of Russian gas transiting through Kazakh territory. The 2005 volumes were somewhat lower, namely, 42.97 bcm of Turkmen and Uzbek gas and 61 bcm of Russian gas, and volume decreased further in the subsequent years. Kazakhstan plans to ship over 47 bcm of Russian gas across its territory in 2008, and more than 54 bcm of Central Asian gas to Russia, according to KazTransGaz. The company transports gas along six pipelines, with the Soyuz link connecting

Gazprom’s Orenburg processing facility in Russia with Ukraine via Kazakh territory.\(^{24}\)

Gazprom is interested in the safe and continuous transit of Central Asian gas through Kazakhstan to third-country markets, and that is what agreements on gas trade with Turkmenistan and Uzbekistan provide. The exploitation of Kazakhstan’s current gas pipeline infrastructure, including upgrading and increasing its efficiency, are national priorities. Kazakhstan is willing to modernize and reconstruct its gas pipeline infrastructure to create capacity for its own increase in production as well as accommodating a boost in Turkmen and Uzbek gas transit.

In 2007, Kazakhstan’s company Intergas Central Asia (wholly owned by KazTransGaz, a KazMunayGaz subsidiary) agreed to supply Gazprom with transport capacity of up to 55.7 billion cubic meters of gas. In 2006, some 7.5 bcm of Kazakhstani gas was transported through the Russian territory, according to the Russian Industry and Energy Ministry officials.\(^{25}\) Intergas Central Asia derives a substantial part of its revenue through gas transit from Turkmenistan to Russia. The company negotiates these earnings on an annual basis with its shippers, principally with Gazprom, which controls the gas from the time of purchase at the Turkmen border. In contrast, Uzbek gas transiting into Kazakhstan (largely for consumption in Kazakhstan) is under Gazprom’s direct control from the time it crosses the Uzbek border, and then Gazprom swaps it for the same volume of Kazakh gas (in 2007, 3.5 billion cubic meters) to be delivered to Orenburg from Karachaganak.\(^{26}\)

**Importing gas for Kazakhstan’s domestic consumption.** Kazakhstan has two separate domestic natural gas distribution networks, one in the west, which services the country’s natural gas fields, and one in the south, which mainly delivers imported natural gas to the gas-importing southern regions. Because of the country’s divided distribution network, Karachaganak’s natural gas goes northward to Russia’s Orenburg processing plant for export, as opposed to supplying Kazakh consumers in the south. The lack of internal pipelines connecting Kazakhstan’s natural gas-producing areas to the country’s industrial belt has hampered the development of its natural gas resources.\(^{27}\)

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\(^{26}\) “ICA Invested KZT 3.3 Billion in Overhauls,” *Oil Review*, August 2, 2006 in Martha Brill Olcott, “KazMunaiGaz: Kazakhstan’s Oil and Gas Company.”

\(^{27}\) Energy Information Administration, “Kazakhstan Country Analysis Brief.”
Southern Kazakhstan receives its natural gas supplies from Uzbekistan. Kazakhstan estimated that in 2008, it would need to import up to 3.8 billion cubic meters of gas (40 percent of the total countrywide consumption) for the needs of its southern regions, and their consumption is likely to increase to by 6.5 billion cubic meters a year. In 2008, Uzbekistan agreed to supply gas to Kazakhstan for a price of $100 per 1,000 cubic meters, unchanged from 2007. The Tashkent-Bishkek-Almaty pipeline crosses Kyrgyzstan, and terminates in Almaty. Reliance on imported natural gas has at times been problematic due to erratic pricing and supplies from Uzbekistan, as well as illegal tapping of the pipeline by Kyrgyzstan that caused supply disruptions to Almaty in the middle of the cold season.

Kazakhstan is working on internal gas development projects so that it can eventually stop importing Uzbek gas for domestic consumption. KazMunayGaz is developing plans to build a 1,500-kilometer Beineu-Bozoi-Samsonovka gas pipeline with an initial capacity of 5 billion cubic meters of gas per year to become operational by 2011. The Southern regions will get gas supplies mainly from gas fields in the Aktyubinsk, Atyrau, and Mangistau regions. According to KazMunayGaz, Kazakhstan is determined to boost its domestic gas sector and lessen dependence on gas imports from Uzbekistan.

Regional Gas Pipeline Infrastructure

The Central Asia-Center pipeline system. Moscow is in the process of reviving and expanding a Soviet-era gas mega-project to bring gas from Central Asia to European Russia and further on to the Western European markets. The pipeline network will unite Turkmenistan, Uzbekistan, Kazakhstan, and Russia. Moscow wants to ensure transportation of Kazakhstan’s future gas production and Central Asia’s output gas for export through the Central Asia-Center pipeline system, with volumes estimated to reach up to 100 bcm per year by 2014.

The rationale for this project is simple: gas extraction on the Caspian Sea continental shelf and mainland fields, such as Tengiz and Korolevskoye, is likely to increase. Without an adequate collection, processing, and transportation infrastructure, the producers can only either pump this gas back into the ground to increase oil output or flare it.

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29 Energy Information Administration, “Kazakhstan Country Analysis Brief.”
In 2004, the Russian institute Giprogaztsentr conducted a study of Kazakhstan’s gas pipeline system capacity at the request of Gazprom. At that time, the volume of transit gas through Kazakhstan’s pipeline system was 121.5 bcm, with the annual growth of gas transit through Kazakhstan projected at about 3-5 percent. Achieving this goal requires significant investments as well as an appropriate investment climate and political stability in the Caspian region.\(^\text{30}\)

Russia’s agreements with Turkmenistan and Uzbekistan on gas trade also require pipeline capacity upgrades. Bateman Oil and Gas BV completed a strategic modernization program of the following pipelines: the Central Asia-Center (Turkmenistan-Uzbekistan-Kazakhstan-Russia-Ukraine-Europe), Makat-North Caucasus (Makat-Atyrau-Northern Dagestan-North Caucasus), and Okarem (on the Caspian coast in Turkmenistan)-Beineu (Western Kazakhstan, Mangistau region). KazMunayGaz, KazTransGaz and Gazprom are coordinating the technical details of this project.

In December 2007, Russia, Kazakhstan, and Turkmenistan announced an agreement to carry Central Asian natural gas from Turkmenistan to Russia via the existing Central Asia-Center gas pipeline. After the pipeline’s upgrade in 2012, the route will have a capacity of at least 2.6 tcf (80 bcm), up from around 2.1 tcf (60 bcm). The agreement stipulates that each country will be responsible for upgrading the section of pipeline in each of its respective territory. In Kazakhstan, the modernization of the Soviet-era system Central Asia-Center has already started. The estimated cost of this project, intended to bring the capacity up to the expected 80-100 bcm level, is some $2 billion.

The Prikaspiisky (Caspian Coastal) gas pipeline. At a May 2007 Caspian summit in the Turkmen port city of Turkmenbashi, the presidents of Russia, Turkmenistan, and Kazakhstan signed a memorandum of understanding to upgrade the Prikaspiisky (Caspian Coastal) gas pipeline. This pipeline carries gas from Turkmenistan, through Kazakhstan, to Russia. It will also carry Kazakhstani gas to Russia.

According to Russian estimates, expansion would allow the pipeline to increase capacity from 0.4 bcm of gas in 2006 to 10 bcm per year by 2009, and up to 30 bcm per year by 2015. Thus, it would further bind the Caspian gas producers to export to Western markets through Russia. After the pipeline is completed, it may transport up to 90 bcm of Central Asian gas through Russia compared to 50 bcm today. Kazakhstan and Turkmenistan agreed to finance the pipeline development in their respective territories without Russian funds. The Russian media commented that with this deal, Kazakhstan committed itself to Russian gas export routes.

On December 20, 2007, in the Kremlin, Russia, Kazakhstan, and Turkmenistan signed a trilateral agreement on the construction of the Caspian Coastal gas pipeline. This became possible as in November 2007 Russia agreed to pay a higher price for the Turkmen gas—ending a dispute that had been a major obstacle to finalizing the deal.

31 Energy Information Administration, "Kazakhstan Country Analysis Brief."
32 “Annual Growth of Gas Transit through Kazakhstan” RosInvest
The Prikaspiisky expansion may thwart plans for a US and EU-backed Trans-Caspian gas pipeline (TCP-gas) that would have delivered Turkmen and possibly Kazakhstani gas across the Caspian Sea and the Baku-Erzurum pipeline to Turkey, and would have further shipped it via the proposed Nabucco pipeline to Europe. This arrangement would have enabled Central Asian exporters to circumvent Russian-controlled gas export routes. Ultimately, the future of this project depends upon the degree of political support and economic benefit the U.S. and the EU are willing to offer to the major Caspian gas producers, including Kazakhstan, Turkmenistan, and possibly Uzbekistan, vis-à-vis the Russian pressure they are facing. In the meanwhile, the Central Asian states have been exploring eastward export direction more actively.

Gas Supply from Kazakhstan to China

Over the last few years, China has been increasing its energy holdings in the Caspian, and aspired to play a greater regional role. In the context of international energy security, it should be viewed as a competitive consumer with vast economic clout. When successfully securing direct pipelines and energy supply contracts from Central Asia, China ships valuable non-Russian energy resources East instead of West.

As China attempts to diversify the geographic sources of its energy imports, and as Russia has at times been an unreliable supplier, dragging its feet on the construction of pipelines to China, Beijing is increasingly looking to Central Asia to meet its rapidly growing energy needs. China also views ex-Soviet Central Asia as a target of economic expansion and eventual integration into the Chinese sphere of influence.

Energy-hungry China is inexorably expanding its presence in the Central Asian energy markets, as its $4.2 billion bid for PetroKazakhstan demonstrated. China is willing to commit major financing to bring home not just Kazakh oil, but also gas via a future gas pipeline to China, which the two countries plan to build along the way of the existing oil pipeline. The Sino-Kazakhstan gas project will be part of the Chinese government’s drive to triple natural gas consumption by 2010. Currently, China is able to buy 8-10 bcm of Kazakh gas, and by 2020 is may be able to buy up

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38 Socor, “Kazakhstan’s Growing Gas Exports to Go Russia’s Way.”
39 Personal interviews conducted by the author with Chinese researchers, Beijing and Shanghai, September 2006. Interviewees requested anonymity.
to 30 bcm. Beijing hopes to replace some oil and coal fired power plants with natural gas-fired ones to reduce its heavy reliance on oil imports, and to improve the environmental impact of its energy generation sector by burning less coal.

Nazarbayev announced an agreement between China and Kazakhstan during his state visit to Beijing in May 2004. The parties had previously viewed the trans-border gas pipeline project as too expensive since most of Kazakhstan’s gas deposits are located in the western regions of the country, and the pipeline would have to cover a long distance to reach the Chinese border. However, the experience of the Atasu-Alashankou oil pipeline demonstrated that the two countries could implement projects of this type in a remarkably short time. Several possible routes for a gas pipeline have been under consideration. According to KazMunayGaz’s officials, the first route would ship Uzbek and Turkmen gas towards Almaty. Kazakhstan will construct a gas pipeline from Almaty to the Chinese border. Judging by the $600 million agreement signed in Beijing by Islam Karimov, President of Uzbekistan, in June 2005, to build a gas pipeline to China via Kazakhstan, Beijing is taking this route seriously.

The second route includes supply of Kazakh gas from the fields in Western Kazakhstan. According to the Deputy Director General of KazTransGaz, Pavel Klimov, the new line will connect the Zhanazhol and Karachaganak fields with the Bukhara-Ural main pipeline via Kzyl-Orda, and will connect to the Shymkent-Almaty pipeline. Construction of a 750 km Almaty-China pipeline will be necessary.

Finally, the third route includes construction of the Ishim (Russia)-Petropavlovsk-Kokchetav-Astana-Karaganda-Balkhash-Druzhba gas pipeline, which may carry Russian and Kazakh gas.

The positive aspect of this pipeline route is its capability to supply the northern, central, and southern regions of Kazakhstan, as well as to export to China. The pipeline would also serve for gas swaps with Russia, in which Russia could swap its gas supplied to the Ishim region for Kazakh gas from the Caspian region and Western Kazakhstan going to Orenburg and beyond. The project would take Russia’s interests in diminishing the transportation expenses on the gas supplies

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40 Jalilova, “Golubaya Mecha dlia Kitaya.”
43 Ibid.
from Siberia to the European part of Russia into consideration, as well as Kazakhstan’s interest in supplying gas to new regions and China’s interests in diversifying its gas suppliers. In late 2007, the parties finally reached an agreement that the pipeline would run from Turkmenistan via Uzbekistan and Kazakhstan to China. In the beginning of 2008, PetroChina and its parent China National Petroleum Corporation (CNPC) committed a combined $2.2 billion via one of their subsidiaries to expand the Central Asia-China natural gas pipeline.44 (See the route of the pipeline on Map 5 below).

Map 5: Gas Pipelines to China

[Map of gas pipelines to China]


The planned construction of a direct gas pipeline to China outside of Russian control is essential for China’s gas supply from Central Asia. Earlier, in April 2006, the Presidents of Turkmenistan and China signed a memorandum of understanding on a new Turkmenistan-China gas pipeline. The parties expect the new pipeline to start at Gedaim, Turkmenistan, in the gas-producing area near the Turkmen-Uzbekistani border, go through Turkmenistan (188 kilometers), Uzbekistan (530 kilometers), and southern Kazakhstan (1,300 kilometers) and into

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southern China’s industrial Guangzhou province (4,500 kilometers). China will fund the pipeline’s construction, which may cost some $10 billion.

To ensure its supply, China has actively championed the pipeline by negotiating separate gas deals with Kazakhstan and Uzbekistan, which at times have difficult relations. In late 2007, China and Kazakhstan signed an agreement outlining the principles for building and operating a China-Kazakhstan natural gas pipeline. China had also entered into bilateral energy cooperation agreements with Turkmenistan. The countries committed to closer ties in the energy and regional security fields during Turkmen President Gurbanguly Berdymukhamedov’s official visit to China in July 2007. A 30-year natural gas supply contract was signed which, according to which CNPC, China’s largest oil producer, will import 30 billion cubic meters of Turkmen natural gas annually through the planned Central Asia Gas Pipeline, starting in 2009. CNPC will be able to obtain up to 17 billion cubic meters of gas per year from exploration and production in the Amu Darya Region under the PSA signed between the two governments, and the rest will come from Turkmenistan’s own production. The parties have not disclosed prices and other contract details. CNPC should produce the remaining 13 billion cubic meters of gas at other fields currently serving to supply Gazprom.

With this field exploration license, CNPC became the first foreign company to gain the right to produce gas onshore in Turkmenistan. Some energy analysts doubt Turkmenistan’s ability to carry out gas supply contracts to Russia (55 bcm), China (30 bcm), and the European Union (10 bcm) simultaneously starting in 2009. If they are correct, Turkmen supplies to China may undermine Russia’s economic and political strategy in Central Asia and threaten the Russian-sponsored Prikaspiisky gas pipeline construction around the Caspian Sea and through the territory of Kazakhstan, due to insufficient gas available for export from the country.

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50 Andrew Neff, “Planned Gas Pipeline Advances.”
51 “China Injects Cash into Cross-border Gas Project,” *Argus*
By providing the Central Asian producers an alternative export route outside of the Russian flagship pipeline, Central Asia-Center, and the future Prikaspiisky pipeline, the gas route to China would bring Central Asian countries closer to their strategic goal of diversifying their energy exports. For China, aside from its need to ensure stable natural gas supplies from Central Asia and reduce its dependence on coal and oil, the new pipeline is a tool for increasing its political weight in the region. With agreements for a gas pipeline passing through the territory of three major energy producers, Beijing has gained an advantage in the regional geopolitical competition.53

**Establishment of a Russian-led Gas Alliance**

Oil and gas have become instruments of choice in Vladimir Putin’s foreign policy. Since his election in 2000, Putin has demonstrated an unprecedented level of activity in the international arena. He clearly would like to go down in history as the leader who reversed the centrifugal processes of post-Soviet disintegration. His administration has consistently sought ways to increase its leverage over the former Soviet republics. Energy, and specifically natural gas, on which many of them depend for heating, energy generation, and industrial feedstock, has always been a core element in Russia’s control over the former Soviet republics.

The idea of creating an organization following the model of the Organization of the Petroleum Exporting Countries (OPEC) dates back to the mid-1980s, when the need for natural gas, including liquefied natural gas (LNG), in the industrialized countries began to grow, resulting in direct competition between the world’s consumers of gas.

The integration of the international energy market has increased, particularly between Western Europe and Eurasia. The December 2005 appointment of former German Chancellor Gerhard Schroeder as President of the Shareholder Council in a joint Russian-German Pipeline Consortium illustrates this trend, as well as the growing power of Russia to hire the services of the foremost Western politicians in the interests of its energy security and foreign policy needs.

The Russian leadership understands that Moscow’s control of the gas infrastructure, supply, and prices can enhance its overall geopolitical power. The Kremlin is in the process of launching an OPEC-like structure to regulate the

production and prices of natural gas. This “gas OPEC” would make energy exporters in the region—Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan—more dependent on Moscow, as Russia is the globally predominant natural gas producer, “the Saudi Arabia of gas.” Russia is also discussing the idea with Iran and Qatar, the second and third most gas-rich countries on the planet.

The concept for this alliance focuses on the transit of Central Asian gas, and Kazakhstan has an important role to play, both as a transit country and as a producer. The “gas OPEC” in the CIS was formed based on principles similar to those underlying OPEC itself—not only are the suppliers part of it, but so are transit nations, such as Syria, Tunisia and Egypt.

The Kremlin is steadily putting the components of a gas cartel into place without making any official proclamations. Russia’s Energy Strategy document briefly mentioned Moscow’s aim to “coordinate just prices for energy resources” with other producing states. During his February 2007 visit to Qatar, Putin called the “gas OPEC” “an interesting idea.” In Doha, Russia initiated the creation of a High Level Group to “research” gas pricing models, and an unnamed “high ranking member of the Russian delegation” told RIA Novosti that “as the gas market undergoes globalization, such an organization [a gas cartel] will appear and is necessary.” The Central Asian states seem to go along with Russian policy.

Russia’s assistance in the development of gas resources in Kazakhstan and Uzbekistan will be paid back in the shipment of vast quantities of gas from these countries. Russia will also help to modernize the Bukhara-Ural and Central Asia-Center gas transit systems. These pipelines, on which the welfare of the energy exporting NIS hinges, are important for tying the Central Asian states to Russia over the long term, both strategically and economically.

On May 6, 2003, a decree by the Kazakh Minister of Energy confirmed Kazakhstan’s membership in a working group for the creation of a gas alliance with Russia. According to Kazakh officials, their participation makes sense. Kazakh experts believe that the creation of a gas alliance will help its members coordinate

59 Ibid.
import-export and investment policies, as well as forecast the energy commodity markets. KazMunayGaz, in particular, supports the idea of this kind of international alliance. It considers the development of long-term strategic gas cooperation between Kazakhstan, Russia, Turkmenistan, and Uzbekistan key to promoting joint resource exploitation and increasing strategic cooperation between national gas companies.

Russia promoted the establishment of a Eurasian gas alliance during Putin’s official visit to Ashgabat, the capital of Turkmenistan, as early as the year 2000. Putin repeated his entreaties during the late Turkmen President Saparmurad Niyazov’s visit to Moscow in January of 2002. However, Niyazov then insisted that only Turkmenistan and Russia would be members.60

Putin, on the other hand, reportedly suggested broadening the scope of the alliance to include the four gas-extracting countries of the CIS—Russia, Turkmenistan, Kazakhstan, and Uzbekistan. His concept, as noted earlier, was much closer to the creation of a nucleus for a “gas OPEC” —the member countries would coordinate the volume of gas extraction, construction of pipelines, tariffs on transit and, most importantly, price policy.

Going along with Putin’s suggestion—or diversifying their export pipelines—would offer Turkmenistan, Uzbekistan, and Kazakhstan an unprecedented ability to raise the price of gas, which they duly announced in March 2008 (see below).61 Consumers of Russian and Turkmen gas, such as Ukraine, would be at the mercy of the supplier. If this alliance does eventually become a reality, it will radically influence the world gas market. Russia is the world’s largest producer, while Iran has the second-largest reserves. The Central Asian states would become important players, although Russia’s hegemony would not allow them to become business competitors.62

The realization of this cartelization plan will position Moscow to do more than make money. It will be able to seize the initiative from the U.S. concerning post-9/11 energy projects in Central Asia and Afghanistan. Moscow is worried that US influence in this region is growing, and that America’s next goal will be launching

energy extraction and transportation projects to the world markets, such as the much-discussed Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas pipeline.

The Kremlin is also concerned that the U.S. will squeeze it out of regional energy projects, giving priority to Kazakhstan and Azerbaijan. Russia is also uncomfortable with the growth of Western influence in Afghanistan, since it considers Afghanistan a transit country for energy flows from Turkmenistan and Kazakhstan to Pakistan and India. Thus, Moscow considered it is especially important to cement a strategic energy relationship with Turkmenistan, after Saparmurad Niyazov died in December 2006 and Gurbanguly Berdymukhamedov became President. Russia wants to secure Gazprom-controlled gas exports.63

The appearance of Turkmen—and in the future, Uzbek and Kazakh—gas on the European market will result in an increase in Gazprom’s net profit. Hence, Gazprom CEO Alexei Miller described the Turkmen-Russian agreements as “historically significant and extremely beneficial to Russia.” Turkmenistan is the ace in Russia’s Eurasian deck of gas cards and a good example of the Russian policy of substituting and reselling Central Asian gas in its domestic market.

Gazprom has agreed to pay a higher price for the Turkmen gas supply to maintain its control over the regional energy flow. Today, Turkmenistan supplies the bulk of Russia’s Central Asian gas, including most of the gas sold to Ukraine. Russia buys up to 30 bcm of Turkmen gas per year,64 compared with Russia’s total 2006 exports to Europe of some 132 bcm. Access to Turkmen gas is strategically important for Russia to be able to meet its international commitments. In the case of Turkmenistan, in 2003, Russia succeeded in securing a long-term agreement that regulates the sale of Turkmen gas to Russia, while no major consortium has been set up.

Another attractive aspect of the gas alliance was the opportunity to develop Caspian resources without the division of the seabed, and hence to overcome stalled negotiations on the Caspian Sea delineation.65

While Russia is strategically committed to expanding its dominance in the Eurasian energy sector, tactically it is quite flexible, readily adapting mechanisms such as long-term supply agreements or joint ventures that carry out gas sales to Europe. Russia’s gas trade coordination with the post-Soviet states inevitably involves setting up regional hubs within the Eurasian gas alliance, such as the one


65 Ibid.
established between Russia and Kazakhstan (KazRosGaz). These hubs facilitate the region’s coordinated gas exports to Europe. Gazprom also created a similar consortium with Ukraine (RosUkrEnergo), which the Yushchenko Administration did not support and could not fully control, especially while Victor Yanukovych was Prime Minister (August 2006-December 2007; and previously, November 2002-December 2004 under President Leonid Kuchma). By the spring of 2008, both Russia and Ukraine were willing to terminate the arrangement that involved RosUkrEnergo and trade gas directly between state-owned entities.

Russia needs the gas cartel to protect its market share and price policies in the world gas market. According to Gazprom, a decline in European gas prices is possible because of increased competition between suppliers. However, Gazprom aims to compensate its potential losses through the growth of Russia’s exports.

A decrease in prices would also press the Netherlands, Norway, Denmark, and Great Britain to lower their gas prices as well, which are currently considerably higher than the price of Russian gas. Norway, not an EU member, has historically been against the gas-exporting cartel of the Netherlands, Great Britain, and Denmark. Oslo could be a potential partner in the post-Soviet gas bloc, but, thus far, Norway has decried Russia’s plans. From an energy security policy perspective, the United States and Western Europeans should coordinate anti-monopoly activities in the gas sphere with China, Japan, and other consumer countries; however, thus far coordination has been lacking.
Electricity

In addition to hydrocarbons, Kazakhstan has some of the world’s largest uranium and coal reserves, and the potential to generate a significant amount of electricity. During the 1990s and early 2000s, Russia’s electric power monopoly, United Energy Systems (RAO UES), created a “free-trade zone” in electricity, which includes most of the countries of the CIS and Lithuania. This regime has effectively been in place since 2003. Russia plays the central role of technical designer, general contractor, engineer, systems integrator, and financier of electric utilities in the post-Soviet space. This allows Moscow to acquire an important source of leverage over its former dependencies.¹

Small wonder, then, that RAO UES Chairman and former Russian privatization architect, Anatoliy Chubais, stated:

> The power industry is a unique example of real integration unparalleled in any other sector...It is akin to Russian business simply overtaking and swallowing up businesses in adjoining countries. Moscow is beginning to control the key sectors in these countries’ economies and, all in all, their existence. A decent winter in Tbilisi is now our concern too.²

Astana hears statements of this type with a shudder. Democratically oriented Chubais is the author of the concept of “liberal empire,” first aired in a speech in 2003, calling upon Russia to construct a “liberal empire” of its own from the pieces of the old Soviet Union.³

Russia is striving to control the economically efficient power generation resources of the former Central Asian republics, primarily the hydroelectric stations in

Tajikistan and Kyrgyzstan, and a massive coal-fired power plant in Ekibastuz, Kazakhstan.

Central Asia, with its high mountains and altitude drops of hundreds of meters, can become a net exporter of energy, especially electricity. In 2006, the Kazakh energy ministry estimated electricity production at levels of 73 billion KWh, and consumption levels of 71 billion KWh, a net surplus. However, separate electricity grids across the country’s vast territory force it to continue importing electricity for its southern regions, which use a separate transmission grid. Kazakhstan is a principal transit country for Tajik and Kyrgyz power generation capabilities. Kazakhstan also has massive coal and uranium supplies, which may allow it to produce electric energy competitively. However, no uranium-fueled power stations function in its territory, though there are plans to build one.

Figure 6 presents the current structure of energy generation and distribution in Kazakhstan.

Figure 6: Structure of electrical energy production in Kazakhstan

Source: Energy Sector Overview in Kazakhstan at http://www.buyusainfo.net/docs_orig/x_5598541.doc

Kazakh-Russian Cooperative Electric Power Generation. Russia and Kazakhstan cooperate in electricity production and other energy sectors, such as uranium

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4 Energy Information Administration, “Kazakhstan Country Analysis Brief.”
mining (see below). Ekibastuzskaya GRES-2, a giant coal power station built in the Soviet era, is a typical example of how Kazakh-Russian cooperation in the power generation sector works. Both states designated the members of an expert working group, including representatives from the Russian and Kazakh Ministries of Energy, Finance, and Justice, creating a Kazakh-Russian joint venture to operate and renovate Ekibastuzskaya GRES-2. Its goals include reconciling the current debts of the Kazakhstani state owned electrical energy company Kazakhstanenergo and Kazakhstan’s electricity distribution companies to Russia’s RAO UES for the electrical power they had received. In turn, Russia had debts for the coal supplied from Ekibastuz and for what the Russian Ministry of Nuclear Industry owed to Kazakhstan for cleanup and utilization of the nuclear waste left in Kazakhstani territory by the Soviet-era nuclear complex.

The working group, together with RAO UES representatives, developed a debt reconciliation mechanism and schedule. In March 2005, Kazakhstan’s Ministry of Energy, Russian UES, and Access Industries (a US-based company) signed a three-party protocol in Moscow on reconciliation of payments arrears and the creation of a Kazakh-Russian joint venture based on Ekibastuzskaya GRES-2, which the energy ministers of both countries approved. As determined in the schedule approved by Deputy Prime Minister of Kazakhstan, Akhmetjan Esimovin, in April 2005, the parties finalized the Kazakh-Russian joint company by July 1, 2005, and the Kazakh-Russian joint venture based on the Ekibastuzskaya GRES-2 station began operating late in the same year.

The Kazakh government owns 50 percent of the venture, with the other 50 percent held by Inter RAO UES, a joint subsidiary of RAO UES and the state-owned nuclear power company Rosenergoatom. Ekibastuzsky Energotsentr, part of the Samruk-Energo state asset management agency, manages Kazakhstan’s share of the venture. This bureaucratically driven and slow process of state involvement in building the power generation infrastructure is a far cry from the market-driven approaches typical of most developed and some developing countries.

Under the August 2006 contract, Ekibastuzsky Energotsentr JSC (wholly owned by Samruk) entrusted a 50 percent stake in Ekibastuzskaya GRES-2 to Access Industries (Eurasia), LLC, for 10 years. In compliance with this contract, Access undertook to invest in the facility’s upgrade. In 2007, however, officials of Samruk voiced their intention to contest the government’s transfer of its share in
Ekibastuzskaya GRES-2 to Access. Inter RAO UES CJSC, the owner of the remaining 50 percent stake in Ekibastuzskaya GRES-2, plans to invest $51 million in 2006, $38 million in 2007, and some $4.5 million by 2010 in the plant’s upgrade project.

The power plant had not been operating at full capacity due to lack of funds for much-needed renovation. After the creation of a joint company and inflow of additional funds, the management approved and launched a reconstruction program in 2006. The implementation of the renovation program resulted in the power plant reaching its design capacity of 1000 MWatt in 2007. It now accounts for about 10 percent of the total electricity generated in Kazakhstan. The next phase of reconstruction, scheduled for 2008-2009, will upgrade filtering equipment and make power generation more environmentally friendly. The company’s management has also decided to construct an additional—third—unit that will considerably increase the plant’s generation capacity (by 500 MWatt). In his February 2008 State of the Nation address, President Nazarbayev named construction of this third power unit among the country’s priority projects. It should start in the second half of 2008 and be completed by 2012. Russian and Kazakhstani companies will jointly finance the project.

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The Coal Industry

Radical changes in the social and political situation in Kazakhstan in the beginning of the 1990s brought about a fundamental transformation in the state-owned Kazakh coal industry. After gaining independence in 1991, Kazakhstan's coal production declined by one third, mainly due to low economic efficiency, lack of much needed outside investment, and poor mining safety conditions. Consumption also fell due to the downturn in the manufacturing sector, which suffered from a precipitous post-Soviet depression. The government of Kazakhstan worked on restructuring the distressed Soviet-era coal mining industry and introducing market mechanisms into the sector.

Kazakhstan is one of the top ten coal producers in the world. Its reserves and mines are the third largest in the CIS, while its income from coal mining per capita is the largest in the CIS. The five largest coal producers in Kazakhstan are located in the Pavlodar and Karaganda regions and account for 87.7 percent of the coal mined in the country. With proven coal reserves of some 34.5 billion short tons of mostly high quality anthracitic and bituminous coal, Kazakhstan has the eighth largest reserves in the world, possessing four percent of the world’s coal. The most valuable are energy-rich and coking coals.

Over 80 percent of power stations in Kazakhstan use coal and need a stable supply of fuel. Natural gas-fired plants and hydroelectric facilities produce the rest of the country’s power. Kazakhstan produced 106 million short tons (Mmst) of coal in 2006, while consuming 78 Mmst, resulting in net exports of 28 Mmst. Over the last decade, Kazakhstan’s resurgent industry fueled an increase in coal consumption. Russia is the largest importer of Kazakh coal, followed by Ukraine. According to official Kazakh estimates, 2007 production fell by around 1.9 percent against the 2006 level.¹

Coal sector improvements in 1991-1998 ensured the continued operation of the industry, attracted investment, and significantly diminished social tensions in the coal-mining regions. The most important factor in this restructuring was the privatization of large companies and the shutdown of unprofitable enterprises.

¹ Energy Information Administration, “Kazakhstan Country Analysis Brief.”
Today, all the coalmining companies in Kazakhstan are under private ownership (Table 7 lists the main coal producers in the country).

The new owners have concentrated their activities on the country’s most profitable mines, improving the exploitation of principal reserves, reducing management costs, and, as a result, reducing the net cost of coal mining. Additionally, foreign investment created vertically integrated structures such as coal-metallurgy and coal-electricity, which ensure stability of supply and profitability of production.

Today, Mittal Steel Temirtau incorporates Kazakhstan’s coal companies and metallurgy. The Arcelor-Mittal Group operates coalmines in the Karaganda region and, as of 2007, planned to raise an additional $500 million in investments to increase coal production by around 5 million tons. Coal and electric energy companies are part of Kazakhmys (a copper producer), the Eurasian Energy Corporation, and Bogatyr-Access-Komir. Bogatyr-Access-Komir produces one-third of Kazakhstan’s total coal output and is a subsidiary of US-based Access Industries Incorporated. Bogatyr-Access-Komir develops the Bogatyr and Severny coalfields in northern Kazakhstan.

<table>
<thead>
<tr>
<th>Company</th>
<th>Share of national extraction (% of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bogatyr Access Komir (Pavlodar region)</td>
<td>42.80%</td>
</tr>
<tr>
<td>Eastern section Eurasian Energy (Pavlodar region)</td>
<td>20.70%</td>
</tr>
<tr>
<td>JSC Maykuben–West (Pavlodar region)</td>
<td>3.3% and 96.6% of national extraction of brown coal</td>
</tr>
<tr>
<td>Coal department Mittal Steel Temirtau (Karaganda region)</td>
<td>12.30%</td>
</tr>
<tr>
<td>Coal department Borly of corporation Kazakhmys (Karaganda region)</td>
<td>8.70%</td>
</tr>
</tbody>
</table>

Source: Kazakhstan’s Ministry of Energy and Mineral Resources

Private ownership halted the industrial decline of the country and stabilized coal mining. Strategic investors brought in much-needed capital and advanced
production and management practices. Nowadays, the coal industry is one of the largest overall in Kazakhstan’s economy. In late 2007, however, the Kazakh government acquired 50 percent of the shares in the Bogatyr and the Severny coalmines in the Pavlodar Region in its drive to “return to state ownership facilities that are of strategic importance to the Kazakh power industry.”

The Kazakhstan-Russia Coal Industry Connection

To power Russia’s electricity generation stations, coal is cheaper than gas, while gas provides a higher value added when exported and is more environmentally friendly. Over 30 percent of the coal extracted in Kazakhstan goes for export to supply Russian power plants. Russian coal mining companies and regions, however, have engaged in active lobbying against the import of Kazakh coal, 95 percent of which comes from the Ekibastuzskoye field. Ten large power plants in the Urals and Siberia use imported Kazakh coal.

Russian policy-makers have thus far resisted pressure to decrease the consumption of Kazakh coal. Anatoliy Chubais’s RAO UES firmly stated it would not reduce imports, which Kazakhstan supplied earlier in this decade as barter for the country’s electricity debt arrears.

The principal argument against imports of Kazakh coal to Russia is its high ash characteristic and low heating capacity (compared with Russia’s Kuznetsk basin coal), which is why the price is lower. In addition, the high transportation costs for Kazakhstan’s coal via Russian railroads further reduce its competitiveness in the Russian markets.

The government of Kazakhstan has confirmed the implementation of a program called The Bilateral Development of Fuel and Energy Balance of Kazakhstan and Russia until 2020. The program aims at securing future Russian demand for the Ekibastuzsky coal. On February 12-13, 2004, a joint Russian-Kazakh Commission established bilateral trade targets for the years 2004-2020 at its session in Moscow, determining quotas for the export of Kazakh coal to Russia: 25 million tons in the 2004-2010 period and 22 million tons from 2010-2020.

With Kazakhstan’s vast coal reserves, this sector remains an important source of energy for domestic consumption. The industry has attracted strategic investors, but—as other segments of the energy market—is subject to increased involvement

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on behalf of the state. After acquiring a 50 percent stake in the Bogatyr and Severny coalmines in Pavlodar region from their Russian investors, Kazakhstan will develop these mining projects jointly with Russia.⁴ Samruk, the Kazakh state asset management company, and Russia’s Russkiy Aluminiy (Russian Aluminum) have formed a joint venture in response to the Kazakh Prime Minister’s call to return strategically important power industry facilities to the state as part of an effort to maintain the country’s energy security.

Some argue that the government needs a reliable supply of coal to boost Kazakhstan’s domestic power generation. Yet the private sector, with its superior management skills, access to financing, and greater efficiency, can do the job better.

The state, via the Samruk holding company, plans to invest heavily in construction of the Balkhash heat and power plant, increase the capacity of the Ekibastuz GRES-2 power station, and renovate the Almaty power stations.⁵ Moreover, as this may not be sufficient, Kazakhstan is also planning to become a major nuclear fuel producer.

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⁵ Ibid.
Uranium Mining and Nuclear Fuel Cooperation

During the Soviet era, most of the USSR’s uranium deposits were located in Kazakhstan and Kyrgyzstan, while all of the enrichment facilities remained in Russia. The demise of the USSR temporarily interrupted these connections, but the countries have been working to restore their industrial ties.

The powerful Russian nuclear ministry, Minatom, has concluded that it needs to develop cooperation with Russia’s neighbors to secure access to the uranium and nuclear processing facilities that remained beyond Russia’s borders after the Soviet Union’s collapse. Russia currently mines just 35 percent of the uranium it needs. It continues to purchase large amounts of uranium for its nuclear power plants, and co-develop export capacity. At the same time, Minatom is working on improving the organization of geological prospecting for uranium deposits in Russia. As its industrial base is picking up and power consumption is rising, the demand within the Russian nuclear power industry for uranium is growing. Simultaneously, global uranium consumption is growing as well, and with it, uranium prices.

Kazakhstan has developed an extensive nuclear sector based on its 1.5 million tons of uranium reserves—the second largest reserves in the world—representing almost 20 percent of the world’s uranium. Kazakhstan produced some 5,280 tons of uranium in 2006 and around 6,600 metric tons in 2007. The country has announced plans to boost uranium production to 9,400 metric tons in 2008 (42 percent growth comparing to 2007).

Some analysts suggest that by 2010, Kazakhstan may produce 15,000-18,000 tons of uranium per year, which is approximately 25 percent of world production. By 2015, Kazakhstan aims to more than double its uranium production and become the world’s largest supplier, racing ahead of Australia and Canada. It intends to supply

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one third of global demand by 2030. While this may be ambitious, surging uranium prices and declining stockpiles of blended-down weapons-grade nuclear fuel define the market today. This creates strong incentives for the national nuclear industry company, KazAtomProm, and international atomic corporations to increase investment in order to provide more uranium to the world markets.

The country may continue to increase production, provided that demand keeps rising, which is probable, with China and other countries building nuclear reactors at a brisk clip. KazAtomProm aspires to build a vertically integrated company active in all stages of the nuclear production cycle to increase its share of value-added nuclear exports chain. It would primarily target sales to the Chinese, Japanese, and Indian markets, and possibly the U.S.

The potential to produce nuclear power is based on its large deposits of uranium and residual technical expertise from the Soviet times. However, there is no nuclear power generation in Kazakhstan today. Instead, coal- and natural gas-powered stations dominate. The relative lack of energy diversification in Kazakhstan, as evidenced by the marked absence of significant hydro- and nuclear-power generating capacity, negatively affects the country’s energy security.

The Kazakh Ministry of Energy believes that the development of nuclear power stations could allow the country not only to produce energy competitively, but also to export nuclear-power produced electricity. This would generate higher value added than selling unprocessed raw materials.5 In spring 2006, Kazakhstan’s Energy and Mineral Resource Ministry announced a decision to build a new nuclear power station by 2015.6 This represents an attempt by Kazakhstan to reduce its reliance on exhaustible and environmentally damaging oil and coal, especially in the southern part of the country where coal-burning power stations have caused high levels of pollution. Kazakhstan’s only Soviet era nuclear power station in Aktau ceased operations in April 1999. The debate over a new power plant has been ongoing since 1998. The likely location is on Lake Balkhash in Eastern Kazakhstan. The prospect of a nuclear power station being located in Kazakhstan does not appear to raise concerns about proliferation risks given the country’s accomplished record of denuclearization.

International nuclear industry cooperation. Russia has played a role in Kazakhstan’s nuclear activities since the Soviet era. Semipalatinsk, the site of Soviet military

nuclear testing, became a symbol of irresponsible nuclear policy. Hundreds of nuclear explosions took place there, in the atmosphere and underground. Tens of thousands of Kazakh citizens died and became sick, many with cancer, because of the massive testing conducted by the Soviets without adequate safety measures and without warning the civilian population. Hundreds of thousands of Soviet Gulag inmates were involved in uranium mining in Kazakhstan and Kyrgyzstan, often paying with their lives for the creation of the Soviet nuclear arsenal. Since the collapse of the Soviet Union, the industry has experienced its ups and down.

When it comes to nuclear energy, Russia’s interest in Kazakhstan and Kyrgyzstan is no accident. In the 1990s, Russia, devoid of working uranium mines in its own territory, confronted barriers to further integration in the nuclear sphere in Central Asia. This included Uzbekistan’s drift towards the U.S. as well as Tajikistan’s unacceptable economic terms for uranium mining. Kazakhstan and Kyrgyzstan remained Russia’s key partners in the nuclear fuel field. However, as Uzbekistan and Tajikistan began a rapprochement with Moscow in 2005, the relatively competitive positions of Kazakhstan and Kyrgyzstan may deteriorate.

After Kazakhstan became independent, Russia remained committed to involvement in the country’s nuclear industry. On July 6, 1998, the Kazakh and Russian governments signed an Agreement on Integration of the Nuclear-Energy Cycle. Under its terms, Kazakhstan, Russia and Kyrgyzstan formed the Zarechnoye joint venture for the development of the large uranium field in the Otrarsk region of the Southern Kazakhstan oblast, formally registering on December 26, 2001. The shareholders of Zarechnoye include KazAtomProm (45 percent), TVEL (20 percent), Techsnabexport (15 percent), and Atomredmetzoloto (10 percent) from the Russian side and Kara-Baltinskiy Metallurgic Refinery (10 percent) from the Kyrgyz side. So far, the venture has invested over $5 million to develop the infrastructure and future sites for the company.

According to industry estimates, the extraction volume is likely to peak at 500 tons of natural uranium per year during the first stage of the field’s exploitation, and increase up to 1,000 tons per year during the second stage. Actual production started in 2005, with 70 tons per year output.

Russia fully financed Zarechnoye by investing some $14.5 million in its development. In addition, despite the fact that Russia and Kazakhstan are equal

partners in this project (45 percent each), Moscow manages the venture in view of Minatom’s control over Kyrgyzstan’s Kara-Baltinskiiy Metallurgic Refinery in 2002. The Russian Tyumen regional governor and head of strategic planning service of the Border Cooperation Association at the time, Alexander Sobyanin, who subsequently became Putin’s Chief of Staff during his presidency, said the following regarding Zarechnoye:

This event is politically significant and Moscow had been waiting for Kazakhstan to determine its position. Previously, Astana had been balancing between Moscow and Washington, cooperating with Russian and American nuclear companies. Virtual transfer of Zarechnoye to Russia means that Kazakhstan has made its choice and prefers nuclear cooperation with Russia rather than the U.S.9

There are environmental concerns. The Zarechnoye field is located in the northwestern part of the Karaktaus and Aryss national parks, and Kazakhstan’s Legislation on Specially Guarded Territories (Articles 23 and 47) prohibits mining in national parks.

On May 23, 2005, Kazakhstan’s then-Prime Minister Daniyal Akhmetov ordered the Minister of Agriculture, the Agency for Land Resources Management and the Head of the Southern Kazakhstan region to confirm the borders of the Aryss and Karaktaus national parks. The Kazakh Ministers of Environment and Agriculture received guidance to draft additional ecological requirements for Aryss and Karaktaus, taking into account the Kazakh-Russian-Kyrgyz company’s development of the Zarechnoye field, which comprises some 4,000 hectares.

Ukraine, like Russia, has a nuclear power industry based on Soviet designed reactors. On October 31, 2001, Ukraine, Kazakhstan and Russia formed the UKRTBS joint company to produce nuclear fuel to supply Ukrainian nuclear plants equipped with BBER-1000 reactors. All three parties have even stakes in the cooperative company—33.33 percent of authorized capital. On May 3, 2003, the governments of Kazakhstan, Russia, and Ukraine signed an agreement on cooperation in developing and operating UKRTBS.

Kazakhstan benefits from the stable production of nuclear fuel at the Ulbinskiy Metallurgic Company. Until 2007, the supply levels of nuclear fuel (powder and

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tablets) to the Russian market (Minatom) remained unchanged, at 300 tons of low-
enriched uranium tablets for power plants per year and 150 tons of uranium dioxide
powder per year.

In July 2006, Russia and Kazakhstan signed an agreement to establish three joint
nuclear industry ventures focusing on uranium mining and enrichment and on the
development of new atomic reactors. First, as part of the agreement, Russian state
nuclear fuel trader Tenex will join Kazakhstan’s state-controlled KazAtomProm in
developing the Budyonovskoye uranium deposit. A second joint venture will
process the mined ore, while the third joint project will concentrate on developing a
reactor similar to the small fast-neutron reactor (VBER-300) and promote it on the
world market.10 The deal benefits both sides, as Astana obtains access to Russian
nuclear know-how, while Moscow ensures the necessary uranium supply.

Besides traditional nuclear cooperation with Russia, Kazakhstan’s uranium
industry is drawing increasing interest from major Asian states. In April 2005,
South Korea and Kazakhstan created a uranium mining joint venture expected to
launch in 2008 with an eventual annual output of 1,000 tons.11 According to the 2006
civilian nuclear cooperation agreement, Japan will import Kazakhstani uranium for
power generation. Earlier, in November 2005, Kazakhstan and Japan agreed to
cooperate in developing uranium mines to supply Japan’s nuclear power plants.
Japan gets 29 percent of its electricity from nuclear energy, and is the third-largest
nuclear power generator in the world after the U.S. and France, according to the
World Nuclear Association. Japanese energy officials say the competition for
access to Kazakhstan’s uranium is tough since the country has not made it clear
how much of its uranium mining will be open to foreign companies.12

Nowadays, Astana aims at boosting the value-added component of its massive
uranium exports. It is planning to build up a vertically integrated national company
that would be involved in all stages of the nuclear cycle. International cooperation
is vital for the development of this high-tech and science-intensive industry. In
May 2007, the Russian state nuclear power agency, RosAtom, agreed to set up a
joint uranium enrichment center in Angarsk located in Russia’s Siberia, while
obtaining a stake in a uranium-mining venture with KazAtomProm.13 Then-

10 Humber, “Russia, Kazakhstan Sign Nuclear Deal.”
11 Energy Information Administration, “Kazakhstan Country Analysis Brief.”
12 “Japan Steps Up Search for Nuclear Fuel Supply,” International Herald Tribune, August 22,
President Putin welcomed this agreement as a first step toward implementing an “initiative to create a global infrastructure for nuclear energy.”

Kazakhstan has also become an increasingly active international player in nuclear acquisitions and investments. The county’s state-owned nuclear power company, KazAtomProm, has established uranium-mining joint ventures with the leading foreign nuclear power producing companies. This basic model of cooperation provides investors with a guaranteed uranium supply from Kazakhstan in exchange for technology transfers to upgrade the Kazakh Soviet-era uranium fuel processing industry.

In 2007, KazAtomProm acquired a 10 percent stake in Westinghouse Electric from Toshiba, the biggest Japanese manufacturer of nuclear reactors, for $540 million. Toshiba, for its part, is set to buy 22.5 percent of rights in the Kharassan mine, which has an estimated production capacity of up to 600 tons of uranium per year. For the Japanese company, mining rights in Kazakhstan help secure a stable supply of uranium to bolster its nuclear power business. Working with Japan and Korea diversifies Kazakhstan’s nuclear industry ties and balances off Moscow’s influence. So does a recent nuclear cooperation deal with China.

In November 2007, Astana and Beijing agreed to an equity swap in the nuclear industry. China will get up to a 49 percent stake in a Kazakh uranium mining venture with KazAtomProm, while KazAtomProm will gain equity in Chinese nuclear fuel processing or nuclear power generation plants. Boosting uranium output comes just in time, as Beijing needs large uranium supplies to fuel its expanding nuclear power generation. According to the agreement, China National Nuclear Corporation and China Nuclear Guangdong Power Corporation, China’s major nuclear power companies, will form a joint venture with KazAtomProm. This joint venture will process Kazakh uranium in facilities located in Kazakhstan, and provide much-needed technology transfer to Astana. Thus, KazAtomProm will become the first foreign company to hold a stake in China’s secretive nuclear

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14 Yermukanov, “Kazakhstan Uses Energy Deals with Russia in ‘Constructive Dialogue’ with Europe.”
17 Gorst, “Kazakhstan in Nuclear Deal with Beijing.”
industry, which, experts believe, highlights China’s aggressive pace in securing access to Central Asian energy beyond hydrocarbons.\textsuperscript{18}

In June 2008, Areva, a French state-controlled nuclear engineering company, and KazAtomProm agreed to establish the Katco joint venture that will produce 4,000 tons of uranium annually until 2039. Areva will own 51 percent in the joint venture, and KazAtomProm—the remaining 49 percent share.\textsuperscript{19} Areva will market Katco’s uranium output. The two companies have been cooperating on a smaller scale since 1996.

**Dealing with nuclear waste.** Finally, disposal of Kazakhstan’s nuclear waste has become a subject of national debate. Keeping nuclear waste and uranium ore and fuel under lock and key, and out of the hands of unscrupulous traders and potential terrorists involves effective anti-terrorism and homeland security policies, practices, and procedures. Lacking effective nuclear regulation, accounting and export controls throughout Central Asia, aspiring regional nuclear states (such as Iran) could “shop for opportunities,” while smugglers engage in transporting radioactive and sensitive nuclear-related materials, including low-grade nuclear fuel and “dual-use” metals, to the West.\textsuperscript{20} After the demise of the USSR, the scale of unauthorized nuclear smuggling was extremely alarming. In the early 1990s, officials disclosed that they had evidence of Iran trying to obtain dual-use, nuclear-related materials from facilities in Kazakhstan through front companies in third countries.\textsuperscript{21} Today, international experts still have concerns about the transparency of the Central Asian nuclear materials trade and grave suspicions regarding the Iranian nuclear program.

Kazakhstan needs to secure more than a dozen inactive and closed uranium mines—as well as large quantities of contaminated equipment. Some experts argue that it is unprofitable for Kazakhstan to export its nuclear waste to Russia for processing. They believe that construction of a long-term storage facility in the Semipalatinsk region would be much cheaper. According to Kazinform, Kazakhstan has 237.2 million tons of nuclear waste in 500 locations—a huge amount, but also a potential economic asset, given the proper reprocessing techniques.\textsuperscript{22}

\textsuperscript{18} Ibid.

\textsuperscript{19} “France’s Areva, Kazakhstan Sign Uranium Production Deal,” RIA Novosti.


\textsuperscript{21} Ibid.

Mukhtar Dzhakishev, President of KazAtomProm, has stated that importing and storing waste from rich countries was the only way of raising the more than the $1.1-2 billion needed to cope with his country’s nuclear legacy. According to Dzhakishev, Kazakhstan gets $10 for extracting a cubic meter of uranium ore, but will get $100 or more to deposit the same amount of nuclear waste. However, any future work in nuclear waste must take into account high security and environmental standards and best practices in order not to create more contamination and to keep nuclear waste out of the hands of wrongdoers.

To conclude, during the first 17 years of its sovereign development, Kazakhstan turned into a robust regional and international energy player. Fueled by abundant hydrocarbons and other mineral resources, the country has demonstrated a commitment to forward-looking economic, political, and social reforms rarely seen in today’s energy-rich states.

Thanks to its skillful multi-vector diplomacy, Kazakhstan has thus far managed to balance between the major players claiming influence in the region and has succeeded in ensuring its own national interests as well as contributing to regional stability.

The young state, however, is still facing a number of development challenges, addressed in the following chapter. Continued commitment to multi-vector geopolitics, market liberalization, and transition to a high value-added and diversified national economy, transparency and the rule of law would resolve these challenges in the best way, benefitting the people of Kazakhstan and its international partners.
Part Three:
The Future of Kazakhstan –
A New Eurasian Tiger?
Kazakhstan’s 2010 OSCE Chairmanship

As world oil prices reach new highs, and with commodity prices skyrocketing, Kazakhstan is facing important choices regarding its future. The coming years will be decisive, as Kazakhstan chooses which direction it will take in the decades to come. Its choices include: 1) a successful petro-state; 2) a failing petro-state; 3) a balanced economy with raw materials exports and processing industries, manufacturing, and services leading the country’s economic development; or 4) a breakthrough into high tech and other high value added sectors. Of course, combinations of the above are possible as well.

Politically, the country’s institutions are developing, though at a different pace and in a different way than in Western Europe and the U.S. After all, it took centuries for Western liberal democracy to become what it is today, and it would be unrealistic to expect Kazakhstan to successfully execute a “great leap forward” and become the Canada of Central Asia.

In the foreign policy arena, Kazakhstan is reaching out to Russia and China as well as to the U.S. and Europe. The role of international organizations is important for the country’s security, foreign policy, and overall development. The 2010 OSCE chairmanship is secure—a great achievement for the country and its diplomacy. It also has ambitious plans for CIS and Central Asian regional integration. Kazakhstan is a leader of CIS cooperation and EurAsEC integration. The government is working on Kazakhstan’s accession to the World Trade Organization. In 2008, it will launch a Road to Europe economic program aimed at making the Eurasian country more compatible with European Union laws and standards. Interviews with EU officials indicate that they may consider Kazakhstan as a candidate to join the European Union’s European Neighborhood policy.1

President Nazarbayev has also proclaimed the ambitious goal of seeing Kazakhstan ranked as one of the world’s 50 most competitive states. To achieve this, the government is promoting the rule of law, more transparent decision-making processes and a more streamlined bureaucracy, as well as economic diversification

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1 Author’s interview, Brussels, Belgium, November 2007; May 14-15, 2008.
beyond the energy sector. This may be Kazakhstan’s greatest challenge for the next decade.

Meantime, the country remains a model of ethnic stability, where many faiths and ethnic groups live in relative harmony. In the fall of 2009, the country will host its third Congress of Leaders of World and Traditional Religions.

For Kazakhstan, winning the OSCE Chairmanship for 2010 was an important step in boosting the country’s international prestige. Astana’s pursuit of this office highlights the significance of the Euro-Atlantic dimension of its foreign policy. Chairmanship of the OSCE will bring with it a higher profile in the capitals of OSCE member countries. Astana has also promoted itself as a unifying force, capable of bridging the divides within the organization between Russia/CIS and the West, and boosting its own clout in the Commonwealth of Independent States (CIS). According to Kazakh officials and regional experts, the country is seeking to overcome the alleged OSCE practice of applying double standards to member states concerning democracy and human rights. Kazakhstani diplomats say that these standards apply depending on the states’ level of rapprochement with the West, pointing to the relatively lenient treatment OSCE ODIHR and election observers granted pro-Western NATO candidate Georgia. In the January 2008 parliamentary and May 2008 Georgian presidential elections, the opposition alleged widespread violations of electoral practices and procedures by the pro-government structure and media, yet reactions on the part of OSCE observers were overall positive. Meanwhile, according to Kazakhstani officials, the OSCE has been more critical of elections held in other CIS countries.

Straddling the Islamic and European civilizations, Europe and Asia, Kazakhstan would like to help settle many ongoing conflicts in Eurasia. That in itself puts Astana in opposition to Moscow, which has been persistently trying to denude the OSCE of funding and authority.

**The long path to OSCE chairmanship.** Since 2004, promoting Kazakhstan’s candidacy for the OSCE chairmanship became a central goal of the country’s diplomacy on both sides of the Atlantic. Astana gained support for its bid at the 2005 CIS summit in Kazan, and at the 2007 summit in Dushanbe.

The foreign ministry developed a communications strategy to win support for Astana’s bid aimed at different target audiences at home and abroad. The strategy included two main scenarios: positive, focusing on the potential benefits of Astana’s presidency for the region and the OSCE, and negative, emphasizing the
adverse consequences of rejecting the bid. The Ministry developed a detailed list of arguments, targeting each of the main audience groups.

For Western audiences, Kazakhstan emphasized the need to uphold democracy and human rights standards for the post-communist transition states and the need to give an equal voice to all member states. At the same time, Astana sent a strong message regarding Kazakhstan’s capacity to bridge the gap between the Western and Eurasian OSCE member states, and promote the organization’s values eastward.

For the home audiences, the campaign linked success in domestic development with the country’s recognition on the international arena. Finally, the information campaign targeted the CIS audiences with messages on the right of the Newly Independent States to pursue their sovereign development paths, while being treated as equal partners in the international community. This, in itself, could not have made Moscow happy.

Reaching consensus among the OSCE members for Kazakhstan’s nomination was a challenging task for Astana—and one it successfully coped with. While Germany, giving priority to economic ties, was ready to support Kazakhstan’s chairmanship, France and the U.S. opposed it until 2007, referring to democratic deficits in the country. Paradoxically, despite Kazakhstan’s use of the OSCE chairmanship to boost its independence, Moscow promoted Kazakhstan’s candidacy as part of its broader efforts to reduce Western influence in the OSCE. Disagreements among the member-states prevented the OSCE Council of Foreign Ministers from making a decision on this matter at the end of 2006, postponing it until 2007.

Miguel Moratinos, Spain’s foreign minister and 2007 OSCE Chairman-in-Office, visited Kazakhstan in April 2007. After a number of high-level meetings, he expressed support for Kazakhstan’s bid and offered assistance for economic, social, and political reforms in the country. In an interview to Kazakhstanskaya Pravda following his visit, Moratinos said:

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2 Ministry of Foreign Affairs of Kazakhstan, “Proposed Information Campaign Scenarios Regarding Kazakhstan’s Application to Chair the OSCE,” Analytical note, 2007 (Russian).
3 Ministry of Foreign Affairs of Kazakhstan, “Kazakhstan’s Application to Chair the OSCE: the Arguments,” Analytical note, 2007 (Russian).
4 Ministry of Foreign Affairs of Kazakhstan, “Proposed Information Campaign Scenarios Regarding Kazakhstan’s Application to Chair the OSCE.”
Kazakhstan plays an important role in the region and we appreciate your willingness to take on the important and demanding mission of the presidency of the OSCE. We see this as the desire [on the part of Astana] to share the responsibility for the OSCE development as a tool for the 21st century and as a way to implement the democratic aspirations through practical measures... The OSCE experts are ready to provide assistance in drafting legislation on media, elections, and freedom of assembly and association, [as well as] support Kazakhstan in its fight against corruption.

Kazakhstan and the OSCE have come a long way together since joining their forces [in 1992]. We can be proud of the overall achievements during this time. However, the work is not over yet. We need to continue intensive efforts to reach the common goal—genuine security for all people living in the OSCE region.6

Winning the chairmanship. Finally, the OSCE’s 2007 year-end Ministerial Council meeting in Madrid resolved that Kazakhstan would hold the organization’s Chairmanship in 2010, a year later than its original bid. All 56 member-states voted in favor of Kazakhstan’s selection, responding positively to Astana’s pledge to advance democratic institution building in the country, and to uphold the basic values of the OSCE.

In 2008, Kazakhstan hosted the OSCE Parliamentary Assembly’s annual session, and in 2009, it will join the OSCE lead trio consisting of the previous, current, and future chairing countries. Kazakhstan is the first CIS state to hold OSCE leadership. Observers expect that Astana will emphasize the opinions and interests of the OSCE members “east of Vienna.”7 Thus, Kazakhstan’s diplomacy scored this victory without compromising the country’s national interests. Kazakhstani political scientist, senior fellow at the country’s Institute for Strategic Studies, Murat Laumulin shared his vision of Kazakhstan’s upcoming OSCE role:

We applied for 2009, they were trying to impose 2011, and some countries did not welcome even that decision. [2010] is a compromise, to the benefit for Kazakhstan. Furthermore, it is very good that one of the post-Soviet

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states will chair the organization. Earlier, our voices were weak, and there was a constant flow of criticism from Vienna. Biased approach blocked many political issues. Kazakhstan should manage to reverse this situation—to change the world’s attitude to the CIS countries. Other post-Soviet republics should take up this effort in the future.\(^8\)

Chairing the OSCE is a matter of national pride for Kazakhstan’s ruling elite and a personal achievement for President Nazarbayev. It is also evidence of a “new level of international recognition” for Kazakhstan and its growing importance in the region.\(^9\) At the same time, some analysts see the decision as “partly motivated by a desire among some countries not to compromise energy security by alienating Kazakhstan,” particularly in the context of growing unease about energy dependence on Russia.\(^10\) For Astana, however, the OSCE chairmanship is another step in the country’s strategy to boost its domestic institutions and international positioning.

Commitment to further reform. Kazakh foreign minister Marat Tazhin, in his address to the OSCE ministerial meeting in November 2007, committed to far-reaching domestic political reform. In doing so, he sought to dispel concerns about the lack of media freedom and democratic standards in Kazakhstan. In particular, Astana is planning to incorporate the OSCE’s recommendations into its newly drafted media law (expected in 2008), including the right to protect the confidentiality of sources, and easing defamation regulations.\(^11\) The Kazakh former minister of culture and information, Yermukhamet Yertysbayev, emphasized Kazakhstan’s commitment to freedom of speech and the right to receive information.\(^12\)

Kazakhstan also plans to incorporate OSCE recommendations into its legislation concerning elections and political parties. It also pledged “as a potential

\(^8\) “Kazakhstan’s Presidency of OSCE will Change the World’s Attitude to the Other CIS Countries as Well,” Kazinform, December 3, 2007, (Russian), at http://www.inform.kz (January 28, 2008).

\(^9\) Embassy of the Republic of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’,” News Bulletin Special Issue No. 3, February 8, 2008, at www.kazakhembus.com (March 10, 2008).


\(^11\) Ibid.

Chairman... not be party to any proposals that are problematic for ODIHR and its mandate” for election monitoring, which Russia has been seeking to weaken.\textsuperscript{13} Moscow will be watching the Kazakhstani OSCE chairmanship like a hawk. Russian foreign minister Sergey Lavrov expressed discontent with the OSCE’s perceived double standard in his statement following the Madrid Ministerial meeting:

> All of the CIS countries, which constitute one-fifth of the OSCE, backed [Kazakhstan’s] application for chairmanship. Unlike all others endorsed for the chair position without a problem until now, our Kazakh friends were compelled to prove their adequacy. This double standard is not to be tolerated.\textsuperscript{14}

Kazakh foreign minister Tazhin, on the contrary, stated that Astana undertook the pledge of political liberalization of its own will and not due to international pressure. Some regional experts observe that Astana’s obligation to integrate OSCE recommendations into the law signifies a break within the Russian “bloc,” since Moscow is always explicit in rejecting any OSCE recommendations and “incites other countries,” including Kazakhstan, to do the same.\textsuperscript{15}

**Keeping the promise of democratization.** Kazakhstan undertook ambitious political commitments at the Madrid ministerial meeting, and the international community is closely monitoring Astana’s progress. US Assistant Secretary for South and Central Asian Affairs Richard Boucher visited Kazakhstan in February 2008 to discuss the country’s progress in political liberalization.

The international community expected to hear an overview of the specific democratization steps in President Nazarbayev’s annual State of the Nation address in February 2008. However, instead, his Road to Europe strategy appears to substitute this with an economic agenda, focusing on “promoting economic cooperation, attracting new technologies and management expertise... improving [Kazakhstan’s] legislation, and setting up the agenda for [its] chairmanship in the OSCE.”\textsuperscript{16} Despite the slow pace of reforms, Boucher was optimistic, saying at the

\textsuperscript{13} Socor, “Kazakhstan to Chair the OSCE: Splitting the Russia-led Bloc?”


\textsuperscript{15} Socor, “Kazakhstan to Chair the OSCE: Splitting the Russia-led Bloc?”

\textsuperscript{16} Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’.”
press briefing that “we are all certainly waiting for the compliance with the commitments...We will continue to observe the reformation process.”

American diplomats say that Kazakhstan has less than one year—until it joins the OSCE trio in 2009—to demonstrate progress on its path to democratization, yet they are optimistic, saying that if the Kazakhstani leadership wants to fulfill their obligations, they have an opportunity and a rationale to present to those who may oppose these changes. Western observers believe that compliance is possible—and that it depends on political will within the leadership. Certainly, if Kazakhstan does not do anything, domestic critics will take note. The opposition in Kazakhstan has thus far been critical of Astana’s ability to uphold its promises of reform.

President Nazarbayev has reassured the international community of his commitment to democratization, as he addressed the OSCE’s Parliamentary Assembly in Astana in the end of June 2008. The Kazakh leader has particularly focused on creating a “more democratic parliament with at least two political parties,” widening media freedom and easing state registration procedures for the political parties.

While the “democracy deficit” still draws criticism, Kazakhstan’s interethnic and inter-faith relations can serve as a model of harmony and tolerance in a multi-ethnic Asian state, despite attempts to limit the practice of “non-traditional” religions (Jehovah’s Witnesses, Hare Krishna’s followers, Seven Day Adventists, etc.) in the country. The success of the state ethnic policy as well as Astana’s active role in promoting tolerance were important factors in favor of Kazakhstan’s selection for the OSCE presidency.

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Kazakhstan as a Model for Interethnic Relations

Kazakhstan experienced an “identity crisis” of sorts after it became independent in 1991, as more than half of its citizens were not ethnic Kazakhs. The Kazakh people had originally been nomadic, and there was no Kazakh state prior to Russian imperial domination and forced settlement. After independence, the post-Soviet elites focused on the memory of their nomadic roots, but recorded historical sources were scant.

The government of Kazakhstan was determined to take up the challenge of creating a new unifying and inclusive national identity, determined by citizenship and not by blood. President Nazarbayev underscored his commitment to multiculturalism as one of the pillars of his policy in an interview to the BBC:

We are the most multiethnic of all post-Soviet republics. As a result of Stalin’s policies, we have people of 130 nationalities living here, people who lived through truly terrible catastrophes and hardships. That is why the first thing we did when we gained independence was to create equality for all.

Still, it was a challenge to balance ethnic diversity with national revival built upon the ethnic Kazakh tradition. The late Kazakh historian Nurbulat Masanov warned that exaggerating the nomadic culture beyond its historic significance could bring with it the risk of creating a myth for the ethnic Kazakh citizens. Kazakhstan needs to maintain a delicate balance between its predominantly ethnically Kazakh nation, Russian neighbors, Muslim faith, and Western business and lifestyle aspirations. While the population is still struggling to reconcile parts of its new national identity, the government plays a prominent role by adhering to a balanced ethnic and language policy. This includes a “go slow” approach to enforcing the use of the Kazakh language and switching the alphabet from Cyrillic to Latin, as there is, among other reasons, no wish to alienate Russia, Astana’s strategic economic

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2 Ibid.
and political ally in the region, or to cause bitterness among Kazakhstan’s Russian speaking population.

**Language policy.** The language policy of Kazakhstan remains a sensitive subject. A considerable percentage of the people still do not speak the state language, despite the fact that since the 1990s, the government has been doing a great deal to promote its usage among the population, regardless of ethnicity.

In his 2007 State of the Nation address, President Nazarbayev announced a tri-lingual language policy for the country, including Kazakh as the official state language, Russian as the language of interethnic communication, and English as the language of international economic integration. This sophisticated approach aims to increase Kazakhstan’s competitiveness and promote the country’s image as a highly educated nation where the population is relatively fluent in three languages.

To implement this policy, the state is funding a new methodology of teaching Kazakh in six-level courses to suit the needs of all citizens; and offers a special bonus to incentivize ethnically non-Kazakh civil servants to master Kazakh. In the meanwhile, the Russian language remains a mandatory subject in the secondary schools, while Kazakh is the language of day-to-day instruction. Starting in 2007, the state has begun taking accelerated steps to improve English training in the schools as well, including recruiting qualified teachers from at home and abroad. Knowledge of English, and some argue, Russian, is key to further Kazakh education, science and technology, boosting R&D, and developing information technologies, as well as business and cultural ties worldwide. The government justifiably considers state funding of the needed language training to be a direct investment in the future of Kazakhstan.

**Interfaith summits in Kazakhstan.** Kazakhstan has become a global leader in promoting contacts between different confessions, countries, and cultures. In an initiative to promote intercultural dialogue, Astana will host a Forum of Ministers of Foreign Affairs of Muslim and Western countries in October 2008 called *Common World: Progress Through Diversity*. According to the Kazakhstani foreign ministry, this policy forum aims at establishing dialogue between the Muslim world and the West and helping to overcome challenges and avoid confrontation by taking the path of mutual understanding and cooperation. This initiative has the support of the U.S., the UK, Spain, the 57 member states of the Organization of Islamic Conference, and the UN High Representative on inter-civilization.

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dialogue. The Kazakh foreign ministry says that the Forum will be “an action-oriented discussion at the level of policy-makers on the issues of modernization, economic cooperation, mutual adaptation of cultures, and the role of mass media in this process.” While working to address some of the issues involved in reconciling Western and Muslim identities, Astana also seeks solutions to its own challenges—reconciling its nomadic roots with the Muslim faith and a secular state, and efforts to build a modern society.

Astana also anticipates hosting the third meeting of the Congress of Leaders of World and Traditional Religions in 2009. Serving as the venue for this forum should help to enhance Kazakhstan’s image as a modern and tolerant state, capable of hosting the culturally diverse spiritual leaders of many nationalities and faiths and promoting interfaith dialogue. The previous meetings in 2003 and 2006, also held in Astana, brought together over 45 national delegations to discuss religious freedom and tolerance, and received very positive international feedback. The 2009 meeting will take place in a world where religious intolerance is on the rise, and where religion is playing an increasing role in fueling conflicts from Sudan, and from Kosovo to Kashmir. By hosting the religious leaders, Astana intends to send a strong signal to the citizens of Kazakhstan, Central Asia, the Middle East, East Asia, and the world at large, that dialogue and mutual respect are necessary and possible.

In line with this approach, Kazakhstan’s Deputy Foreign Minister Nurlan Yermekbayev said that while chairing the OSCE Astana plans to make combating all forms of discrimination and promoting tolerance and “mutual adaptation of cultures” primary items on the organization’s agenda.

Islam in Kazakhstan: moderate and tolerant. With interfaith tolerance being a pillar of state policy, Kazakhstan’s leadership maintains the separation of state and religion. Kazakhstan is a secular state, with its predominantly Muslim population adhering to moderate traditional teachings of Islam.

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The government is keen on keeping all religions represented within the state moderate and tolerant, and fights any attempts by radical Islamist movements, such as the Salafists or the Muslim Brotherhood, to gain a foothold in the country. Kazakhstan’s law enforcement has increased their scrutiny of Hizb-ut-Tahrir al Islami (the Party of Islamic Liberation), which Kazakhstani authorities have listed as an extremist organization. The police are also standing up against the unregistered Tablighi Jamaat movement, which promotes an extreme version of Islam. To date, Astana has been a reliable ally for Washington in the war on terrorism.

In one of his recent interviews, the Kazakh Ambassador to Russia, Nurtay Abykayev, quoted the late John Paul II, who said during his earlier visit to Kazakhstan: “Peace and harmony in the Great Steppe pleasantly surprise and argue that the multiracial country in the world can be saved.” The U.N. Committee on the Elimination of Racial Discrimination said in its report that Kazakhstan has created the necessary conditions for the peaceful coexistence of different ethnic groups and faiths.

Nevertheless, some Kazakh politicians have called for alterations in the current inter-religious balance through changes in the Law on Freedom of Faith and Faith-Based Associations. They favor restrictions on “new religions” and some protestant denominations, which they label sects. This follows a trend, which is already in place in Russia.

The Majilis accepted the draft law for consideration in early April 2008, and Prime Minister Karim Massimov backed the bill. A broad public discussion has emerged in Kazakhstan concerning the issue. While a possible crackdown on Protestants and New Age religions may be unnecessary, the law also facilitates screening against violent and radical Islamist activities, and should be viewed in this context as well. The new amendments would create stricter rules for missionary activities and collecting charitable contributions, which sometimes end up supporting radical Islamist communities (jamaats) or terrorist activities.

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9 Smirnov, Interview with Ambassador Nurtay Abykayev.
The bill would also limit the distribution of faith-related materials by small religious groups that do not belong to the “traditional” religions, and impose censorship on imported religious literature. Only missionaries registered with the local authorities may operate in the country, while all religious organizations will have to seek re-registration under the new rules.

According to the expert group working on the bill, there are over 4,000 faith-based organizations in Kazakhstan, and over 200 individual missionaries, therefore the state needs to “bring some order” to this field. The new regulations would outlaw religious groups that encourage their members to break up families, refuse to educate children, or prevent their members from receiving healthcare services. However, leaders of some religious communities, such as the Lutherans, and human rights activists have criticized the proposed amendments to the law. They quoted uncertainty regarding the rights of smaller denominations as their primary reason for concern.

As Kazakhstan is still forming its new identity, managing the delicate balance of secular statehood, diverse faith activities, and ethnic tolerance is crucial for the success of the country. Ethnic and religious tolerance have thus far helped create the basis for steady and peaceful economic advancement, while forward looking economic policies and growing wellbeing have, in turn, contributed to maintaining a harmonious society. The Kazakhstani middle class is mostly keen on political stability and the economic benefits, which stem from it; and the more affluent and educated strata are a key support base for the President’s course on social harmony. As veteran Central Asia analyst John C. K. Daly noted in his March 2008 presentation, Kazakhstan’s leadership views a “stable middle class as a guarantor of social stability against everything from religious extremism to agrarian riots.”

The development of social services. Improving social services is another of the President’s priorities for maintaining social stability. Kazakhstan is still working to advance beyond the outdated medical and social infrastructure inherited from the Soviet Union. The leadership aspires to improve the population’s living standards in such areas as healthcare, education, job creation, and housing. The President envisages an increase in social security benefits in order to:

- Raise average pensions by 2.5 times in the period from 2007 to 2012.

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- Increase government social and special benefits by an average annual rate of 9 percent starting in 2009.
- Gradually increase childcare benefits by an average factor of 2.5 by 2010/2011.
- Gradually raise government employees’ salaries to double them by 2012.
- Increase the annual quota for government supported resettlement of Kazakh families returning to the country from abroad to 20 thousand families a year.\textsuperscript{12}

Advisor to the Kazakh Healthcare Minister Malika Kuandykova, set to introduce international best practices into Kazakhstan’s healthcare system, said in an interview to \textit{Kazinform}:

According to the principles of smart economy, physical and mental health, genetic fund, lifestyle and life conditions are ‘investments’ into the national human capital. We need intensive development of the health industry, which means rational division of responsibility between the state and the citizens... A great number of studies conducted in the developed countries have proved that good health greatly contributes to economic success.\textsuperscript{13}

\textsuperscript{12} Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’.”
National Development Policy

In 1997, the Kazakh government adopted *Kazakhstan-2030*, a strategy that set the long-term vision for the country's development, particularly in the energy and transportation sectors. This program emphasized the need to expand Kazakhstan’s oil and gas export opportunities and develop wide ranging international cooperation on energy transport policies. Strategic planning remains a crucial instrument of Kazakhstan's transformation into a regional economic heavyweight.

At the same time, Astana aspires to develop the nation into a major economic player beyond the energy sector. In his latest 2008 State of the Nation address, President Nazarbayev pointed out that “Kazakhstan’s further industrialization through making concerted efforts to join the community of the world’s 50 most competitive nations and forming a select group of 30 (national) corporate leaders should remain the primary goal.”

The international development community reaffirms Kazakhstan’s need to create a diverse economy including a high-tech sector. In 2007, U.N. Resident Coordinator and UNDP Resident Representative to Kazakhstan Haoliang Xu commented:

No doubt, Kazakhstan has benefited significantly from oil and gas resources, which have fueled its economic development. However, oil and gas account for only 25 percent of its Gross National Income (GNI) and it has significant other sub-soil resources, such as ferrous and non-ferrous metal, [as well as] agricultural resources. [However], the challenges include equitable and inclusive development, and the fact that the oil and gas industry does not generate a large amount of job opportunities... The key to addressing these challenges is to diversify the economy and expand it into high value added and employment generating sectors, such as high-tech sectors, financial services and small and medium enterprises (SMEs). The government and its development partners are doing a lot to achieve this goal.²

¹ Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan's 'Road to Europe'.”
² Interview with Haoliang Xu, UN Resident Coordinator and UNDP Resident Representative in Kazakhstan, May 29, 2007, at http://content.undp.org/go/newsroom/2007/may/interview-with-
Since the first years of energy windfall revenues, the Kazakhstani leadership has been investing in innovative and value added industries, and attempting to preserve wealth for future generations. By January 2008, the National Fund of the Republic of Kazakhstan (NFRK), otherwise known as the National Oil Fund, accumulated over $21.5 billion, nearly double its 2006 value due to high oil prices. Sovereign Wealth Funds, such as the National Oil Fund, are important tools for preserving and increasing national wealth, and their management and strategy deserve attention at the highest levels.

To provide proper management of other state assets and revenues, in early 2006, Nazarbayev initiated the establishment of two national development agencies—the Kazyna Sustainable Development Fund and the Samruk State Holding Company. He also launched the Regional Financial Center of Almaty (RFCA) in an attempt to boost Kazakhstan’s financial market development. These holding companies are charged with managing state owned assets in key national companies and developing major investment projects with the general aim of improving corporate governance, preparing state-owned holdings for initial public offerings and privatization, and speeding up socially oriented (housing, water, roads) and non-hydrocarbon sector growth, as will be discussed below. The agencies employ many young managers and economists trained at the best American and European universities.

The Kazyna Sustainable Development Fund

Kazakhstan’s government is actively involved in supporting the non-resource export-oriented economic sectors by providing funds to take risk-sharing positions in innovative projects. President Nazarbayev established the Kazyna Fund in April 2006 to enhance innovative economic development and investment in the interests of sharpening Kazakhstan’s competitive edge. Kazyna aims to diversify the national economy away from its commodity focus, increase its export capacity, and ensure Kazakhstan’s successful integration into the world economy. The Fund promotes effective corporate governance of affiliated organizations. Kazyna works to increase the profitability of the assets under its management by using such
financial and management tools as lending, restructuring, and taking equity stakes in companies.

Former Kazyna Chairman of the Board Kairat Kelimbetov underlined the Fund’s primary focus on facilitating business infrastructure and coordination among privately managed companies to boost the competitiveness of Kazakh business:

Historically, business is more effective than the state structures. However, the creation of infrastructure is another question. We will create national champions, i.e. corporate leaders, via transformation of the cluster initiative and through construction of value chains in different segments. For instance, we may compete as a cluster: Kazakhstan textile with textile of Central Asia, or as a metallurgic cluster: Kazakhstan-Russia.5

The Kazyna Fund consolidated all of the national development agencies created during 2003-2004, including Kazakhstan’s Development Bank, the Investment Fund, the National Innovative Fund, the Small Business Development Fund, the Center of Marketing and Analytical Research, the Export Operations Insurance Corporation, and Kazinvest LLP.6 Kazyna serves as an active shareholder in these affiliated organizations and represents state interests on their boards. Kazyna will also accumulate funds for the acquisition of valuable assets abroad.

In mid-2007, Kazyna’s investment portfolio included 183 projects with an overall budget of $5.2 billion, of which Kazyna will finance $1.8 billion.7 In 2008, the Fund plans to launch 11 more investment projects worth $950 million.8 The overall investment portfolio incorporated under Kazyna’s management grew almost five-fold since 2005 (see Figure 7 on the next page).

According to the fund’s current chairman, Arman Dunayev, it has served as a positive factor in Kazakhstan’s economic growth. By 2008, the management company had developed into a coherent structure capable of running large scale

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strategic planning, corporate governance, and investment projects.\textsuperscript{9} In addition, Kazyna continues to support small and medium-sized businesses through financing micro credit initiatives by the Entrepreneurial Development Fund.

Some recent reforms at the Fund’s top management level have launched the introduction of Western-style corporate governance, accountability, transparency, and anti-corruption practices in Kazyna’s operations. By May-June 2008, Kazyna has introduced more transparent project selection, financing, implementation and reporting procedures, as well as anti-corruption requirements for the Fund’s executives and subsidiaries. The leadership in also making an effort to optimize Kazyna’s corporate structure and operations in line with best practices in management (for example, by adopting the Code of Corporate Ethics and introducing independent audit.) In the second half of 2008, the Fund plans to institute regular audit reporting, improve tender and information disclosure procedures as well as lending and financing decision-making practices. The Fund will also establish common evaluation approaches to Kazyna’s investments. Nazarbayev set the long-term priorities for Kazyna in his 2007 State of the Nation address:

\begin{quote}
Kazyna Fund must deliver modern services with the view of raising competitiveness and supporting the most promising exports, from
\end{quote}

\textsuperscript{9} Ibid.
financing applied research to promoting Kazakhstan’s goods in foreign and domestic markets. The Fund should become the state operator in providing export support services...Kazyna [should help] our pioneering enterprises mainly in non-extractive industries to improve conditions of their foreign trade and to expand their exports. [In addition] the Fund... should [invite] appropriate international companies to set up joint ventures with export potential.10

The main assignment Kazyna Fund received for 2008 is the implementation of the Thirty Corporate Leaders of Kazakhstan Program, an essential element of the government’s diversification and competitiveness effort.

Thirty Corporate Leaders of Kazakhstan

President Nazarbayev initiated the state-run Thirty Corporate Leaders of Kazakhstan Program in his 2007 State of the Nation address, and officially launched it in November 2007. The Program will determine the 30 largest corporate entities that can be in the forefront of industry and provide economic breakthrough for the country. The program will provide financial and managerial support to these companies to help them enter the international markets with competitive products. President Nazarbayev views the Program as a major step towards modernization of the Kazakhstani economy by boosting companies willing to develop and market products that can successfully compete at home and abroad.

In his 2008 State of the Nation address, President Nazarbayev emphasized that the Thirty Corporate Leaders initiative aims to contribute to sustaining Kazakhstan’s dynamic growth and “helping true development of the non-commodity sectors of our economy.”11 Kazyna’s ex-Chairman Kelimbetov said the new program is a “transition from funding the points of growth to forming new competitive branches, stimulating production and development of corresponding strategic infrastructure and close partnership with the private sector.”12 The state will look to international best practices to cultivate its corporate leaders as part of achieving the goal of Kazakhstan joining the ranks of the world’s 50 most competitive nations.

10 Nazarbayev, Annual Address to the People of Kazakhstan, 2007.
11 Interview with Kairat Kelimbetov.
12 Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’.”
As of November 2007, the program included 97 projects worth $60 billion, involving industries such as machine building, mining and metallurgy, the petrochemical industry, transport and logistics services, telecommunications, agro-processing, and production of construction materials. The projects will bring advanced technology and know-how to produce high value-added goods and increase the share of processing and manufacturing in the country. The former chairman of Kazyna noted in an interview to Kazakhstanskaya Pravda:

There is a level of national companies: we know Samsung, LG in South Korea, and Mitsubishi in Japan...we have Kazakhmys, KazMunayGaz, Kazakhtelecom—they are leaders in their spheres. However, the [President] asked to create corporate leaders in other branches, primarily, in the high value-added sectors. It means, in the near future the leaders are to appear in metallurgic, chemical, petrochemical, bio-fuels, and other branches. At present, the priority is to find and help form them in non-commodity sectors—the state is mostly interested in this. Such projects are to become the foundation of a new economy.

The Kazyna Sustainable Development Fund is implementing the Thirty Corporate Leaders Program in cooperation with the Ministry of Economy and Samruk Holding. Domestic and foreign investors, the state budget, the National Oil Fund, as well as banks and other financial institutions, will finance the program. The state can support the projects by developing infrastructure and providing co-financing. Participation of the state at the initial stage will not exceed 25 percent plus one share, with each project being worth at least $100 million. In addition, the state will adopt other ways of sharing the risks with businesses, including by providing political support; as well as attempting to create a favorable business

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14 Interview with Kairat Kelimbetov.
environment, possibly by lowering taxes. As a result, the state expects to boost its GDP to $300 billion, and reach an investment position of $127 billion.\footnote{Kazyna, “Thirty Corporate Leaders of Kazakhstan Program is a Path to Turning Leading National Companies into Modern Transnational Corporations.”}

The program builds upon the public-private partnership mechanism, which is supposed to become a model of productive state-to-business relations. While Kazyna acts on behalf of the state, it is a business structure and follows business models. With this in mind, the Fund can address issues on both state and business agendas. Kazyna officials cite international examples of state-owned cooperation when the states use protection for their export-oriented and future-looking industries to facilitate their entry into global markets. These policies were part of the success of the “Asian tigers” where, at early stages of the economic breakthrough, the state created a favorable business environment for the nascent major export industries. Yet, free market proponents indicate the dangers of the state picking winners and point out that many state-protected industries, such as Brazilian and Soviet information technology, have failed. The Economist Intelligence Unit observed that the initiatives “premised on a strategy of ‘picking the winners’ will do little to foster diversification.”\footnote{Economist Intelligence Unit, “Kazakhstan: Country Report,” February, 2008.} Boosting the competitiveness of Kazakhstan’s industries is especially urgent as the country is seeking to join the World Trade Organization (WTO) and further open up its economy to international competition. State ownership of industrial assets always brings with it the threat of corruption, cronyism, and poorly thought through investment decisions.

**The Samruk State Holding Company**

Another state development agency working towards Kazakhstan’s economic modernization is the Samruk State Holding Company. Samruk began operations in January 2006 to promote efficiency and accountability in state asset management. The holding company acts as an active shareholder on behalf of the state in major national companies. This facilitates implementation of strategic government priorities without outright state interference in company operations. Samruk’s management portfolio includes KazMunayGaz, Kazakhstan Temir Zholy (railways), Kazakhtelecom, the Kazakhstan Electricity Grid Operating Company (KEGOC), and KazPost (national postal service). A special governmental council oversees and guides these national companies on issues including distribution and reinvestment of capital. In this way, the government hopes to increase the efficiency and accountability of state asset management. Samruk senior officials
say that introducing modern corporate governance methods is part of the work of the holding company’s management package, and that once restructured and made transparent, many state assets will undergo privatization. However, Samruk has published no privatization timetable, nor has it chosen a privatization model.

In his 2007 State of the Nation address, Nazarbayev underlined Samruk’s role in national development. Its primary purpose is to ensure that the value of state owned companies under its management grows. In the future, according to Nazarbayev, Samruk should apply its resources to facilitate projects that can “produce a competitive edge for all national consumers of infrastructural services and relevant sectors of the economy in external markets. Namely, businesses and citizens must finally obtain unconditionally higher quality and, if feasible, cheaper energy, railroad, telecommunication and utility services.” In his 2008 address, Nazarbayev reiterated the importance of functional modern infrastructure for such a vast country as Kazakhstan and called for “proactive infrastructure support for key sectors of the economy.”

As Kazakhstan’s successful pension reform has built a modern system of private pension funds, Samruk also draws investment capital from these funds. As of February 2007, Kazakhstan had 14 pension funds managing some $7.7 billion in assets (about 10 percent of the GDP), with an expected increase by 2016 to about $72-75 billion. Of this amount, some $32-35 billion are intended for investment in the domestic equity market. However, as of 2007, the pension funds did not have sufficient domestic investment opportunities, because the total market capitalization of A-category stocks on the Kazakhstan Stock Exchange was below the accumulated capital of the funds. As a result, Kazakhstan’s pension funds had to invest overseas. The development of a world-class financial center in Almaty could provide opportunities for investing pension fund monies in domestic economic activity.

Kazakhstan’s Financial Sector and the Regional Financial Center of Almaty

Kazakhstan is reaching out to the world’s top financial executives to provide expertise and strategy to the Regional Financial Center of Almaty (RFCA). The Kazakhstani leadership invited former World Bank President James Wolfensohn

19 Nazarbayev, Annual Address to the People of Kazakhstan, 2007.
20 Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe.’”
to become Nazarbayev’s informal advisor on Almaty’s development into a major financial center. 22 In particular, Wolfensohn will advise on RFCA strategy and supervise the center’s consultants to boost Almaty’s financial and economic performance as a regional financial hub.

Overall, Kazakhstan’s financial system has been the most robust in the region. Nevertheless, the financial sector still needs to improve its regulatory base and operations to protect itself from the risks posed by the rapid and uneven growth of the financial services sector.

In particular, banks still heavily dominate the financial industry. Finance experts identify the need for Kazakhstan to boost non-banking financial institutions such as insurance companies and pension and equity funds, as well as to develop leasing and mortgage markets. 23 The underdevelopment of these institutions may pose additional risks for the Kazakhstani emerging financial sector. Additionally, equity and venture capital could fuel medium-sized non-raw materials companies, much needed for Kazakhstan’s economic diversification plans. Kazakhstani banks also need to continue increasing the transparency of ownership and improve corporate governance. To accomplish this, the government needs to enforce more effective accounting, auditing and disclosure practices, as well as to promote the development of reliable payment systems, credit information systems, and rating agencies. 24 These, together with further liberalization of the financial sector in anticipation of the WTO accession, will increase competition and thus improve the quality of financial services.

After the 2007 international credit crunch exacerbated internal problems in the Kazakh financial sector, the Kazakh government focused its attention on enhancing financial stability, expanding structural reforms, and developing the equity market. Prime Minister Karim Massimov listed structural reforms of the financial sector

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and more effective regulation among the government’s top priorities.\textsuperscript{25} The government is aware that a well-functioning financial sector can create jobs and boost the development of the real economy by attracting domestic and foreign investment to the productive sectors, and encouraging savings.

At an international business forum, Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) Supachai Panitchpakdi suggested that the Central Asian governments should take the following steps to ensure the development and stability of their financial systems:

First, they should create a framework for the organization and infrastructure of banking, financial and capital markets, so as to ensure competition in financial intermediation. Second, they should partner with the private sector in establishing modern, secure and efficient payment systems for the clearing and settlement of transactions in monetary and securities markets. Third, they should provide an effective regulatory structure. And, fourth, they should clearly define the rights of establishment, licensing, entry and exit for all financial intermediaries. These various issues can be looked at under two broad headings: creating an environment conducive to sound financial services, and developing an appropriate institutional framework along with fair and competitive market structures.\textsuperscript{26}

Agricultural development and KazAgro National Holding

Kazakhstan is a country of vast agricultural production potential, with a large share of the population still involved in agriculture. However, the sector has suffered from a number of challenges, including technological backwardness, high production costs, and poor logistics that result in low productivity and profitability. According to the World Bank, Kazakhstan’s labor efficiency in agriculture lags far behind Eastern European averages. These challenges make Kazakhstan’s low-value-added agricultural produce uncompetitive, even domestically, and the country currently exports agricultural commodities and imports processed foods, mainly from Russia.


\textsuperscript{26} UNCTAD, Statements by Supachai Panitchpakdi, Secretary-General of UNCTAD.
With negotiations on Kazakhstan’s WTO accession approaching, the vulnerability of the domestic food industry to external pressures has become more obvious.27 The Kazakh authorities have taken steps towards much-needed modernization of the agricultural industry, vital for sustainable broad-based economic growth. The country needs to enhance the competitive ability of its domestic producers and bring them up to international quality and technology standards in time for Kazakhstan to benefit from WTO membership.

To further agricultural modernization, the government established KazAgro as a specialized development agency affiliated with the Kazyna Fund. KazAgro works to increase agricultural productivity and water use efficiency, prevent land degradation, and upgrade agricultural technologies. It also promotes applied agricultural research to assist the farmers. Nazarbayev has called on KazAgro to concentrate on developing new agricultural processing companies with export potential.28

As Kazakhstan is searching for value-added export-oriented niches for its vast agricultural complex, KazAgro has identified ecologically clean foodstuffs and biofuels as having particularly strong potential. In the wake of rising oil prices and concerns about CO₂ emissions, many developed countries plan to increase the use of alternative energy in order to reduce their oil dependence and carbon emissions. Kazakhstan is eager to enter this potentially lucrative market. In 2009-2011, Kazakhstan’s Food Contract Corporation plans to build two bio-ethanol plants using rapeseed as the main raw material in Northern Kazakhstan, with an overall capacity of 100,000 tons of bio-fuel and 34,000 tons of gluten per year. During 2011-2013, the corporation plans to invest in the construction of a bio-diesel plant in Northern Kazakhstan with a projected production capacity of 100,000 tons of fuel per year.29 To supply these facilities, Kazakhstan is increasing its rapeseed sowing areas.

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28 Nazarbayev, Annual Address to the People of Kazakhstan, 2007.
Kazakhstan’s Economic Outlook

In the period of high oil prices, which began in 1999, Kazakhstan’s GDP experienced rapid growth. The economic challenges it faced in 2007 slowed down the growth rate to 8.5 percent per year, and growth may decelerate further, to 6-7 percent in 2008. However, it is likely to return to the 8 percent level by 2010, according to current forecasts (see Figure 8). Spillover effects from the commodities sectors can still benefit services and retail, and support the economy through the slowdown period.

Figure 8: GDP and Inflation Forecast (2007-2012F)


The current slowdown is reportedly not going to affect Nazarbayev’s pledge to double Kazakhstan’s GDP by 2008 (comparing to the 2000 level) and triple it by 2015. The Economist Intelligence Unit reported that Kazakhstan nearly doubled its 2000 real GDP by the end of 2007, and would meet the 2008 target even with a lower annual growth. As to tripling the 2000’s GDP level by 2015, a compound annual growth rate of near 5 percent over the next seven years (2009-2015) would be sufficient. While economic forecasts are difficult when oil prices are as volatile as they have been in the first half of 2008, most economists agree that Kazakhstan’s

GDP will grow at around 8 percent annually. If the international environment remains similarly favorable for Kazakhstani exports, the country is set to meet its GDP growth 2015 target.

Rapid growth presents its own challenges. For example, in the coming years, the country may experience increased tensions among its elites and dissatisfaction within the business community over the relatively slow pace of reforms and the burdens of corruption and bureaucracy. The growing middle and low-middle classes are unhappy with rising food prices and the 17 percent consumer price inflation forecasted for 2008. The government will also have to address the liquidity problems in the banking sector that resulted from the global credit crunch. In 2008 and beyond, the government will have to be more proactive in managing some sectors of the economy. Many policy-makers in Astana seem to believe that an unadulterated free-market approach is ill suited to handle the adverse effects of global economic instability in a commodity-based transitional economy with relatively poor industrial diversification. However, overcompensating for the credit crunch and a slowdown in the housing and construction sectors may prove counterproductive. International experience repeatedly demonstrates that economic “cures” are often worse than the disease. After all, Kazakhstan is experiencing inflation because of a massive inflow of cash for commodities, which may compensate for the credit shortage if the banking system adequately performs its mediating function.

Record high oil prices continue to underpin Kazakhstan’s superior budget performance. In the longer term, however, following the global economic slowdown, a drop in demand for commodities may decrease the price of metals—another major export from Kazakhstan. Overall, Kazakhstan’s accounts in 2007 showed a deficit of some $6.6 billion due to the massive demand for imported machinery and consumer goods. With personal incomes growing and national currency appreciating, the Kazakhstani middle class is driving the demand for better quality products.

**Accession to the World Trade Organization (WTO)**

Kazakhstan seeks to complete its WTO accession by the end of 2008, 12 years after it first applied for membership in 1996. Twenty-five of the country’s major trading partners (with the 15 EU states acting as one party) have been holding bilateral negotiations with Astana on accession since 1997. The talks have focused on trade

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barriers such as import licensing, price controls, industrial subsidies, and technical barriers to trade (TBT). The parties have also discussed the customs system, including regional customs union arrangements, as well as transparency and reform of the legal system. Another major focus area has been the agricultural sector, with talks focusing on sanitary and phyto-sanitary measures (SPS) and state support of industry, including subsidies. Finally, the negotiating parties have insisted on the liberalization of Kazakhstan’s services sector, especially banking, insurance, telecommunications and transport, and enforcement of intellectual property rights.

While many countries have signed the accession protocols, several key countries are still in the negotiation process. Six bilateral agreements were still pending as of mid-2007, including protocols with the U.S., EU, Australia, Canada, India, and Mongolia. While Australia, Canada, and the U.S. have mainly focused on agricultural subsidies, the EU has pursued the liberalization of banking and financial services. On February 13, 2008, Kazakhstan completed its bilateral negotiations with Canada, which is interested in accessing the Kazakh meat, milk, alcohol and tobacco markets, as well as architectural, construction, financial, engineering, and energy services. Astana hopes to complete bilateral talks with the rest of the parties in 2008 as well.

In a September 2006 joint statement by Presidents Bush and Nazarbayev, the White House expressed support for Kazakhstan’s WTO aspirations:

> The United States supports Kazakhstan’s membership in the World Trade Organization...recognizing that a market access agreement will enhance free trade and contribute to the continuing modernization of Kazakhstan’s economy.

To meet WTO accession requirements, Kazakhstan has already amended the regulations on licensing and supervision of the financial services sector to allow for the entrance of foreign capital into the banking and insurance sectors. These

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amendments have enabled the $2.1 billion acquisition of Kazakhstan’s ATF Bank by the Italian-based UniCredit Bank in 2007. This deal sent a clear signal that restrictions on market access to financial services in Kazakhstan are easing, an issue of importance to the EU negotiators.

According to recent estimates, the services sectors, including finance, stand to gain the most from opening the doors to multinational service providers; and this in turn will have a positive effect on other economic sectors through an overall reduction of transaction costs.\(^7\) Under the terms of the WTO accession, Astana will also abolish the 49 percent cap on foreign participation in architectural and construction companies.

Geopolitical considerations also play a strong role. Many in Kazakhstan favor coordinating the country’s WTO accession with Russia’s accession process in recognition of the close economic and political ties between the two states.\(^8\) Yet, international experts believe “there is little reason beyond political symbolism to synchronize the accession dates, and there are good reasons for not delaying accession once substantive negotiations are complete,” referring, for example, to the benefits of WTO-based dispute resolution mechanisms in case of unfair trade measures taken against Kazakhstan’s exporters.\(^9\)

As Kazakhstan prepares to open its borders to international trade and investment, some of its experts fear competition, concerned that economic liberalization could have adverse consequences for “national” capital. Some suggest that Kazakhstan should adopt public sector-led development programs even in the presence of strategic investors.\(^10\) In other words, they advocate strong national champions in the key industries capable of competing on domestic and international markets, which would support Kazakhstan’s economic position after the anticipated WTO accession.

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\(^9\) Pomfret, “Lessons from Kyrgyzstan’s WTO Experience for Kazakhstan, Tajikistan and Uzbekistan.”

\(^10\) Mergaliyeva, “Kazakhstan’s National Capital Development Problems.”
However, foreign competition only strengthened the economic performance of the Asian “tigers” and “dragons,” whereas protectionism, especially over a prolonged period, creates a greenhouse environment in which the domestic sectors become complacent and non-competitive. The experiences of such recognized development success stories as Hong Kong and Singapore, both of which embarked on consistent programs of economic liberalization, demonstrate that it does work.

After 1965, Hong Kong liberalized its banking and financial services, and diminished the regulation of foreign investment and international trade, including tariffs, licensing, and other barriers. It also established export processing free economic zones that rid manufacturers of the red tape involved in producing and selling goods overseas. These reforms provided the grounds for a large export industry that fueled Hong Kong’s economic growth. Hong Kong had to refocus its economy when international market conditions changed. Manufacturing drove its economic miracle in the 1960s-1980s. Hong Kong later turned towards the finance and services sector in the 1980s when other emerging Asian economies began to compete with it as sources of cheap labor. In 2006, finance, insurance, real estate and business services generated 21 percent of Hong Kong’s GDP, import and export activity accounted for over 27 percent, and manufacturing was only at 3.5 percent.

Singapore, like Hong Kong, instituted a series of economic reforms aimed at boosting foreign investment and exports. This case also demonstrates that the rule of law and freedom from corruption play a vital role in economic development. Investors flocked to Singapore, which had an efficient legal system based on British common law. Singapore has a well-functioning government bureaucracy, and it has created one of the world’s best education systems. Unlike Hong Kong, which moved its production facilities to the Chinese mainland, Singapore still generates some 25 percent of its GDP from manufacturing. However, as other Asian economies began to compete in cheap manufacturing, Singapore moved up the value chain, away from low-end electronics, into lucrative new niches, such as the marine engineering and biomedical sectors, which are growing at around 40 percent.

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13 Johnson, “The World Bank and Economic Growth: 50 Years of Failure.”
per year.\textsuperscript{14} Singapore also boasts a sophisticated financial sector and a vast import and export shipping industry based on one of the world's busiest marine ports. Following these examples, Kazakhstan might be able to achieve its ambitious goals more quickly if it limits government intervention and allows the domestic and private sectors to do their jobs, while allowing greater freedom of movement for foreigners willing to bring their business expertise to the heart of Eurasia.

Kazakhstan is still undergoing a transformation towards an effective and transparent business environment. Although the government supports economic reform, the burdensome bureaucracy is often slow to respond to the demands of modern business.\textsuperscript{15} Despite attempts to improve the environment and join the World Economic Forum's \textit{Global Competitiveness Top 50}, Kazakhstan fell in ranking from 56 in 2006-2007 to 61 in the 2007-2008 report.\textsuperscript{16} Among the most problematic factors for doing business, the report pointed to corruption, tax regulations and high tax rates, deficiencies in the rule of law, and an inadequate business infrastructure. In some sectors, like oil and gas, the deteriorating investment climate brought about by Kazakhstan's increasing tendency to let resource nationalism guide its economic policymaking may further hurt the country's competitiveness.

\textbf{Growing Resource Nationalism}

Deloitte's publication \textit{Power Play: Resource Nationalism, the Global Scramble for Energy, and the Need for Mutual Interdependence} by Joseph A. Stanislaw explains what resource nationalism means for emerging energy exporting economies, like Kazakhstan:

Resource nationalism refers to state control or dominance of energy resources, and the resultant potential to use this power for political purposes. As energy markets are increasingly led by producers rather than consumers, fears have arisen that resource nationalism will be misused. In fact, with oil passing $120 per barrel, producer nations everywhere—from Russia to Venezuela to Algeria to Libya to Bolivia to Ecuador to Nigeria

to Kazakhstan—are rethinking their arrangements with oil companies and other partners, seeking to maximize their share of today’s high oil prices.17

Astana wants to increase state influence over the highly lucrative energy sector. In his 2008 State of the Nation address, Nazarbayev proclaimed that “in the oil and gas sector, it is necessary to strengthen the positions of the government through national involvement in energy markets.”18 Meantime, Astana has been monitoring some 831 firms, which hold natural resource contracts. The authorities found that just over half were fully meeting their financial obligations, while 97 companies were meeting less than a third of them. In response, Kazakh Prime Minister Karim Massimov said that the government would expropriate the mineral resources from investors who “fail to work properly.”19

Our instructions on claiming back mineral fields from unscrupulous developers and landowners for the state will take place within this year… The Tax Code that we are preparing will set clear rules of the game for mineral developers and increase the intake of revenues from the mineral sector… Until the adoption of the new Tax Code, all negotiations with mineral developers are suspended.

[The field developers] captured all more or less significant mineral fields in the country in the first years of independence. They are sitting and doing nothing and waiting for someone to pay ten times more. If they do not meet their obligations [on developing mineral fields]… take them away and return them to the state.20

The government maintains that production sharing agreements (PSAs) with foreign companies are more beneficial to the investor than to the host state. Kazakhstan signed these PSAs in the early and mid-1990s, when its economy lacked basic institutions and investing there was a risky and economically unattractive proposition. Which is why, the logic goes, the government has to revisit these PSAs now.

18 Watson, “Kazakhstan Looks In, Out and Shakes it all About.”
20 Ibid.
There are a number of ways to ameliorate the situation. As mentioned above, the authorities are developing a new tax code. Astana insists that the new regime will be more transparent and clear and protect investors from future changes in the regulatory environment. The investors, in turn, are expressing concerns that the energy companies will carry the burden of higher tax rates compared to what they have to pay under the PSAs. In particular, the new tax code will replace the mineral lease tax, which is determined according to export prices, with an extraction tax based on the amount of extracted hydrocarbons. With the increased tax revenue expected to come from this switch, the government plans to cut taxes for the non-raw material sectors to stimulate economic diversification towards value added industries.

In the meantime, the authorities are also trying to boost the role of the state owned national companies in the strategic industries beyond oil and gas. In February 2008, the London-traded copper giant Kazakhmys announced its acquisition of Kazakhstan’s largest power station, Ekibastuz, and the state immediately expressed an interest in securing a stake. The government has been putting pressure on the ArcelorMittal steel giant, which operates coalmines in Kazakhstan, particularly after a deadly mine accident in January 2008, which triggered reminders to foreign investors of their safety and environmental protection responsibilities to the host communities. Nazarbayev emphasized that as the state undertakes greater social obligations, these companies need “to define and adopt principles of corporate social responsibility.”

The strong emphasis on environmental issues in the speeches of the Kazakh leadership often has a base in reality. Yet, it also reminds investors that the government may use ecology to increase rents or even push some of them out. In recent years, Astana has increasingly applied environmental penalties to pressure investors into accepting its growing demands. In 2007, the authorities fined the Tengiz field investors for violations of sulfur storage regulations, and issued a $15 million fine to the Karachaganak field foreign investment consortium for alleged unauthorized gas emissions. While currently KazMunayGaz is not a shareholder

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in Karachaganak, according to some analysts, it is waiting for an occasion to negotiate its entry into the consortium.

Earlier, Moscow set the notorious example of using environmental regulation as a tool to exert pressure on the international energy companies working in Russia when it forced a renegotiation of Gazprom’s stake in the Sakhalin-2 project. In 2006, under pressure from the Kremlin for alleged environmental breaches, Royal Dutch Shell announced the sale of 50-percent-plus-one share in the project to Gazprom. Shell remained the project operator with a 27.5 percent stake.

Although Nazarbayev attempts to reassure the business community concerning Kazakhstan’s open and positive investment environment, businesses remain somewhat leery of what further steps the state might take to secure its stake in the booming economy.

The Kazakhstan government’s interest in maximizing the benefit from the country’s natural wealth is understandable. However, without massive investment accompanied by transfers of advanced technology and know-how, Kazakhstan’s challenging projects would be difficult to bring on stream. Investors, in turn, are naturally looking for a fair balance of costs, risks, and yields, which the toughening Kazakhstani energy investment regime may fail to provide. The UK’s Special Representative for International Trade and Investment, the Duke of York, said in a speech at the July 2006 Investing in Kazakhstan’s Future Conference:

> It is only right that countries such as Kazakhstan want to retain their fair share of the wealth generated through their natural resources. However, at a time when there is massive global competition for investment and resources, it is equally important that investors, of whatever size, are not deterred by those perceived and sometimes very real barriers to doing business. Equally, it is vital for countries such as Kazakhstan to continue to attract both the industry’s major players and the smaller but essential companies who together have the financial and operational strength to sustain massive programmes over many decades. These are not just international, but more importantly, domestic.

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Openness to investment in the 1990s bolstered Kazakhstan’s commodity sector. The nature and profitability of the hydrocarbon sector motivates international oil majors to take risks despite a less than perfect investment environment. However, advanced value added industries, such as high tech, information technologies, and biotech, do not face the same constraints. For the Kazakhstan of the 2000s, foreign investment will become a driver of “smart economy” only if the investment climate remains attractive and secure for all industries.

The continued dependence of Kazakhstan on oil, gas, and other commodities for both export and fiscal revenue is a source of long-term economic vulnerability. Besides the challenge of economic diversification, Kazakhstan has to cope with several other important challenges on its “road to Europe.” These include attending to the case for further democratization being pressed by the opposition and the international community, as well as the fight against corruption, which today is present in many spheres of public life. Lack of progress in the anti-corruption effort could become a major political issue while Astana prepares for the OSCE Chairmanship in 2010.

**Persistent Challenges of Fighting Corruption**

The US Department of Commerce says in its *Doing Business in Kazakhstan* guide that enforcement of contracts remains poor as the judiciary often acts as an arm of the authorities rather than the guardian of the rule of law. Businesses also complain of selective interpretation and application of law, which stymies the creation of a level playing field for international and domestic companies.

The 2008 issue of the Heritage Foundation’s *Index of Economic Freedom* rated Kazakhstan as “moderately free” and ranked it 76th out of 157 countries, well above neighboring Russia and China and just above the world average. The Foundation’s report gave Kazakhstan high marks for trade freedom, government size, and labor freedom. However, the report also noted “significant shortcomings in three areas: investment freedom, property rights, and freedom from corruption. Foreign investment in virtually all sectors is restricted by non-tariff barriers and bureaucratic incompetence. Government policy actively favors domestic businesses, and the weak rule of law allows for significant corruption and insecure property rights.”

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8 Ibid.
In 2007, Kazakhstan’s rank declined to 150th place out of 180, compared to 113th position out of 163 states in 2006, in the Corruption Perception Index,30 published by corruption monitor Transparency International (TI). TI placed Kazakhstan31 ahead of other Central Asian states, just behind Russia, and well below states such as South Korea and Malaysia, which Astana sees as its development models.32 One of the key opposition parties, the True Ak Zhol said in its anti-corruption statement:

The declarative nature and ineffectiveness of the government’s counter-corruption activities explain the [deteriorating corruption rank]... The extremely high level of corruption in Kazakhstan hampers full-fledged development of the country and its competitiveness.33

True Ak Zhol further stated that “systemic eradication of corruption in Kazakhstan is impossible without genuine political reforms, which would provide for real separation of powers, free speech, freedom of peaceful assemblies, fair elections of all branches of power... their accountability to the society... and independence of the judicial system.”34

The Kazakhstani opposition does not mince words. According to the Financial Times, the head of Kazakhstan’s International Bureau for Human Rights, Yevgeniy Zhovtis, observed that “Kazakhstan has a typical Soviet style regime, but based on a market economy [which results in] a corrupt and criminal state.”35

Corruption places a massive burden on the economy. The Kazakh authorities have accelerated their effort to fight corruption and improve the country’s anti-corruption practices. A presidential commission for the fight against corruption held its first meeting in February 2008 to focus on an action plan against corruption, following a call from the president “for drastic and fundamental

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34 True Ak-Zhol, “Anti-Corruption Activities.”
35 Gorst, “Politics: Preoccupied by a Need to Hold on to Power.”
improvement in the work of the law-enforcement agencies as well as for real and significant achievements in the fight against corruption.”

Reportedly, the commission recommended setting up a national anti-corruption hotline to collect complaints for further investigation.

As part of its strategy, the Nur Otan ruling party will set up a network of regional public anti-corruption councils that will also include other political organizations, civil society groups/NGOs, media, and some local officials. The councils will collect complaints on bribery and embezzlement of public funds, and facilitate reporting of corrupt practices to the police. The authorities say that they will cooperate with these public councils in the fight against corruption. Foreign experts and the opposition, however, doubt whether the new anti-corruption strategy is a genuine effort to make the country’s politics more transparent, and suspect it may be just an attempt by the ruling elite to boost Kazakhstan’s international image as the country prepares to assume the OSCE presidency in 2010.

The opposition, in turn, insists that in order to achieve true progress, the national anti-corruption commission should include public appointees, such as civil society and political party representatives on a parity basis. In the opposition’s view, the following anti-corruption measures are necessary:

- Promote Kazakhstan’s accession to international conventions on fighting corruption and money laundering.
- Establish legally mandated open tenders (bidding procedures) for the allocation of exclusive economic rights, such as privatization, extractive sector contracts, land allocation, and provision of significant services to the national and regional governments. These tenders should involve full participation of civil society groups and business associations.
- Adopt a requirement that all public officials and managers of state-owned companies publish their income and property statements, and sell their business interests for the period of public tenure.

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39 True Ak-Zhol, “Anti-Corruption Activities.”
The government has heeded to at least some opposition demands. In March 2008, the Majilis (Lower House of the Parliament) ratified the U.N. convention against corruption. The Majilis concluded that signing the convention would facilitate a more efficient domestic anti-corruption effort, and would strengthen international cooperation in this area, including cooperation in return of illegally acquired assets. The convention, adopted by the U.N. General Assembly in October 2003, covers anti-corruption measures in public service, public purchases, and public finance management, and outlines the role of the civil society in the state fight against corruption.

In his 2008 State of the Nation address, President Nazarbayev emphasized the significance of combating crime and corruption in the country. A presidential initiative—the Ten Smashing Blows Against Corruption Program—is aimed at corruption and red tape, particularly among law-enforcement and the judiciary, which “must assure fair and effective protection of Kazakhstani citizens’ rights, while protecting business from unlawful interference.”

The opposition has emphasized that corruption is endemic, especially in property deals, and is calling for proper investigation of prominent cases, including:

- Alleged embezzlement of funds during large-scale construction projects, such as airport terminals in Almaty and Astana and traffic infrastructure in Almaty;
- Suspected illegal payments from investors to Kazakh officials in order to secure desirable contracts in Kazakhstan, including a rumored Baker Hughes Company bribe to KazakhOil to secure an oilfield service contract in the early 2000s, the rumored Mittal Steel payment to secure a stake in the privatization of the Karaganda Metallurgy Plant, and Tractebel Company’s payments;
- Alleged illegal interests of high-ranking officials in business, financial, and media groups;
- Suspected award of beneficial contracts to businesses without proper tender or auction procedures.

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41 Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s 'Road to Europe'.”
42 True Ak-Zhol, “Anti-Corruption Activities.”
Only with significant improvements on the anti-corruption front, as other Asian tigers have succeeded in achieving before, will Kazakhstan be able to pursue its modernization agenda successfully.

The Foreign Investment Outlook

It was its early policy of openness to Western foreign direct investment, which largely positioned Kazakhstan as a clear regional economic development leader. Investors meant an inflow of modern technology and capital as well as employment and training opportunities for the local workforce. The Duke of York, quoted previously as the Special Representative for International Trade and Investment from the UK, noted in his July 2006 address to the Investing in Kazakhstan’s Future Conference:

Whilst this is a recently independent country from the former Soviet Union, it has demonstrated its openness to the outside world and willingness to learn from best practices. Importantly, in this day and age, it is a country, which has also preserved ethnic and religious stability through difficult times.

One of the rewards for this is the highest Foreign Direct Investment in the CIS and a country that has seen rapid economic growth from the wise exploitation of its vast oil and gas reserves. This is a country with an economic future to look forward to with optimism; with its breadth of natural resources and people, provided that it is able to maintain its competitiveness in a tough global marketplace (emphasis mine-A.C.), something...that is recognized in the highest places in Kazakhstan.43

Since late 2007, analysts have begun to comment that Kazakhstan appears to be taking a turn away from openness to the West. Encouraged by energy wealth, Astana is increasing pressure on foreign investors, with a slowing inflow of capital investment as a result. Nevertheless, analysts forecast sustained high levels of investment in the medium term, since international oil majors continue to bring in funds and technology to develop their ongoing projects.

Assuming that all strategic investors implement their existing investment agreements, Kazakhstan is likely to maintain an average annual Foreign Direct

43 The Duke of York, Speech, at the “Investing in Kazakhstan’s Future” Conference.
Investment (FDI) inflow of up to $7 billion per year during the 2007-2011 period.\textsuperscript{44} (See Figures 9 and 10 for comprehensive economic forecasts). However, when the current pool of investors complete their investment plans, if the investment climate continues to deteriorate, this could deprive the country of much needed capital, technology, management skills, and export channels. At the same time, major international corporations are still likely to lobby for lucrative contracts and continue investing in natural resources, as global demand is strong, the yields are high, and the country's untapped opportunities are still vast.

With global commodity demands skyrocketing, and China's market located next door, it is little surprise that the natural resource sector still dominates the Kazakhstani economy. Revenue from these sectors has fueled the boom in banking, metallurgy, and construction. In Kazakhstan, the inflow of strategic foreign investment and expertise is directly connected to the country's energy sector outlook. Foreign investment remains concentrated in the hydrocarbon industry. As much as 80 percent of FDI in the country is related to the energy sector, including 38 percent in oil and gas production and 42 percent in oil and gas services.\textsuperscript{45} As noted earlier, Astana is planning to encourage diversification of investment beyond oil and gas into such areas as technology, finance, alternative energy, and transport. However, this is easier said than done.

\textbf{Figure 9: FDI Inflows to Kazakhstan, (2004-2011F)}


\textsuperscript{45} Ibid.
Outside of the energy sector, the remaining 20 percent of investment has boosted Kazakhstan’s real estate and financial markets in recent years. As a highlight of rapid modernization in both of these sectors, the country will soon see the construction of famed architect Sir Norman Foster’s twin towers in the downtown area of its financial capital, Almaty. When completed in 2009, these two 48-floor skyscrapers will be the tallest buildings in Kazakhstan.\(^46\) Astana, the political capital, already boasts the Palace of Peace and Reconciliation pyramidal structure and the tent-like Khan Shatyr Entertainment Centre (completion expected in late 2009), both designed by this renowned architect.

At the same time, non-resource sectors, such as agriculture, services, technology, and value-added manufacturing, are becoming increasingly attractive as target industries for FDI. The government, which puts economic diversification high on its agenda, should create a favorable environment for the industries that are viewed as key to Kazakhstan’s economic breakthrough and can generate vast opportunities for skilled local employment.

The Future of Kazakhstan’s Energy Sector

The Outlook for Kazakhstan’s Gas

The Kazakh government laid out the main strategies for accelerated development of Kazakhstan’s gas industry in the *Development Concept of Kazakhstan’s Gas Industry Until 2015*. By that year, the country expects to produce 40-50 billion cubic meters (bcm) per year, up from 29 bcm of gas in 2007, and to be the third largest producer in Central Asia after Turkmenistan and Uzbekistan. However, while Turkmenistan, the largest Central Asian producer, exports most of its natural gas, Uzbekistan consumes most of its annual production of 65.3 bcm or sells it to immediate neighbors. By 2014, Uzbekistan expects to export 16 bcm of gas per year, up from the current 14.5 bcm.¹

Kazakhstan is striving to reach some ambitious natural gas goals. In early 2008, then president of KazMunayGaz, Uzakbay Karabalin, announced plans to increase national gas output from 29.6 billion cubic meters in 2007 to 114 bcm in 2020, while exportable production should reach 30 bcm in 2020, up from the current 12.9 bcm. Over the same period, the government expects Kazakhstan’s domestic consumption to grow by some 5.4 bcm and reach 18.7 bcm per year.² Kazakhstan plans to stop the gas flaring associated with oil drilling by 2011, at which time it expects to export most of those volumes.³ Thus, the export availability will be high; however, the lion’s share of gas ships through Russia.

**Competing gas pipelines.** Currently, Kazakhstan exports most of its gas to Europe through Gazprom’s pipeline system. An attractive option would be to connect Kazakhstan’s gas system to the Baku-Erzurum gas pipeline, which links to the Turkish gas system and would continue further, via the proposed European Union-sponsored and US-supported Nabucco pipeline project, to Central and Western Europe. However, Russia’s resistance to this alternative route; combined with a

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³ Socor, “Discussions Intensify with Kazakhstan on Trans-Caspian Gas Pipeline.”
lack of coherent European political support; and the high cost of projects such as Nabucco, have resulted in delays. After prolonged secret negotiations, in February 2008, Hungary signed onto Russia’s South Stream project. Hungary’s participation, together with that of Austria, Bulgaria, and Serbia, is a severe blow to Nabucco.

Map 6: Major Oil and Gas Pipelines is Europe and Eurasia

Source: Energy Information Administration at http://www.eia.doe.gov/emeu/cabs/Russia/images/772861%20%5bConverted%5d.pdf (August 20, 2007)

Before the March 2, 2008 elections that formalized his succession of Vladimir Putin as the Russian president, Dmitry Medvedev visited Serbia and Hungary to sign the South Stream deal, a major foreign policy achievement, which brought him instant international visibility, especially during the Kosovo crisis.

Russia has put a lot of work into fostering its relationship with Hungary. Putin met Prime Minister Ferenc Gyurcsany five times in three-and-a-half years—a frequency unprecedented in the history of the two countries’ diplomatic ties. A former young communist leader, Gyurcsany had never outright rejected South Stream.

In March 2007, Gyurcsany called Nabucco a “dream”—and the Russian Blue Stream and South Stream pipelines a “reality.” His country, he said, needed reality, not dreams. A barrage of complaints from its EU and NATO allies subsequently
caused the Hungarians to be more cautious and secretive in their pursuit of deals with Russia. “It appeared that Budapest was becoming more serious about the Nabucco project. Instead, it seems Hungary only learned to better conceal its intention to make a deal with Russia,” said a senior Hungarian politician who requested anonymity. The Gyurcsány government knew that Washington, Brussels, and the majority of its Western partners in NATO and the European Union would strongly disapprove of Hungary’s cooperation with Moscow on South Stream.

On February 22, 2008, the US Deputy Assistant Secretary of State, Matthew J. Bryza, met with EU Energy Commissioner Andris Piebalgs and others European Union officials in a last-ditch attempt to accelerate Nabucco and block South Stream. Bryza criticized the high prices Europe is paying for Russian gas and said that “helping Europe diversify its gas supplies has become extremely urgent.” However, it is what the Europeans and the Russians do, not what the Americans say, that defines the balance of energy power in Europe.

The EU is still trying to promote Nabucco, which would transport gas from the Caspian Sea littoral states, including Azerbaijan, Turkmenistan, and possibly Kazakhstan, to Europe. However, depending on European consumption levels, South Stream may saturate the market, making Nabucco economically unfeasible. Without Nabucco, the EU will face difficulties in diversifying its natural gas supply. Essentially, all of the Central European members of the EU will remain dependent on Russia for natural gas, while the Western Europeans will see their own dependency increase. Turkmenistan and Kazakhstan, the principal Central Asian gas exporters, in turn, will lose an opportunity for an alternative export route and will remain at the mercy of Moscow.

In addition to Western Europe, Kazakhstan is interested in exporting its gas directly to other countries, from China to Turkey—and beyond. The country’s current gas exports come mainly from the Karachaganak gas deposit.

Starting in 2009, KazMunayGaz is likely to increase the sale price of its gas to Russia. Although as of March 2008 Gazprom did not reveal the price it might agree to pay, regional analysts believe it may succeed in obtaining a sum ranging between

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$306^6$ and $350-400^7$ per thousand cubic meters (as compared to $180$ per thousand cubic meters in 2008). Russia is reportedly agreeing to pay a price close to what it charges on the European markets to maintain its grip on the valuable Central Asian market share, especially as the Chinese are gaining a stronger presence in the Kazakh energy sector.

As companies and countries are to meet today’s tightening carbon emissions targets, the demand for natural gas is continuing to grow. Kazakhstan is positioned strategically to export its gas to Russia, China, and Europe. However, it may also opt to develop mid- and downstream petrochemical industries, adding value and using its natural gas as a feedstock. Clearly, Kazakhstan in the decades to come will opt for oil and gas exporting strategies that add maximum value and enhance its geopolitical position in a difficult situation whereas Russia, China and the United States are competing for real or perceived interests in Eurasia. In the meantime, failure to meet development targets at Kazakhstan’s two largest oil fields has forced the government to review its medium-term hydrocarbon production outlook.

The Outlook for Kazakhstan’s Oil

Although the diversification of export routes is high on Kazakhstan’s agenda, in 2008 over 80 percent of its oil and all of its gas for export reached their markets via Russian pipelines. When the CPC export capacity finally doubles, and the Atyrau-Samara pipeline is expanded, Kazakhstan will increase its oil export capability from 45 million tons to 92 million tons per year. With these two projects successfully implemented, Russia will retain its status as the main export route for Kazakh oil beyond 2015.

In addition, Kazakhstan pumped some 4.5 million tons (around 85 thousand barrels per day) of crude oil to China through the Atasu-Alashankou early oil pipeline in 2007. In the beginning of 2008, Kazakhstan allocated TNK-BP and Gazpromneft some 600 thousand tons per year (12 thousand bbl/d) of export capacity each for their crude oil in the Kazakhstani-Chinese pipeline. TNK-BP’s vice president for supply, trading, and logistics, Jonathan Kollek, said in an interview to Argus Media that the company is ready to ship more oil to China. “The demand is high... particularly in winter, when Chinese companies need Russian crude in order to

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reduce the pour point in Kumkol... and the pipeline capacity allows us to pump up to 5 million tons per year of crude."\(^8\)

At the same time, Kazakhstan expects its own oil exports to China to reach 20 million tons per year in 2010, double today's volumes, according to Kazakh energy officials.\(^9\) The country will achieve the target with additional volumes delivered through the Kenkiyak-Kumkol pipeline link coming on stream in 2009.\(^10\) The prospects for the final pipeline link construction will in part depend on the availability of Kashagan crude oil by that time.

KazMunayGaz expects that some 25-30 million tons of oil beyond Kazakhstan's primary commitments to Russia and China may also be available for the BTC pipeline. Experts say that the amount of Kazakhstani oil actually pumped via this pipeline may remain limited due to BTC's current capacity restrictions—only 6 million tons per year excess capacity is available, and it may remain low if there is a surge in Azerbaijani oil production.\(^11\) The BTC has been the primary export route for Azeri oil since 2007. In 2008, the BTC Co., a consortium that manages the BTC pipeline on behalf of its shareholders, will expand the pipeline's carrying capacity from one to 1.2 million barrels of oil per day. It will also install equipment for injecting chemical reagents into the pipeline at pumping stations in Azerbaijan, Georgia, and Turkey to decrease viscosity and increase the speed of oil transport. BTC's capacity may expand further to 1.6 million barrels per day after 2009, if the BTC operators build several bypass sections of pipeline and install additional pumps in the existing pumping stations along the route.\(^12\)

Washington supports diversification of the pipeline routes from Eurasia, including trans-Caspian pipelines for oil and gas. On May 29, 2008, Nazarbayev signed into law a Kazakhstani-Azerbaijani agreement to provide Kazakhstani oil to international markets via BTC.\(^13\) At this point, Kazakhstan will supply its oil via tanker, delaying the construction of a Trans-Caspian oil pipeline. The functioning BTC project has been a major achievement of diplomacy and business cooperation

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\(^10\) Energy Information Administration, “Kazakhstan Country Analysis Brief.”

\(^11\) Socor, “Kazakhstan’s Oil Export Picture Detailed.”


on both sides of the Atlantic. However, Russia’s objection to Kazakh participation in BTC may lead to further complications over CPC.

Russia and Iran want to maintain the position of a near-duopoly to control energy exports from the Caspian.\(^\text{14}\) The question remains as to whether this policy will prevail, or whether it will push the smaller Caspian players closer to their potential Western European customers.

In the meanwhile, Kazakhstan extracted 72 million tons (1.45 million barrels per day) of crude oil in 2007, up from 54 million tons (1.1 million barrels per day) in 2006.\(^\text{15}\) In the same year, it also produced 10.5 million tons of condensate.\(^\text{16}\) Kazakhstan currently consumes 11 million tons of oil per year (220.9 thousand barrels per day) and expects domestic consumption to reach 16 million tons per year (321.3 thousand barrels per day) by 2015.\(^\text{17}\)

In the National Program for Caspian Oil Resources Development (2003-2005), the government of Kazakhstan initially projected that oil production would reach 100 million tons a year by 2010 and 160 million tons (about 3 million barrels per day) by 2015, including 60 million tons from the Kashagan field and 100 million tons from other offshore oilfields.\(^\text{18}\) These production volumes would have put Kazakhstan ahead of such major oil exporters as Norway and Mexico.

In practice, however, a number of factors, including the failure to advance development of the Tengiz field and delays in bringing the Kashagan field on stream, have limited Kazakhstan’s oil production growth. In view of this, the government has officially downscaled Kazakhstan’s oil production forecast for 2015 from its earlier figures of 150-160 million tons per year (3-3.2 million barrels per day) to 120-130 million tons per year (2.4-2.6 million barrels per day).\(^\text{19}\)

The output slowdown demonstrates that the Government of Kazakhstan cannot afford to scare off foreign capital. To achieve the projected oil and gas output and realize the attendant state revenue, the extractive sector needs to attract vast amounts of capital (according to some estimates, $60 billion over a ten-year period) as well as to gain sufficient pipeline access to the international markets. These


\(^{15}\) Energy Information Administration, “Kazakhstan Country Analysis Brief.”

\(^{16}\) Socor, “Kazakhstan Oil Output and Export Data Dramatize Need for Trans-Caspian Outlets.”

\(^{17}\) Socor, “Kazakhstan’s Oil Export Picture Detailed.”


\(^{19}\) Socor, “Kazakhstan’s Oil Export Picture Detailed.”
challenges are likely to remain the focus of Kazakhstan’s foreign economic policy, especially in the energy sector.

After the first phase of the giant Tengiz gas-injection expansion project, successfully completed in February 2008, the field will account for almost one-third of Kazakhstan’s crude oil production. The government expects the Tengiz field to produce some 20-27 million tons of oil per year (400-500 thousand barrels per day) in 2008, and reach its maximum production level of some 50 million tons per year (1 million barrels per day) by 2012.20

In the drive to advance the value-added stages of Kazakhstan’s oil and gas industry, the authorities are considering the further expansion of oil refineries in Atyrau, Pavlodar and Shymkent and construction of a new oil refinery and a gas processing plant near the Karachaganak field.

Astana’s economic arm is increasingly reaching outside the national borders through the acquisition of foreign industrial assets to establish Kazakhstan’s presence beyond its national and Central Asian regional borders. Kazakhstan’s KazMunayGaz has completed the acquisition of a majority stake in Romania’s Rompetrol Group for a reported $3 billion.21 Kazakhstani companies are reportedly also pursuing the acquisition of refineries and pipeline companies in Slovakia. In addition, Kazakhstan is considering a refinery project with a capacity of 3 million tons per year at Ukraine’s Yuzhny oil terminal near Odessa to ensure stable oil exports to Europe.22

In the post-Soviet area, Kazakhstan’s role as a foreign economic player, both as a sovereign wealth investor, and through private companies, is second only to Russia’s. This is both a great achievement for the republic, which rose from the rubble of the Soviet collapse, and a great challenge for it in the international arena. With it come the challenges of demonstrating responsible behavior in the international markets and making wise investment decisions. How it performs will define Kazakhstan’s relations with its neighbors and partners near and far, and will influence the country’s global image.

The international community will scrutinize investment decisions by the Kazakhstani state and large Kazakh enterprises for their compliance with political

20 Energy Information Administration, "Kazakhstan Country Analysis Brief."
agendas and international economic standards. Effecting foreign investment decisions that lead to a successful economic presence abroad is an even higher art form than developing an attractive investment framework domestically, by itself a complex and challenging endeavor.

Kazakhstan’s foreign investments need to serve at least three objectives: first, they need to secure the country’s geopolitical presence along the major routes of its energy exports. Thus, Kazakhstan’s investments in Georgia (such as a grain terminal in the port of Poti and an oil refinery in Batumi) make sense despite political volatility there, as Georgia is Kazakhstan’s window to global markets due to its access to the Black Sea. Second, these investments need to ensure a stable and sustained return on investment (ROI) for Kazakhstani state and private assets. Finally, they need to withstand international scrutiny, be transparent and, as much as possible, corruption free, in order not to expose Kazakhstan to the kind of international criticism typically directed at the investments of other oil-rich countries. Thus far, Kazakhstan’s captains of policy and industry seem to be largely up to the challenge. Foreign economic activity is already part and parcel of Kazakhstan’s overall foreign policy, and this trend is likely to accelerate in the future.
Russia, China, and the United States will remain important factors in the region for years to come. Kazakhstani foreign policy will remain a triangulation exercise between the three great powers, despite the increasingly assertive international agenda being developed by Astana.

In the 1990s, Russia was slow to formulate its strategic, political, and ideological interests in the post-Soviet area. Over time, especially under the late Yeltsin and during the first Putin Administration (2000-2004), the profitability of state monopolies and large Russian companies determined the course of Russia’s foreign policy. Economic integration has now become a priority for Russia and its negotiating positions towards its CIS partners have become tougher and more businesslike. In the words of one Russian journalist, “if you can’t pay off the debt, give us your enterprises instead.”

During the second Putin Administration (2004-2008), Russia became more assertive and positioned itself in open opposition to the U.S. in Eurasia and the Greater Middle East. It has also actively sought to maintain a dominant position over Kazakhstan’s oil and gas transit and exports, as well as bilateral deals in the coal, uranium and other energy sectors. Russia views joint economic projects as an antidote for massive foreign investment, which would increase Western influence in what Moscow views as its sphere of influence.

However, regardless of the immediate profitability of joint economic projects between Russia and Kazakhstan, some analysts see them as an important dimension to ensure stability in both Kazakhstan and Russia itself over the next 10-20 years. At times, Moscow views Kazakhstan and the Central Asian countries in a manner similar to the way the U.S. views the economic development of neighboring Mexico and other countries, which contribute to wide-scale immigration to the United States. Moscow has no interest in a quick and chaotic migration of ethnic Russians from Central Asia. It would rather use them in its

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multi-faceted system of influence in the region. Kazakhstan, for its part, is not interested in losing its relatively skilled Russian-speaking population either.

Still, some in Moscow believe that Kazakhstan is almost ideally suited for an economic merger with Russia, which presents a challenge to Kazakh independence. One of Russia’s long-term goals is to project its economic and security power to the periphery, rebuilding a sphere of influence that some would like to call an empire.

Russian policy makers and experts believe that promoting “stability” rather than democracy among their neighbors can help strengthen their country’s strategic position. The ruling elite in Moscow views efforts on the part of players such as the U.S. to spread notions of political and economic freedom and liberal democracy with hostility. They reject such notions as “Atlanticist,” a code word for American.

Many among the Russian elite perceive the democracy promotion agenda of the George W. Bush Administration as a tool of destabilization. While this may be a chief cause for concern in Moscow today, in the future, Russia may find itself competing with China for the hearts, minds, and loyalties of the Eurasian elites. The future Sino-Russia race for Eurasia may leave Kazakhstan in limbo between its old imperial master and the rising Asian great power.²

The dynamics in Sino-Russian relations and how Russia and China develop relations with India will strongly affect the Central Asian balance of power in the next two decades. Any future conflicts between China and India or between China and Russia are likely to impinge on the stability of the region.³

Since 1991, Kazakhstan’s “multi-vector” foreign policy has meant that Astana built bilateral relations with each geopolitical actor, and avoided sacrificing one vector for the sake of the other. In his February 2008 State of the Nation address, Nazarbayev reaffirmed this approach:

> We must continue to strengthen our economic and political cooperation with Russia, China, and the Central Asian countries. We must create a firm foundation for stability, open dialogue and interaction in the region. We are also expanding our constructive exchanges with the USA, EU,

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and NATO with a view to strengthening security in the Central Asian region.⁴

While seeking to continue working with all parties, Kazakhstan also clearly assigns priorities to its foreign relationships: Russia first, followed by China and Central Asian regional cooperation. Astana’s strong links with Moscow are likely to prevail in many areas of mutual interest, including the growing energy sector, while it may tend to relegate relations with the U.S. and the European Union to second tier status. Astana will continue strengthening its ties with China and Russia, while balancing the East-West vector, reaching out to the European countries through its European policy initiative.

**Geopolitical implications.** The Eurasian states have to adjust to the new rules of the game as the real balance of power in the region shifts. To borrow old-style Soviet terminology, there are changes in the ‘correlation of forces in accordance with the changing objective factors.’ The roles played by Russia, China, Iran, and India in Eurasia will only increase, as the authoritarian tendencies in the area do not trouble these countries, while criticism of internal political developments in Eurasia on the part of the West remains an irritant.

In the matter of Eurasian pipeline geopolitics, Moscow is still stuck in a predominantly zero-sum-game Cold War mode of thinking. Moscow is not pursuing and does not wish to pursue a win-win strategy with the West. While it cooperates with China in opposing radical Islam or the US presence in Eurasia, which both Moscow and Beijing view as a threat, the Kremlin also looks upon China’s energy, economic, and political aspirations in the region as a source of concern.

Hydrocarbon arteries and transit dependence are one of the Kremlin’s preferred tools to tie Astana to Moscow. During his May 2007 tour of Central Asia, Vladimir Putin obviously intended to strengthen Russia’s influence in the region and reach economic and energy agreements. Russia intensified its Central Asian policy dimension exactly during a period when the U.S. appeared to be preoccupied with Iraq and Iran, applying the Sun Tsu dictum about advancing when the adversary retreats. At the same time, Putin also moved to advance the South Stream and prevent the construction of the Nabucco alternative. Russian energy geopolitics can further two simultaneous goals for Moscow—strengthening its grip over the

⁴ Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’.”
regional energy sector and downgrading Western presence, influence and involvement in the area.\(^5\)

Some experts believe that Moscow is coercing Kazakhstan into excessive reliance on Russian pipelines.\(^6\) However, Nazarbayev reiterated in his February 2007 State of the Nation address that cooperation with Russia and integration in the Euro-Asian Economic Community (EurAsEC) remain clear priorities for Astana. Successful integration into the CIS and EurAsEC, in Astana’s view, is largely dependent on being able to conduct balanced and skillful policies. Despite Russia’s influence, the U.S., the EU, Japan, and other democracies may have attractive features, which the Kazakhstani leadership finds useful and which the Kazakh elites admire. The U.S. is likely to stay involved in Central Asia, and particularly with Kazakhstan, due to its strategic location and immense natural resources, especially energy reserves.

**Avoiding the Bear Hug.** Some analysts in the West believed that after the May 2007 constitutional reform lifted incumbency restrictions for President Nazarbayev, criticism coming from abroad would push Kazakhstan right into Russia’s embrace. However, this did not happen, as regional security considerations apparently balanced off the U.S. democracy promotion agenda. Many in Washington, London, and other Western capitals and financial centers see Nazarbayev as a steady steward of economic growth and a responsible guardian of the country’s immense hydrocarbon wealth. Accordingly, some policymakers and experts took the news that he will increase the role of the parliament while remaining on the political stage as a boon for the Eurasian country’s continuing stability.\(^7\)

US officials would like to ensure that Kazakhstan does not completely shift into the Russian camp, and hope that Nazarbayev will preside over the evolution of a stable political system, relying on his personal authority and popularity, while simultaneously encouraging nascent institutions to learn to function on their own. One danger that Kazakhstan may face is stagnation of its political institutions and economic life. Observers hope that ultimately, when Nazarbayev leaves office, these institutions will be strong enough to ensure a smooth political transition.

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\(^6\) Socor, “Moscow Pressuring Kazakhstan to Frustrate Westbound Energy Transport Projects.”

\(^7\) Cohen, “Kazakhstan: President Nazarbayev Makes a Power Play.”
Kazakhstan-Russia relations

After Dmitry Medvedev, Vladimir Putin’s handpicked successor, won the presidential elections in March 2008, he signaled that Kazakhstan would remain a primary target for Moscow’s diplomacy in Eurasia in Russia’s quest to compete with China and the United States for influence and profit in mineral-rich Central Asia, which many in the Moscow elite still view as their backyard. Kazakhstan was the first stop on Medvedev’s first foreign trip, which also took him to China.

Russia and China are anxious to curry favor with the Caspian states. They both cover the region’s energy and mineral wealth, and both are promising multi-billion dollar investments to get it. The Russian leadership, elites and some experts are busy promoting the notion that Kazakhstan will benefit from integration with Russia even at the price of diminishing or giving up “parts” of its sovereignty. Specifically, Russia would like to control Kazakhstan’s ability to manage its foreign relations with Washington, Beijing, Brussels, and other capitals, and wants a decisive say in the country’s future WTO accession. Russia is comfortable seeing Kazakhstan as a member of a modern version of the Warsaw Pact: the Shanghai Cooperation Organization, the Collective Security Treaty Organization of the CIS, and the Common Economic Space.

Advocates of Russian domination over its former Eurasian dependencies juxtapose the desirability of Kazakhstan’s integration into a Russia-led Common Economic Space and EurAsEC, against integration into the global economy pursued independently. According to this approach, Kazakhstan should give preference to the Russian capital and Russian (and possibly Chinese) ownership of infrastructure, including pipelines and ports.

The notion of integration advanced by Russia also involves increased military cooperation with Moscow, which presupposes massive military purchases by the Kazakhstani armed forces exclusively from Moscow and training of Kazakhstani officers in Russian military academies (see above). Limitations on the size of the Kazakh navy in the Caspian likewise may be part of a package advanced by Moscow.

In recent years, Kazakhstan got the short end of the stick in some deals in the energy area. Until 2009, it will sell gas to Gazprom at below-market prices, resulting in huge profits for the Russian gas giant (and concurrent losses for Kazakhstan). In addition, Russia and China have also put pressure on Kazakhstan to prevent construction of the TCP, a pipeline connecting its oilfields with the BTC pipeline, and to preempt Western-led oil and gas consortia from playing a leading role in the development of new Kazakhstani oil fields.
Overall, Russian-Kazakhstani relations are of overwhelming importance to the state of affairs in Central Asia and the wider region. Kazakhstan’s Ambassador to Russia Nurtay Abykayev said in an October 2007 interview to RIA Novosti:

For our country, Russia is the closest neighbor, a country with which we have not only a common historical past, but also great potential for mutually beneficial cooperation in the present as well as in the future... Both parties equally recognize the prospects for closer interaction, the strategic partnership between Kazakhstan and Russia. Our countries are true to the spirit and letter of the 1998 Declaration on Eternal Friendship and Cooperation. Today, bilateral ties are expanding rapidly in many fields—in the economy, culture, and humanitarian field. This is largely due to the high level of trust between our leaders... President Nazarbayev has repeatedly stressed that relations with Russia are an important priority of Kazakhstan’s foreign policy.8

The extensive trade and economic relations between Russia and Kazakhstan are built upon their largely intact Soviet-era cross-border economic ties. In 2006, the bilateral trade volume reached $12.8 billion (34.5 percent above the 2005 level), 55 percent of which was due to trans-border commerce. The two countries increased their bilateral trade to $16.6 billion in 2007, and the growth has continued with $5.9 billion bilateral trade turnover in January-April 2008, a 28.8 percent increase over the same period in 2007.9 The leaders of the two states are planning to increase bilateral trade to $20 billion in the near future,10 which is quite realistic considering the possibilities for expanded joint projects as well as establishing a common market for goods, services, capital, and labor. Besides energy, the two countries may develop large-scale transportation infrastructure joint projects along the West-East international corridor. For example, Moscow and Astana are planning to create a unified tariff scheme for import-export railway transit.11

8 Interview with Ambassador Nurtay Abykayev, RIA Novosti.
10 Interview with Ambassador Nurtay Abykayev, RIA Novosti.
Russia and Kazakhstan are investing increasing amounts of money in each other’s economies. Kazakh investors launched the Pushkino Logistics Park (office space, transportation and warehousing hub) in Moscow, and have started to build a similar park in the Domodedovo airport area, also in Moscow. Russian investors, in turn, are building a large office-hotel complex in the left-bank area of Astana.

Russia and Kazakhstan are committed to the integration of the post-Soviet space and agree on issues of security and regional stability. At this time, Kazakhstan, together with Ukraine and Belarus, is among the CIS states with development and growth levels comparable to Russia. In addition, the Russian and Kazakhstani national economies have a similar structure, as a large share of their national output comes from the energy and natural resources sector. The two states will continue to cooperate on issues of energy production and transit, space, and development of Caspian Sea resources.

At the same time, reliance on energy also contributes to competition, since the two states supply the same products to the same set of foreign markets. With customers currently competing for access to energy supplies, the demand is sufficient to offer both countries numerous opportunities to sell their oil and gas. Rivalries arise, instead, around ownership of the lucrative hydrocarbon transport and refining infrastructure.

Energy cooperation is multilateral in nature. Russian experts note that foreign investors often pursue not only purely economic motives, but also are guided by geopolitical agendas in their home countries. These experts often picture the Western states as de facto enemies of the deepening Russian-Kazakh relations, actively opposing reintegration in the post-Soviet space.¹² For instance, on the contentious issue of energy transport infrastructure, the Western states actively promote diversification of export routes to bypass Russia.

America’s appeal to Kazakhstan, many Russians believe, is driven by a desire to “weaken the role and influence of Russia in the post-Soviet space, and sow the seeds of distrust and even hostility in the relationship between Russia and its partners in the EurAsEC and the SCO.”¹³ Russian experts, perhaps mirror imaging their own agenda, see calls for export diversification as geopolitically motivated. Therefore, they say, Astana and Moscow need to coordinate their policies to “avoid

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¹³ Ibid.
the risk of becoming involved in the geopolitical and geo-economic intrigues of third countries.\textsuperscript{14}

In this context, the Kazakhstani and Russian government have repeatedly advocated the establishment of an SCO-based energy club, which could allegedly take into account the best interests of both energy producers. Yet, such a Club would put SCO consumers such as China at a disadvantage, as producers, not consumers, would dictate energy policies. Cooperation through this proposed framework would also define export policies with respect to consumers outside the region. Thus, Russia fiercely opposes the construction of a Trans-Caspian pipeline to carry Kazakh gas to Europe outside of Russian control. As Moscow is imposing its priorities on Astana, policy coordination by Russia, Kazakhstan and other SCO energy producers, increasingly looks like an effort to build a global energy empire under the Kremlin’s auspices.

\textbf{Kazakhstan-China Relations}

Rising China is an increasingly important partner for Kazakhstan. As the country wants to diversify its exports and secure a stronger negotiating position with Russia and the West, China is looking for a bite of the Central Asian energy pie. Bilateral trade turnover reached $13.9 billion in 2007, and the countries are working to push it up to $15 billion in 2008.\textsuperscript{15} The two states are also planning to establish a fund to finance joint infrastructure projects with initial capitalization of $1.5-2 billion on a parity basis.\textsuperscript{16}

China is importing Kazakh oil and gas via the Atasu-Alashankou pipeline, which it financed (see Map 3 in Part II for details). China built this early oil pipeline from Kazakhstan in 2005, and has reached an agreement to build a gas pipeline from Central Asia, while more infrastructure projects are in the planning stages. The projected annual capacity of the oil pipeline is 20 million tons a year. In 2009, the two countries expect to complete a second stage of the pipeline complex, the 750-kilometer long, $1 billion Kenkiyak-Kumkol oil pipeline (see Map 3 in Part II for details).\textsuperscript{17} With this in place, China will have better access to Kazakhstan’s

\textsuperscript{14} Ibid.


\textsuperscript{16} Interview with Kairat Kelimbetov.

oilfields, specifically Kumkol, and Kazakhstan and China will be well on their way toward building a strategic energy infrastructure linking the Central Asian hydrocarbon supply to China’s growing energy demand.

China is increasingly competing with Western and Russian companies for access to the regional energy resources. Beijing is looking for “equity oil,” i.e. ownership of barrels in the ground, not spot market purchases. China’s CNPC has already invested some $6.5 billion in Kazakhstani oil projects, and produces some 13 million tons of oil per year in Kazakhstan.

However, the Kazakhstanis are somewhat wary of letting China expand too much in their country. Regional analysts observe “mounting Sinophobia” in Kazakhstan as the country increasingly assumes the role of a cheap raw materials supplier for China and a market for low-priced Chinese goods. Regional primacy, which China may find difficult to achieve in Central Asia through traditional political means, may be sought through economic domination. Wariness and fear of China may become a significant factor in shaping future Kazakh-Chinese relations.

Another possible challenge may come from the economically developing, predominantly Muslim Xinjiang province of China, which borders Kazakhstan. Xinjiang has a vast Muslim Uighur population, who also reside in Eastern Kazakhstan. Uighurs are nationalistic, and many of them resent Chinese rule and the influx of Han immigrants to Xinjiang. Astana does not want to get involved in an internal Chinese conflict, which would threaten the stability of the region.

Putting these concerns aside, Astana broadly subscribes to the SCO slogan of fighting “the three evils—terrorism, separatism, and extremism.” Kazakhstan also supports the “One China” principle regarding Taiwan. Overall, current relations between Beijing and Astana are good. The two countries are pursuing people-to-people exchanges. The number of bilateral exchanges is growing, with more Chinese visiting Kazakhstan for tourism and business, and up to 3,000 Kazakh students attending Chinese universities. In October 2007, the Kazakh Embassy in Beijing held a Cultural Days of Kazakhstan event in China that, in the words of Kazakh Ambassador to China Ikram Adyrbekov, was symbolic of the genuine strategic partnership proclaimed by Presidents Nursultan Nazarbayev and Hu Jintao:

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18 Yermukanov, “Amid Mounting Criticism in Kazakhstan, Beijing and Astana Seal New Deals.”
Kazakhstani people regard modern China as an influential, constructive and friendly neighbor, which has proved to be a reliable political and economic partner. The Kazakh society and establishment regard the future development of equal and pragmatic interaction as a firm guarantee of the stable and successful development of both Kazakhstan and Central Asia in general. For Kazakhstan, the dynamic development of energy cooperation with China is of great importance as it fully corresponds to our desire to diversify export routes for our hydrocarbons.19

Partnership with Beijing is an important vector for Astana, while China utilizes Kazakhstan’s established role in Central Asia to promote its long-term regional agenda, including energy infrastructure projects.

Beijing has a clear strategy for Central Asia. With no internal political strings attached to infrastructure loans and investments, some Central Asian states find it easier working with China than with the West.

In August 2007, the presidents of China and Kazakhstan signed a program of cooperation in the non-raw material economic sectors with particular focus on manufacturing, food industry, textile industry, transportation, logistics services, metallurgy, construction materials, and tourism.20 During Karim Massimov’s April 2008 visit to China, he and his Chinese counterpart Prime Minister Wen Jiabao reached a number of additional agreements on non-resource economic cooperation in such sectors as finance, agriculture, road and infrastructure construction, electricity, and hydropower. Thus, for example, the Bank of Kazakhstan and the Export-Import Bank of China agreed on preferential loans, while the KazAgro Holding Company and a Chinese corporation producing crops, oil and foodstuffs, agreed that Kazakhstan would supply grain to China.21 In addition, the Chinese side has expressed an interest in constructing the Moinak hydroelectric power station and Balkhash thermal power plant.

At the opening of the April 2008 Kazakhstan-China: Partnership for Success Business Forum in Beijing, Kazakh Prime Minister Karim Massimov noted that the two countries have “entered a new stage of business cooperation—the stage of

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implementation of large-scaled non-extraction projects.”22 He was particularly referring to the anticipated launch of the Khorgos International Center for Trans-border Cooperation in 2008, and a railway connection through the Khorgos border crossing planned for 2009. Currently, the parties are also working to create a free trade zone at the Dostyk-Alashankou railway border crossing and launching the 8500-km West Europe-West China transcontinental road corridor, 2800 km of which will run across Kazakhstan.23

Kazakhstan and China have also intensified finance sector cooperation in such areas as large project financing, export credit insurance, and the entrance of second-tier banks into each other’s financial markets.24 Additionally, Astana would welcome foreign investments into its manufacturing and processing industries, as well as in technology-intensive sectors.

Management of the trans-border rivers is high on the bilateral agenda. Kazakhstan and China both rely on the ecologically threatened Lake Balkhash basin for their water supply. This lake, the second largest in Central Asia after the Aral Sea, is unique as the western part of it is fresh water and the eastern is saline. The lake is located in southeastern Kazakhstan, and its eastern coast served as the western border of the Chinese empire in 1644-1864, before China ceded the region to the Russia Empire.

Environmental experts fear that Lake Balkhash may be at risk of following the tragic example of the Aral Sea, which shrank and dried up as a result of diversion of river waters to irrigate Central Asia’s cotton fields. The Ili, the main river to feed the lake, flows through the densely populated and resource-rich Xinjiang region. In addition to providing drinking water for the population, Lake Balkhash also serves to irrigate vast nearby rice and sugar farms. Kazakhstan and China may need to adopt a cooperative policy, under which everyone has to pay for water and take responsibility for the management of water resources.25 Although the heads of states have committed to cooperate on joint water resource management, the parties are yet to adopt specific mechanisms.

23 Ibid.
24 Ibid.
Kazakhstan-Central Asia Relations

Aware of the attention that global powers are paying to their country and the region, Kazakhstani decision makers have increased their focus on relations with their next-door Central Asian neighbors. They believe that regional cooperation is a win-win game, where the outcome is greater than the sum of its components. In addition, as many 21st century challenges, such as migration, water, the environment, power generation, drugs and crime, religious extremism, etc, are trans-border issues, Astana believes that insufficient regional cooperation may exacerbate these problems and threats. To address the “cooperation deficit,” Kazakhstan has strengthened its regional diplomacy. Some experts believe that for a while Astana had put too much emphasis on relations with great powers such as China, the U.S., and Russia, which has caused a “deteriorating [national security] situation along its border perimeter.”

A priority issue on the Central Asian agenda is joint water resource management. The Eurasian Economic Community (EEC) has already addressed water resource usage in the Syr Darya and Amu Darya river basins. Astana is leading an effort to establish a water-energy consortium in the Central Asian region. Realizing the importance of water for balanced regional development, Kazakhstan desires to achieve and maintain sustainable water usage that would best address the needs of the area’s states. This kind of multi-country development will require vast reservoirs of good will, cooperation, and investment.

As Kazakhstan remains committed to regional integration, it may try to balance Russia’s influence in the Central Asian neighborhood. To advance integration, in his 2007 State of the Nation address Nazarbayev proposed the creation of a Eurasian Economic Union (EEU), a new economic and political organization to build upon the success of current regional groups. According to Kazakh Ambassador to Russia Nurtay Abykayev, “there is an objective need for further regional consolidation to strengthen mutual economic benefits as well as social, cultural, humanitarian and other relations.” The underlying idea of the Union is to increase the global competitiveness of the Central Asian region as a whole. However, Uzbekistan does not see eye to eye with Nazarbayev on the appeal of regional integration.

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28 Interview with Ambassador Nurtay Abykayev, RIA Novosti.
Disagreements between Central Asian heavyweights Kazakhstan and Uzbekistan became apparent during a visit by Uzbek President Islam Karimov to Astana in April 2008. While the leaders agreed to enhance bilateral economic cooperation, including the creation of a free trade area, Karimov delivered a public blow to Nazarbayev’s initiative to form a Central Asian Union (CAU), stating, “once and for all, in order to avoid any speculations on this matter, [the idea of a Union] is unacceptable to Uzbekistan… [since] the development levels of the Central Asian states is incompatible.”

The Uzbek president apparently disregarded the fact that the levels of development in Europe prior to the creation of the European Community also differed drastically. Nevertheless, the European leaders, recognizing the potential advantages of integration, made an effort to unite Spain, Portugal and Greece with Germany, the UK and the Scandinavian countries. The Central Asian states could learn from their European counterparts. Still earlier, the states of the United States came together despite differences between the agricultural South and industrial North.

Mr. Karimov’s speech demonstrated a differing approach—and the difficulties of integration in Central Asia. It also came against a background of informal but persistent rivalry between Astana and Tashkent for leadership of the region. Presidents Karimov and Nazarbayev are the two longest-serving leaders in the entire post-Soviet area who have remained in power since their states gained independence in 1991. Since then, the two states have been competing over primacy, which has inevitably hampered rapprochement on many important issues.

Both leaders have declared that they are committed to boosting bilateral economic cooperation, harmonizing their transportation and customs tariffs and regulations, and promoting joint business activities. However, as Kazakhstan has achieved impressive economic, social and political progress, Uzbekistan has increasingly isolated itself in the global arena, has been a laggard in terms of economic integration into world economic and financial flows, and has suffered from much higher rates of religious radicalism and terrorism than Kazakhstan. In view of this, it is indeed encouraging that in April 2008, the two leaders agreed to accelerate the creation of a more favorable trade regime and renewed talk of a free trade zone between their states.

Uzbekistan and Kazakhstan have a mixed record as far as their relations with Russia. While Astana has managed to balance its Russian and Western ties, Uzbekistan—on the contrary—has abruptly changed its orientation from Washington to Moscow. Tashkent at times prioritized one vector at the expense of another. The fact that the newly elected President of Russia Dmitry Medvedev chose to visit Kazakhstan on his first state trip overseas signals that the new administration is going to adhere to Vladimir Putin’s foreign policy course of building alliances in Eurasia and East Asia, while giving the cold shoulder to the Western capitals and especially the United States. From the Central Asian regional perspective, the choice of Astana over other regional capitals demonstrates that the Kremlin considers Kazakhstan a close ally and a regional leader.

Kazakh-Uzbekistani cooperation is encouraged by Russia over energy transit issues, yet other areas need immediate attention. One of these is improving border patrol, border crossing, and customs operations. The porous borders of both countries are poorly protected, often allowing criminal groups and drug traffickers unimpeded transit. The borders of the Central Asian states with Afghanistan are of particular concern. Kazakhstan has an immediate interest in making those borders less permeable, and preventing terrorists, arms, drugs, and illegal migrants from crossing. Yet the response from Tashkent, Dushanbe and Bishkek has been insufficient.

To boost its security, in 2007, Astana launched an ambitious military reform that should upgrade the country’s defenses as described in Part I. Astana also aspires to transform its defense industry capabilities, and to become a leading Central Asian arms exporter, particularly in artillery systems. Kazakhstan’s military technology cooperation with Israel, which has included the purchase of arms samples and technology transfer, has been instrumental in boosting the modern arms production capabilities of Kazakhstan. In particular, Astana acquired the technology to produce the new Nayza missile system, and will do so in close cooperation with Russia. Kazakhstan’s dependence on Russia confirms that Astana views its defense and security interests as interlinked with Moscow.

Although Kazakhstan has turned towards strengthening its ties with the Central Asian states, persistent distrust, partially caused by the Kazakh military build-up,

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has impeded its efforts. Unlike its neighbors, Kazakhstan’s booming economy can bear the cost of military modernization. To keep up with the military build-up, other Central Asian states, most notably Uzbekistan, have to spend a relatively higher share of their GDP for defense. At the same time, military competition in the region could ultimately compromise stability. In this context, the Kazakhstan-led Conference on Interaction and Confidence-Building Measures in Asia (CICA) is a valuable tool for strengthening regional security. President Nazarbayev initiated this international security forum at the 1992 UN General Assembly. Modeled along the lines of Europe’s OSCE, CICA aims at enlarging cooperation, and creating and strengthening “the atmosphere of peace, confidence, and friendship on the Asian continent in order to promote regional security.” It is remarkable that CICA is the only regional forum, which high level Israeli and Iranian leaders attend. During its 2002 Summit, CICA adopted a Declaration on Eliminating Terrorism and Promoting Dialogue among Civilizations. Kazakhstan will hold the third CICA Summit in 2010, the same year it will chair the OSCE.

Kazakhstan and Europe

Since its independence, Kazakhstan has pursued broad bilateral and multilateral relationships with the countries of the European Union. Astana is a strategic partner for Europe in its Eurasian policy, while the European vector has been among the top five priorities for Kazakhstan even before it won the OSCE presidency in late 2007. Kazakhstan has developed its Road to Europe policy initiative, while there are voices, for example in the European Parliament, which call for the inclusion of Kazakhstan in its European Neighborhood Policy.

After the 2004 and 2007 eastward enlargements, through which the EU drew nearer to Central Asia geographically, politically and economically, Europe attempted to strengthen its positions in Eurasia. During a meeting of the EU Troika in Astana in March 2007, Benita Ferrero-Waldner, Commissioner for External Relations and European Neighborhood Policy, said:

Yermukanov, “Kazakh Foreign Minister Shifts Priorities from Superpowers to Next Door Neighbors.”

CICA’s membership includes Afghanistan, Azerbaijan, China, Egypt, India, Israel, Iran, Kazakhstan, South Korea, Kyrgyzstan, Mongolia, Pakistan, Russia, Tajikistan, Turkey, Uzbekistan, and the Palestinian National Authority, while the United Nations, OSCE, Indonesia, Japan, Ukraine, and the U.S. hold observer status with the organization. Source: Embassy of Kazakhstan to the USA and Canada, Conference on Interaction and Confidence-Building Measures in Asia: History of Success,” at http://www.kazakhembus.com/CICA.html (May 30, 2008).

EU enlargement has brought us closer to Central Asia and the time is ripe for a more intensive engagement with the Central Asian countries. That is why the Commission is contributing to the development of a new EU Strategy for relations with the region...The new higher profile that the EU is giving Central Asia reflects in a very substantial increase in our future assistance to the region.³⁵

To respond to the new geopolitical realities in the region, the European Union has adopted a new Regional Strategy Paper for assistance to Central Asia that envisages some €719 million in aid. Specifically, the European Commission will devote 40-45 percent of this aid budget to poverty reduction programs, 30-35 percent to regional cooperation and good neighborly relations, and the remaining 20-25 percent to promotion of good governance and economic reform.³⁶

Energy and trade relations are significant areas of cooperation between the EU and Kazakhstan. During a meeting with his European counterparts, Kazakh Foreign Minister Marat Tazhin said that energy cooperation between Kazakhstan and Europe should go beyond mere energy supply. He underscored the need to “improve the infrastructure of energy supplies from Central Asia through the Caspian and Black Sea to Europe. Collaboration will occur not only in the supply of raw materials. The energy dialogue that we are talking about means the creation of a liberal regime for our investment, including in the hydrocarbon sector... in the economies of the EU.”³⁷ As Kazakhstan’s wealth grows, the question of its investment in the stable climate of Europe becomes increasingly relevant.

As the Kazakh government presses for the formulation and execution of development strategies in industry and innovation, education, transportation, tourism, and combating corruption, the Road to Europe program will focus on boosting Kazakhstan’s political, economic, and humanitarian cooperation with the European states and the European multilateral structures. Astana wants to attract advanced technologies and know-how into priority sectors of the economy and to access European best practices in management and economic development policies. Astana seeks partnerships with the leading European states that drive European

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integration. It is also working with the EU in a multilateral format as part of the EU’s New Partnership Strategy with the Central Asian states. Kazakhstan is interested in leading efforts to maintain security and stability, as well as furthering regional integration in Central Asia, by combating transnational crime. As far as economic cooperation goes, the country is keen on expanding commercial ties by creating a favorable trade and investment environment and accelerating WTO accession talks with the EU.

In the energy sector, the EU and Kazakhstan will continue working on diversifying Kazakhstan’s energy supply routes to Europe, despite Moscow’s resistance, as well as energy conservation.

Astana also looks to Europe for assistance in improving its legislation, particularly on elections, political parties, mass media, libel, and defamation. In turn, Kazakhstan would like to offer its experience and expertise in cultivating inter-ethnic and inter-religious harmony and stability.38

As attitudes towards the U.S. are becoming more negative, some Europeans suggest that a degree of distancing themselves from the U.S. could lead to a more cordial perception of the European Union in the region.39 On a visit to Kazakhstan, a member of the German Foreign Ministry delegation noted that the EU might need to review its policy towards Central Asia in order to change the perception of the EU as a representative of American interests in the region. This statement clearly indicates a desire, at least on the part of the German diplomatic establishment, to distance itself from the U.S.40 The German suggestion reflects the current thinking in certain quarters in Berlin and Brussels.

The main weakness of the European Union stems from “the lack of unanimity over energy issues, on the one hand, and constant disputes with Russia on the other.”41 European players still have financial and technological resources to offer to Kazakhstan, but lacking a coherent strategy, Europe and its constituent members are not leading powers in Central Asia. The ongoing political courtship by Moscow, Beijing, Washington and Brussels (as well as individual European capitals) and plentiful natural resources allow Astana to maneuver among the interested parties, maximizing its geopolitical leverage.

39 Gusev, “Germany – Central Asia, Cooperation in Political, Economic and Cultural Spheres.”
40 Ibid.
41 Sharip, “European Energy Consumers Likely to Lose Kazakhstan Battle to ‘Oriental Bloc’.”
Kazakhstan and the United States

As US influence in Central Asia is declining, the geopolitical and geo-economic situation in Central Asia remains in flux. In the last years of the Bush Administration, Washington increasingly focused on Iraq, followed by Afghanistan, Iran, and the global war on terror. Central Asia, though adjacent to the Afghan theater of operations, was nevertheless somewhat peripheral to the US global strategy. Washington’s ability to withstand joint Sino-Russian pressure to squeeze America out of the area is weakening, at least as far as the Central Asian countries perceive the situation.42

However, the region should not count the United States out, at least not yet. In the past, it greatly contributed to the security of Central Asia by spearheading the post-Soviet denuclearization in the early 1990s, defeating Al Qaeda and the Islamic Movement of Uzbekistan in Afghanistan, and providing military training and assistance to Central Asian states.

The Islamic Movement of Turkestan did not reconstitute itself after the defeat of its predecessor, the Islamic Movement of Uzbekistan, by American forces and the Northern Alliance in Afghanistan in 2001. US support of independence for Kazakhstan, Uzbekistan, and other Newly Independent States (NIS) in the 1990s, as well as the US presence in Central Asia after 2001, contributed greatly to the consolidation of sovereignty and a variety of geo-strategic options for the five countries of the region.

Bilateral US-Kazakhstan relations have traditionally been strong and may continue to deepen, especially if the two countries move to bring the Kazakhgate corruption investigation to a conclusion and take it off the agenda. Today, relations center on cooperation in the energy sphere and the participation of Kazakhstan in Washington’s “Greater Central Asia” geopolitical strategy. The two states regularly exchange visits, starting at the presidential and prime minister/vice presidential levels; and work in the framework of the Kazakh-American commission on energy partnership, the latest session of which took place in Washington in March 2008.

However, some voices in U.S. industry and government are expressing concerns about the state’s increasing role in the Kazakh economy. In his February 6, 2008 State of the Nation address, President Nazarbayev announced that the state would strengthen its role as an “influential and responsible participant” in the oil and gas

42 Interviews with Kazakhstani senior officials who requested anonymity, Almaty and Astana, April 2008.
business. This is understandable in view of high energy prices, but would violate the sanctity of contracts if the state takes unjustified and especially retroactive measures to revise these agreements. For example, the January 14, 2008 framework agreement on the Kashagan oil field doubled state-owned KazMunayGaz’s share in the project to over 16 percent. As discussed earlier, the underperformance of the Kashagan consortium in general and managing partner Eni in particular triggered this move. However, the state should avoid wonton revision of existing mineral rights.

According to Nazarbayev, the state is also planning to review underperforming natural resources contracts, and increase its role in the development of heavy industry and infrastructure. These are still rather moderate measures in the context of the trend toward resource nationalism sweeping the world, but US policy makers would like to clarify that, as a general rule, the private sector is always more efficient in economic development than the state. Kazakhstan needs to remain investor-friendly and competitive. It should not take US political support and business sector commitments for granted.

In the meantime, bilateral cooperation is continuing. The countries’ energy ministers discuss cooperation in hydrocarbon and electric power industry, as well as renewable energy and environmental protection. The establishment of the Friends of Kazakhstan US Congressional caucus sent another signal that strengthening relations with Kazakhstan is an important point on the American foreign policy agenda. Astana is a vital partner to Washington in the Greater Central Asian region despite the alternatives represented by Russia and China.

The desire to check American global power will continue uniting Moscow and Beijing. While they pursue ascendancy, the contradictions between the two remain manageable, for now. For both states, Central Asia is an important area of foreign policy and security cooperation, a source of raw materials and market for finished goods, as well as a source of related transit and export revenues. Resource-rich Kazakhstan represents an important element in both states’ regional geopolitical and geo-economic strategy.

To limit the American global influence and to consolidate a Eurasian non-democratic axis in opposition to the Euro-Atlantic one, Moscow and Beijing work together, including within the U.N. Security Council, on issues ranging from their

soft posture on Iran (when it comes to rejecting robust and meaningful anti-Iran sanctions) to opposition to the independence of Kosovo. Russia and China blocked U.N. sanctions against dictatorships such as Zimbabwe and Myanmar. Moscow and Beijing are also likely to explore their growing military cooperation within the Shanghai Cooperation Organization further. Nevertheless, in the longer term regional rivalries, particularly for dominance over resource-rich Central Asia and possibly the Russian Far East, could outweigh the shared Russian-Chinese anti-Western stance.

Since its independence, Kazakhstan has learned the balancing game and has managed to maneuver skillfully between the competing interests of the great powers to its own advantage. For this reason, even though in the near term Astana may incline towards Moscow or Beijing, the West should keep Kazakhstan at the top of its Eurasian geopolitical agenda.

It may be more convenient for Astana to deal with Russia and China, which do not insist on democratic politics, business transparency, or improving the national human rights track record, than with America. However, in the longer run, as Astana sees itself being a full member of the modern community of states, it may be unwilling to tie itself solely to the SCO mast, discarding altogether its relationships with the U.S.

Keeping geopolitical alternatives open remains an imperative of Kazakhstan’s foreign policy. The U.S. should not do differently. If political and energy cooperation with the U.S. and European powers proves to be more attractive for Kazakhstan, policy makers in Astana will pragmatically keep the doors open. However, this will require coherent policies formulated and implemented by the U.S. and members of the European Union on many fronts, as cooperation with Astana in securing the OSCE presidency has demonstrated.

**Kazakhstan’s Iranian Connection**

Iran, one of the five Caspian littoral states, is a sizable player in the Central Asian region. It is a lucrative potential commercial partner, which Kazakhstan finds harder and harder to ignore, despite US insistence on minimizing economic ties with Teheran. The U.S. imposed economic sanctions against Iran under the 1996

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45 Whitmore, “Central Asia: Behind The Hype, Russia And China Vie For Region’s Energy Resources.”
Iran-Libya Sanctions Act (ILSA), which envisaged sanctions on foreign nations and companies that invest over $20 million per year in Iran’s energy sector.\textsuperscript{46}

In the meantime, bilateral trade between Kazakhstan and Iran crossed the $2 billion mark in 2006, having nearly tripled from the 2004 level. To facilitate regional trade, Kazakhstan, Iran, and Turkmenistan are planning a massive joint infrastructure project—the construction of a 900-kilometer railway from Aktau seaport in West Kazakhstan via Turkmenistan (700 km) to Iran (90 km). This is an important component of the much-hailed North-South Transportation Corridor, which Russia and Iran are championing. China, India, and Western Europe may be important players in this project.

The Presidents of Kazakhstan and Turkmenistan reached a bilateral agreement in May 2007, while the final deal with Iran was signed during the September 2007 Caspian Sea Summit.\textsuperscript{47} If constructed, the new railway connection will carry three to five million tons of cargo annually; and the intention is to raise its capacity to around 12 million tons, which will facilitate Kazakh exports to the Gulf States and East Asia.\textsuperscript{48} The head of the foreign policy department at Kazakhstan’s Institute for Strategic Studies, Askar Nursha, commented that the Kazakh-Turkmen-Iranian railway agreement “was long awaited by the signatory countries. It opens up new opportunities in political and economic cooperation for the Central Asian states and Iran, and allows a more complete use of the resources.”\textsuperscript{49}

Kazakhstan is already supplying its oil to Iran, conducting swaps via the Persian Gulf, despite existing political risks.\textsuperscript{50} However, KazMunayGaz exports only limited amounts of oil (70-80 thousand barrels per day in 2007) via this route, presumably to avoid angering the U.S.\textsuperscript{51} At the same time, as Kazakhstan’s growing oil output pushes Astana to search for additional export routes, the Iranian transit

\textsuperscript{49} Veronica Lim, Interview with Askar Nursha, “The Immediate Task for Kazakhstan’s Diplomacy is to Contribute to a Compromise agreement on Seabed Delimitation in the Southern Sections of the Caspian Sea,” Central Asian Monitor, October 19, 2007 (Russian), at www.camonitor.com (January 12, 2008).
\textsuperscript{50} Sharip, “European Energy Consumers Likely to Lose Kazakhstan Battle to ‘Oriental Bloc’.”
options becomes more attractive. Teheran wants to increase the volume of oil swaps with Kazakhstan. To this end, Iran has offered to expand the capacity of the Neka terminal and a planned Neka-Jask (Caspian Sea-Arabian Sea) oil pipeline link that would lower the cost of oil transit for Kazakhstan. The estimated cost of the Neka-Jask transit option would be around $45 per ton, in contrast to $75/ton via BTC, $55/ton via CPC and $73/ton via the Baku-Batumi-Kulevi railway. Teheran is also offering landlocked Kazakhstan access to the Chabahar Port Free Trade Industrial Zone (CFZ) on the Arabian Sea, which would give Astana “the easiest access to the open ocean.” With such attractive options on the table, it makes it more and more difficult for Astana to discard the Iranian direction for its exports.

In addition to luring Kazakhstan into increased energy transit cooperation, Iran is offering Central Asia and the Caucasus a duty-free export transit corridor through its territory. Iran hosts five out of twelve Caspian Sea ports, with a combined capacity exceeding that of the remaining post-Soviet seven ports. Iran is planning to build up the Anzali port to become the largest on the Caspian. It will also have a free trade-and-industrial zone. This free trade zone could potentially divert some Caucasus and Central Asian commodities and goods away from the expensive Russian transit options. Although the Iranian transit direction is commercially attractive for Central Asia, Teheran’s pursuit of a nuclear program outside of full IAEA control raises security concerns not just across the Atlantic, but also across the Caspian.

During his April 19, 2007 opening speech at the Sixth Eurasian Media Forum in Almaty, Nursultan Nazarbayev appealed to Iran to prove the peaceful intent of its nuclear program to the international community:

...[A] military confrontation with Iran is fraught with serious consequences for the entire world. We hope Iran, our friendly neighbor, unequivocally proves to the world that it is engaged only in peaceful nuclear energy research. The nations of our region and... the entire world are waiting for this...

Our country was the first in the world to shut down the largest nuclear weapons test site and voluntarily renounce nuclear weapons, thus strengthening the foundation for the nonproliferation system. Our

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52 John C. Daly, “Iran Offers Ocean to Oil Giant Kazakhstan,” Middle East Times, May 12, 2008, at http://www.metimes.com/Business/2008/05/12/iran_offers_ocean_to_oil_giant_kazakhstan/6011/ (May 28, 2008).
53 Daly, “Iran Develops Caspian Port.”
renunciation of nuclear weapons in exchange for guarantees from nuclear weapon states was Kazakhstan’s strategic choice based on our understanding of our global responsibility. We call on other countries to follow our example. First of all, we direct this call to countries seeking nuclear weapons.54

Nazarbayev also urged the review of the approach to nuclear nonproliferation due to the lack of noticeable progress in disarmament by

...a limited group of nuclear weapon states [that] view the NPT as an asymmetric agreement, which levies special obligations... only on non-nuclear weapon states. At the same time, the nuclear weapon states... continue to invest considerable funds in research, development, and modernization of nuclear weapons [and] do not consider it necessary to respect their obligations on disarmament. All of this feeds destructive moods and a sense of unfairness of the NPT in certain regions of the world. The worst about it is that this provides arguments for countries seeking weapons of mass destruction.55

Clearly, Nazarbayev is convinced that in the modern interdependent world, states need to switch from global competition to global responsibility and active formation of a regime of trust and strategic dialog.

Commenting on the potential role Kazakhstan can assume in the international community and in Central Asia in particular, Haoliang Xu, the U.N. Resident Coordinator and UNDP Resident Representative in Kazakhstan, said:

Kazakhstan has made impressive progress in its post-independence economic, social and political transformation. It has seen a significant increase in the per capita income... The country has educated a group of young professionals both in Kazakhstan and through its aggressive scholarship programs overseas. They are knowledgeable, confident, and dedicated. Kazakhstan has stated a policy to assist countries in the region whenever possible and has invested heavily in a number of CIS countries.

55 Ibid.
I can foresee a country that will play an increasingly important international and regional role in the future.

In the political sphere, Kazakhstan will continue to advocate confidence-building measure in Central Asia and will be a critical partner in key regional organizations such as the Eurasian Economic Community and the Shanghai Cooperation Organization. As a landlocked country, Kazakhstan will seek to work closely with regional and other partners to improve infrastructural and other conditions for expanded international, regional trade. It will make a serious effort to improve conditions for transit transport through its territories.56

It is now up to Kazakhstan to utilize its natural endowments in a responsible way that will guarantee equitable and sustainable development, and to stay on the development path the state leadership chose during the first years of independence—the path of forward-looking economic reform and social stability.

56 Interview with Haoliang Xu.
Geopolitical pressures and options, as well as dynamics in the global commodities markets, are influencing Kazakhstan’s development priorities. Natural resources are a blessing, but can be a curse, if mismanaged or squandered. A resource-rich state like Kazakhstan has to be careful in its selection of economic priorities. It has to avoid the traps, which the development literature frequently associates with resource-driven economic growth models. Many scholars of international development agree that in recent decades, the resource-rich countries have underperformed compared to their resource-deficient competitors. In developing countries abundant with mineral resources, per capita incomes have grown at rates 2-3 times slower than in non-resource based economies.¹

In addition to their negative effects on economic development, most of the literature argues that an abundance of oil and other minerals has undesirable effects on democracy.² A smaller number of studies question the causality of this factor. One recent study, for example, suggests that what matters for the impact of energy wealth on democracy are not the mineral endowments themselves, but their ownership structure. Thus, in countries where the oil and gas industries are in private hands and ownership is diffused, oil may have a positive impact on the democracy and development record.³ Another study found no proven association

between resource dependence and persistent authoritarianism or failed democratic transitions.\(^4\)

Numerous scholars warn that abundant mineral resources can be a curse for the state and society that own them. They refer primarily to the socio-political and economic challenges a country is likely to face in the resource-driven development scenario. First, there is a high risk of political rivalry for access to the resources. The scale of these struggles varies, and may range from factional battles within the country’s elite for ownership and control of lucrative energy assets, as it is the case in Russia, to encouraging secessionist movements and fueling lengthy armed conflicts, as has happened, for example, in Angola and Nigeria.\(^5\)

The post-Soviet energy-rich states have avoided oil wars. However, they are far from being immune to other adverse effects of hydrocarbon riches—rent seeking,\(^6\) high levels of corruption, bureaucratic inefficiency, poor governmental accountability due to windfall revenues, and power struggles for control over the valuable assets. Secondly, economic challenges include the risk of suppressing non-commodity value-added economic sectors in a phenomenon known as the Dutch disease (discussed in Part One) and overexposure to external price shocks and financial fluctuations of the hydrocarbons market.

Paul Collier proposes remedies for resource-driven risks along the lines of monitoring energy revenues, scrutinizing expenses and tracking commodity flows, as well as creating the ability to cushion price shocks.\(^7\)

The creation of sovereign wealth funds in oil-producing countries is a good example of an effective counter-measure, which aims to isolate the national economy from excessive petro-dollar cash inflows. The establishment and transparent management of Kazakhstan’s National Oil Fund and the Government of Kazakhstan’s multiple initiatives on economic diversification away from commodity dependence aim at tackling these known development risks. Additionally, Astana’s focus on social cohesion and harmony from the first days of

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\(^4\) Haber and Menaldo, “Do Natural Resources Fuel Authoritarianism?”


\(^6\) Rent seeking refers to an organization or individual (official) using their access to resources to obtain an economic gain from others without reciprocating any benefits back to society through wealth creation. Such activities do not create any value or benefit for society. Instead, they create inefficiencies and impose large costs on the society. In other words, rent seeking practices redistribute resources from the taxpayers to the special interest group. Source: Investopedia, s.v. “Rent-seeking,” at http://www.investopedia.com/terms/r/rentseeking.asp (June 21 2008).

\(^7\) Collier, “Natural Resources, Development and Conflict.”
independence has thus far precluded the possibility of violent conflicts, which did occur elsewhere in the Central Asian neighborhood, including Tajikistan, Kyrgyzstan and Uzbekistan, and in oil producing economies.

States that follow the typical resource dependence path tend to create protectionist economic regimes, as the ruling elites are reluctant to allow for foreign competition in the “strategic” resource sectors. The rhetoric of resource nationalism, which talks of “national patrimony” instead of tradable commodities, and of “people’s ownership” (while enriching the national leadership and the top tiers of the bureaucracy) prevails.

The crucial connection between open economic regimes and democracy is often overlooked. Economic freedom, besides being a value in itself, “is also an indispensable means toward the achievement of political freedom.” All of these factors are vital for achieving the ultimate aim of a country’s development—the development of its human capital. Figure 11 on the following page maps 22 selected states according to their United Nation’s Human Development Index (HDI) value, which measures life expectancy, literacy, education, and the standard of living for countries worldwide, and the Heritage Foundation’s Index of Economic Freedom (IEF)—a complex measure of macroeconomic, financial, investment regime, and freedom from corruption.

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9 For the purpose of mapping and evaluating Kazakhstan’s development success, the benchmark countries include energy-rich states from Eurasia and other regions, including the recognized petro-states such as Iran, Venezuela, and Nigeria; non-energy based economies of the former Soviet Union that gained independence at the same time as Kazakhstan; emerging Asian economies, including the “Asian Tigers” Singapore and South Korea, which Kazakhstan views as a source for best practices in development; as well as oil-rich developed European countries, which faced similar challenges due to energy windfall revenues.

The chart demonstrates a positive correlation between economic freedom and human development, with Kazakhstan clearly following this trend. Kazakhstan has demonstrably outperformed most other CIS states, both in terms of economic freedom (except for Kyrgyzstan’s slight superiority), and in terms of human development (slightly yielding to Russia). The country has demonstrated that over the years it has adhered to a more open and sustainable set of policies in comparison to other developing oil-rich states. In marked contrast, the three recognized “petro states” (Iran, Nigeria, and Venezuela) rank low in economic freedom and in terms of human development (arguably, with the exception of Venezuela).

Remarkably, Kazakhstan is following its own tailored development pattern that includes elements of both resource-driven and export-driven models. On the one hand, it relies on the commodities sector for a large share of the state budget revenues, while at the same time it has remained committed to responsible and
sustainable spending practices. On the other hand, Astana has pursued a set of policies, which boosted the performance of the emerging Asian economies some three decades ago.

Export driven development is another development model, which sparked the economic miracle in the resource-deficient Asian economies in the 1960s-1990s. The original group of “Asian Tigers,” including Hong Kong, Taiwan, Singapore and South Korea, to which Kazakhstan looks for best practices in economic development, focused on boosting the industries with high value added and export potential. In the early stages of their “economic miracle,” the governments created protectionist trade regimes to boost the nascent export-oriented industries and discourage domestic consumption of imported goods through a system of high import tariffs. Yet, protectionist barriers were lifted rather quickly, to expose the nascent industries to healthy competition. They also invested in high quality national educational systems in an effort to create an educated and productive workforce. Among the challenges faced by this group of countries was clear overexposure to external shocks due to the high level of their foreign currency holdings, and dependence on the economic health of their export-destination nations. The most recent example of such overexposure was the 1997-1998 financial crisis that negatively affected the “Asian Tigers.” In addition, these countries faced the challenge of re-orienting their economies in the value-added and service sectors after other emerging Asian economies, from China to Thailand, Vietnam and Indonesia, took over as suppliers of cheap skilled labor.

Looking at Kazakhstan’s developmental model in this context, the state is already doing much to boost the value-added production sectors and to become a regional hub for financial services. Unlike a typical petro-state, Kazakhstan funds professional education for its youth abundantly, and welcomes Western best practices in management and business. Astana, however, maintains its right, as an emerging economy, to create a favorable environment and protect the raw materials processing and non-commodity sectors. At the same time, the values of economic integration and openness to foreign investment still prevail in Kazakhstan, perhaps with the exception of natural resources sectors. As it aspires to join the WTO, it will have to open up its economy.

To maintain its outstanding economic performance, Astana needs to stay committed to economic openness, transparency, and political accountability. Following the trend on Figure 11, it is Kazakhstan’s responsible economic policies that will be associated with higher indicators of human development, which in turn will boost the competitiveness of Kazakhstan’s economy.
Conclusions

Kazakhstan’s road to independence is a unique phenomenon in the heart of Eurasia, which combines elements of the East and the West, of the developing and industrialized world. It synthesizes its Turkic and nomadic past, tolerant Islam, multiculturalism, and the positive Soviet-era emphasis on education and modernization. Its independence is robust, as the country is the most successful in Central Asia and among the most successful in the CIS. As geopolitical challenges abound, it will remain crucial for Kazakhstan’s elites and its people not to allow their homeland to fall into the hands of nostalgic empire builders or aspiring hegemons.

During the years of independence, the leaders of Kazakhstan turned the oil rich country into “an outward-looking market economy that is the envy of its backward Central Asian neighbors.”

However, the challenges to Kazakhstan’s future are many. They include the rising geopolitical and economic appetites of Russian natural resources companies, both state and privately owned; and resurgent Russian nationalism especially among the political and military elites, which translates to specific foreign and security policies.

Religious extremism and terrorism, while currently under control in Kazakhstan, are still active in other Central Asian states, and especially in the Fergana Valley. As long as terrorism and insurgency continue in Afghanistan and Pakistan, Central Asia will not be completely safe.

The rise of China also remains a concern. While today China seems to be satisfied with the level of Kazakhstan’s energy and natural resources cooperation, in the future, its appetites are likely to increase as its economy surpasses that of the United States by 2030-2050.

In the economic area, the pitfalls of a natural resource driven development model are discussed above. The challenges for Kazakhstan’s leadership are to use natural resource revenue for the benefit of the state and the society in a transparent and equitable fashion; to diversify the economy; and to keep inflation under control.

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1 Gorst, “Politics: Preoccupied by a Need to Hold on to Power.”
Corruption and lack of transparency are the flip side of natural resources driven prosperity, as state bureaucrats wield tremendous power in approving mining licenses or recalling them; deciding on bidding tenders (or lack thereof) worth billions of dollars; and raising or decreasing tax rates on natural resources. While not unique to Kazakhstan, this remains an ongoing uphill struggle unless the state develops and implements appropriate anti-corruption policies, and even then it can only manage corruption, not eradicate it entirely.

Kazakhstan does not live in a vacuum. The reason President Nazarbayev insists on Central Asian integration is that in the 21st century the borders are porous. As the wellbeing of Kazakhstanis rises, poorer neighbors from near and far may come over to work—or worse. Fighting religious extremism and terrorism, crime (including organized crime), drug trafficking, weapons and people smuggling, energy transit and transportation management, environmental problems like the Aral Sea or Lake Balkhash, require wide-ranging regional cooperation. Kazakhstan is taking a welcome lead in this area.

Kazakhstan is much more than a source of oil and gas. It is a successful model of development for the entire Eurasian space, for the Muslim world, and for the countries with transitional economies. In particular, multi-ethnic, multidenominational societies should study and use as a model Kazakhstan’s harmonious interfaith relations and religious tolerance.

The West, and particularly the U.S., have played a major role in developing Kazakhstan’s energy potential, and still has much to offer in such essential areas as macroeconomic policy development, innovative education and management training, as well as transparency and anti-corruption programs. Astana is still struggling with the challenges involved in diversifying its natural resources-based economy and developing high tech, financial services and agriculture. The solutions for these challenges are inconceivable without Western involvement. American and European investment and assistance, side by side with that of East Asian partners, are vital to Kazakhstan’s attainment of successful outcomes.

American and European companies have been playing a leading role in the Kazakh oil industry since the 1990s, including developing the giant oil fields of Tengiz and Kashagan, where Chevron and Exxon respectively are major stakeholders. Chevron recently committed to a gigantic $900 million environmental clean-up project, positioning itself as an exemplary corporate citizen.

To conclude, Kazakhstan’s overall potential is immense. Its territory is four times that of France. It currently surpasses Kuwait in its oil production, and expects to export 3 million barrels of oil a day by 2015, more than Iran currently provides.
Kazakhstan also has some of the largest reserves of uranium on the planet, and is a major exporter of grain. Kazakhstan’s economic and political reform agenda is largely on track, despite setbacks caused by the spread of global financial instability.

As many in the West hope for a more robust political development of Kazakhstan, President Nazarbayev said in his 2008 annual address that “political parties, NGOs and other civil society institutions” should play a greater role “in developing an up-to-date political system in Kazakhstan” that combines “universally recognized principles of democratic development and values of our society.” In effect, the Kazakh leader reiterated that the country would implement those international practices that are compatible with boosting stability and modernization, while hedging against social unrest and chaos. The US foray into democratization in the Middle East and the less than stellar performance of the not-so-velvet revolution in neighboring Kyrgyzstan make Kazakhstan’s choice of stability understandable.

Geopolitically, Kazakhstan has managed to successfully balance between the North and South, the East and the West. From the leadership’s perspective, currently there is no reason to change this proven course, and the people of Kazakhstan by and large support it.

The United States and the European Union should recognize the geopolitical asset they have in Kazakhstan. They should strengthen their relations with it by offering incentives to keep its thriving economy open to foreign investment; to continue market liberalization; to fulfill promises of internal liberalization undertaken in relation and to OSCE chairmanship; and to remain a secular, progressive country friendly to the West.

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2 Embassy of Kazakhstan to the USA and Canada, “President Nazarbayev Delivers Annual State of the Nation Address, Announces Kazakhstan’s ‘Road to Europe’.”
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