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KAZAKHSTAN FINANCIAL MARKETS AND THE DEVELOPMENT OF SDR DENOMINATED FINANCIAL PRODUCTS

by Dominique de Rambures

January 2019

CENTRO STUDI SUL FEDERALISMO

Robert Triffin International

A watch on the international financial and monetary system

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Kazakhstan Financial Markets and the Development of SDR Denominated Financial Products

Dominique de Rambures *

Kazakhstan is located at the crossroads of Russia, China and India spheres of influence. Although Kazakhstan is a secular state, the population is mainly Sunni Muslim (70%) but includes many ethnic minorities, such as Russians (23%). As a result, Kazakhstan is a full member of several international organizations: Commonwealth of Independent States (Russia); Shanghai Cooperation Organization (Russia and China); Organization of Islamic Cooperation. Although it is not a member, Kazakhstan is an active participant of ASEAN. However, since independence in 1991, Kazakhstan managed to lower its dependency on the Russian market in order to diversify its trade relationships, particularly with China.

Before the 2008 financial crisis, the Kazakhstan economy experienced a very strong growth rate, around 10% a year. Since then the growth rate, as a result of the worldwide recession, has slumped (1% in 2016), but has been slowly recovering (3% in 2017). Based upon hydrocarbons and mining, the Kazakh economy is highly dependent upon world growth, which requires a new economic model and a new growth engine.

The Kazakh economy is mainly based upon oil that until recently accounted for up to 56%of export value and 55% of State income (down to 35% in 2017). Kazakhstan owns three-quarters of the oil reserves in the Caspian Sea, most of them in deep water, requiring sophisticated drilling techniques, meaning that the extraction is relatively new and the potential high. Now the fifteenth world oil producer, Kazakhstan is expecting to enter the top five within the next decade. Kachagan oil field is the world largest discovery in the last 30 years (36bn barrel reserves), the world's largest industrial project ($150bn), with an estimated daily production of 1.5m barrels. The consortium has brought together the world's largest oil companies (ENI, Shell, Exxon, Total, Conoco Philips, Impex, and the Kazakh national company, KazMunayGas).

To cope with this situation, mineral resources provide a significant source of diversification: iron (8% of world reserves), chrome (1/3 of world reserves), uranium (33% of world production and 17% of world production), coal, potassium. Now Kazakhstan is focusing on service industries, such as the financial markets.

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1. Development of Kazakh financial markets

On top of the Almaty financial center, the economic capital of the country, the government is considering starting up a new financial center in Astana (AIFC or Astana International Financial Center), the new capital city (2008) located in the northern part of the country.

The creation of an international financial center is a long-term venture that requires the combination of several factors which reinforce each other to produce significant synergies: clearing systems covering all the markets (cash, foreign exchange, securities, derivatives), money markets, foreign exchange markets, credit markets to provide the necessary liquidity and the relevant expertise.

Historically all financial markets are built upon the trading of the supposedly safest financial instruments, i.e. the Government Debt (Treasury Bonds, Government Bonds, Municipal Bonds), a strong foundation upon which other financial markets are built: security markets (corporate bonds and equity), commodity markets and hedging instruments such as derivatives (futures, options). A financial market needs to gather the whole range of financial institutions: deposit banks, investment banks, fund management companies, brokerage firms, institutional investors, insurance companies, pension funds, index, audit firms, and, finally, a supervisory authority to ensure a steady flow of bid and offer in accordance with liquidity and security requirements.

Since the creation of the Almaty Stock Exchange (1993), the managing company, KASE (Kazakhstan Stock Exchange), has dramatically improved the trading infrastructures necessary to build up new markets, quote new securities and trade new contracts.

Foreign Exchange Market

The Kazakh foreign exchange market is very active, accounting for up to half of all the transactions processed by the Almaty Exchange and a very significant portion of the interbank market (50 to 83%). The foreign exchange market quotes the US dollar, euro, yuan, ruble, but the US$/KZT (tenge) contract amounts to95% of the whole market.

Security markets

Market infrastructures

Transactions are processed through a CSD (Central Security Depository) which manages the security accounts and handles the clearing operations, according to the DVP system (Deposit versus Payment): the two legs of the transaction (cash v. cash, cash v. security, security v. security) must be delivered before the transaction is finalized. KASE is planning to set up a new netting and settlement system guaranteeing security and counterparty risk management based upon margin calls and reserve funds with the CSD accounts.

Government Bonds

Debt instruments are made up of Municipal bonds, Treasury bonds and Government bonds issued by the Ministry of Finance, and notes issued by the Central Bank (National Bank of Kazakhstan). The number of negotiable government bonds amounts to 200 securities and a total outstanding volume of US$1,7bn.

Although half of government debt is denominated in foreign currency, the financial state of Kazakhstan is very sound: the country is net creditor vis-à-vis the foreign countries; the trade balance generates a significant surplus (US$9bn in 2017); the central bank's foreign exchange reserves amount to 8.6 months of imports; the foreign assets of the sovereign fund (Samrouk-Kazyma) accounts for 42% of the GDP. On the other side, over two-thirds of the exports (69%) are made up of hydrocarbons while imports are mostly made up of oil and mining equipment. However, thanks to the reforms undertaken by the Kazakh government, the country is meant to be one of the most favorable to foreign direct investments (FDI). In 2017 the total amount of FDI amounted to US147bn while the annual flow reached US$4.6bn. Government indebtedness is low (12.3% of the GDP), so that the volume of Government securities available on the market is relatively limited.

Corporate bonds

The market of corporate bonds is made up of 75 issuers mostly banks – both local and foreign – issuing 288 bonds with a total amount of US$42.5bn. As opposed to the government bond market, the banking and corporate sector is heavily indebted (100% of the GDP), a way to ensure a wide supply of a deep corporate bond market.

Equity

The equity market includes 80 shares of companies – both local and foreign – amounting to a total capitalization of US$42.5bn. Most of the listed companies are state companies, government owned, and public companies listed following the privatization program.

Repo market

The Kazakh repo market is very active as it accounts for half of the overall volume of transactions. The market trades direct transactions (market-to-market) with a 90-day limit according to a permanent up-dating of the market conditions, and automatic (anonymous) transactions with a 30 days limit, according to the order-driven system (market price set up on a case-by-case basis by both sides).

Derivatives

The Almaty Stock Exchange is trading two future contracts, a foreign exchange contract (USD/KZT) and a contract based upon the Stock Exchange index.

2. SDR denominated financial instruments

With its infrastructures and products, the Kazakhstan Stock Exchange could take a number of initiatives in order to attract investors, notably foreign ones:

- quotation and settlement currency

The Denge being unused beyond the Kazakh borders, the US dollar is the most obvious choice to quote securities tradable by foreign investors. However, the use of SDR listing might be a suitable alternative aiming at narrowing the foreign exchange fluctuations, provided that US$/SDR and KZT/SDR markets are operational and SDR investment products are available.

- SDR interbank clearing system

The development of an interbank SDR deposit market needs the support of an efficient interbank clearing system combining both security and liquidity. The clearing system should gather the most active banks in this market. On the other hand, the member banks of the SDR clearing system will enjoy the benefit from acting as both clearer and market maker. The clearing center should be in a financial center combining the expertise and banking community, out of reach of legal, foreign interference.

- SDR denominated financial instruments

To start the market, it would be useful to place Eurobonds issues denominated in SDR. Originally the SDR bonds may be settled in US$ with an updated exchange rate pending the development of an SDR deposit market. SDR Eurobonds may be of interest to both investors and borrowers as a hedging instrument; alternative investors may use it to diversify their portfolio, while borrowers may use it to better manage their borrowing costs and foreign exchange exposure.

- SDR invoicing of oil export

By mutual agreement between sellers and buyers, it may be possible to start the SDR invoicing of oil export, to lower the foreign exchange risk and to escape from foreign sanctions and legal interferences. A growing number of invoices denominated in SDR would soon build up a wide and sound basis of SDR deposits and the development of an interbank market.

- SDR oil future contract

When the volume of SDR oil invoicing and payment is large enough, then it might be timely to issue an SDR oil future contract.

- privatization of government owned companies

In order to widen the number of companies listed on the Stock Exchange, it may be useful to privatize – wholly or partially – the state companies, focusing on the most promising industries, such as oil and oil related companies, mining. On the demand side, the Kazakh sovereign fund Samrouk-Kazyma must be an active market maker to stabilize the market andback up the stock prices in case of need, acting as an investor of last recourse. If the SDR market is developing, it may be envisaged to issue SDR denominated company shares starting with state companies and banks.

- Astana-Almaty Exchange Connect

Still underdeveloped, the Almaty Stock Exchange may be adversely affected by a competing financial center based in Astana. In order to cope with this potentially self-destructive situation, a link may be established between the two centers – like the Shanghai-Hong-Kong-Shenzhen Connect - so that investors may deal in both Exchanges as though they were one single market, thus avoiding transaction costs.

Conclusion

The creation and development of a Stock Exchange is a long-term venture that requires vision, continuity and innovation. The development of SDR markets, starting with SDR Eurobond issues, is a way to diversify the range of financial products, initiate a worldwide SDR market and attract international investors.

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