

## Government Strategic Support for Investment Activity

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### ABSTRACT

When system risks are high most investors choose to exit the market; however, there are some contrarian investors who opt to make investments. The authors analyzed the main goals of the investment process and measures that should be provided by the government to stimulate investments and innovation especially by means of investment banking. The authors gave key recommendations as regards investment regulation and support for banking as a key sector that can provide assets. The purpose of this study was to analyze the main functions, methods and directions of state regulation of the investment process, particularly in investment banking as a key resource area, which ensures resumption of economic growth and to provide recommendations related to the government support for innovation in Kazakhstan.

### KEYWORDS

Government support, investment process, investment banking, economic growth

### ARTICLE HISTORY

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## Introduction

Today, one of the key policy areas of the Republic of Kazakhstan policy includes attraction of foreign investment and technology within the framework of industrial and innovative projects, promotion of Kazakhstan's exports to foreign markets.

According to studies related to investment attractiveness of Kazakhstan (Total respondents: 211, 78 of which present active investors, 133 – potential investors), the proportion of respondents who noted the following attractive factors is as follows: macroeconomic stability - 81.2%; telecommunications infrastructure - 72.8%; corporate taxation - 56.8%; entrepreneurial culture 35,4% (Ernst & Yong, 2014). The Kazakh government is taking measures to improve the domestic investment climate, aimed at the qualitative improvement of life conditions and business in the country (International Investment Forum "Ontustik Invest - 2016"). Kazakhstan developed the required legal framework for large-scale activities with a view to attract investment. It is worth noting

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that in the ranking of Doing Business (2016) Kazakhstan ranked No.41 among 189 countries, being ahead of Belgium, Italy, Turkey and Luxembourg, which is the best indicator for the country over the entire period.

As part of further implementation of the Nation's Plan "100 concrete steps" aimed at implementation of five institutional reforms, based on OECD standards, Kazakhstan scheduled deep reform of the entire state system, with a special emphasis on creating better conditions for investment activity in the country. The priority sectors of Kazakhstan's economy in terms of investment attractiveness include non-oil and gas export-oriented and high-tech industries, infrastructure development, and the development of alternative and "green" energy technologies (OECD, 2009, 2011).

Investment resources concentrate mainly in large metropolitan areas and regions rich in natural resources. Other regions and the larger part of the country do not have the possibility to use the investment potential. Therefore, solution of problems related to regional economic growth in the long term requires a comprehensive approach to investment activity. Problems related to attraction and development of investment strategies is of paramount importance.

Moreover, a key task of economic policy in the new environment of low prices for the main export commodities is to strengthen the role of market mechanisms and the private sector in the economy, along with transition from a factor-based economy to the investment-based economy providing competition (Government meeting, 2015)).

### **Background Paper**

According to neo-classical investment model, investment should be a function of the expected future interest rates, prices and taxes (Clark, 1979). Moreover, the increase in government stake, especially provided its debt financing, causes withdrawal of private investment. P.H. Mo (2008) finds that larger government stake reduces productivity growth and, in turn, decreases private investment, which further reduces economic growth. A. Cooray (2008) states that increase in the government stake can impede growth due to the negative impact of taxes on incentives, increased rent seeking and withdrawal of private investment.

Foreign direct investments were the main subject of many researchers. Macroeconomic stability (growth, inflation, exchange rate) and transparency of legal regulations play the main role in attracting foreign investments (Lucas, 1993; Lankes & Venables, 1996; Jun & Singh, 1996; Meyer, 1998; Holland & Pain, 1998; Alan & Estrin, 2000; Resmini, 2000; Demekas et al., 2007; Shahbaz, Nasreen & Afza, 2011).

As regards FDI, P. Paziienza (2014, 2015) outlined three main discussion points: 1) environmental effects of foreign direct investments flows; 2) competition of foreign direct investments and its impact on environmental standards; 3) cross-border environmental performance

In terms of investment policy disclosure, A. Dixon & A. Monk (2012) argued that foreign investors might face difficulties in explaining performance results and investment strategies to their constituencies, particularly when the constituencies viewed fund performance with a short-term orientation. Actually,

they emphasize the fact that although investment policy disclosure had benefits it could increase risk level.

W.K. Wang (2005) studying government investment in real estate elaborated a decision support system that converted numerical data into the information that could be used to evaluate possible real estate investments. He used the Chinese case to obtain strategies aimed at the improvement of real estate investment.

M. Firth et. al. (2012) investigated the relationship between the internally generated cash flows and fixed asset investments of Chinese firms and found that it was U-shaped. The authors found that government-controlled listed firms had greater investment – cash flow sensitivities carried out by the privately controlled listed companies, especially on the left-hand side of the U-shaped curve where cash flow was negative. The difference in sensitivities appeared only among firms that possessed few profitable investment opportunities. They attributed this finding to the government having multiple socio-economic objectives, which lead to increased capital expenditures by the controlled firms when internal funds were abundant and when internal funds were negative. There was no evidence that financial and soft budget constraints explained the differences between the investment – cash flow sensitivities of government-controlled and privately controlled listed firms.

N.P. Uttama (2014) presented a preliminary result of the first phase of a research project that explored the emergence of domestic and foreign investment in the Northern border area of Thailand. He examined the structure of investment promotion policies in this potential border area and found that economic and investment promotion policies should have been initiated from the onset of the border area context in order to trigger actual border circumstances. In addition, he noticed that comprehensive and integrated economic promotion policies with regional and national policies could be provided in the best available manner.

G. Sarafopoulos & P.G. Ioanidis (2014) investigating local governments and investment strategies examined the strategies of cooperation and conflict adopted by two dominant local agents aimed at maximizing their payoffs. They were based on the game theory and concluded that local government had significant power in the field of local entrepreneurship while local firms were interested in new investment in the region.

I. Ropke (2016) studied the development of ecological macroeconomics. He considered investments in sustainability provision systems and demonstrated complexities of implementing such transformations during the economic crisis.

### ***Research purpose***

The purpose of this study was to analyze the main functions, methods and directions of state regulation of the investment process, particularly in investment banking as a key resource area, which ensures resumption of economic growth and to provide recommendations related to the government support for innovation in Kazakhstan.

### **Research questions**

The overarching research question of this study was to analyze and to provide recommendations regarding government support for innovation in Kazakhstan.

### **Methods**

This study was based on various approaches and methods. The obtained information was generalized, analyzed and scientifically integrated. The authors used analysis and synthesis. Research analysis gave the possibility to consider the main problems of government support for investment process and to provide relevant recommendations.

### **Data, Analysis, and Results**

In order to ensure the conditions for competitiveness of Kazakhstan's investment climate, legislation in the field of investment activities was harmonized with the standards of the Organization for Economic Cooperation and Development (OECD). Currently, Kazakhstan is concluding agreements with foreign states on promotion and mutual protection of investments and avoidance of double taxation.

Public-private partnerships, being widely used in the world, became one of the possible and effective mechanisms used to attract private investment in the implementation of socially important projects, and a tool used to reduce state budget costs.

Kazakhstan's GDP growth in 2015 made 1.2% inflation - 13.6%, in 2014 - 4.3% inflation - 7.4%, respectively (Government meeting, 2015)).

Analysts believe that the growth of Kazakhstan's economy in 2016 will amount to 0,9-2% with an inflation rate of 10-14% (Interfax-Kazakhstan Information Agency, 2016). In 2016, ING Bank projected GDP growth in Kazakhstan at a rate of 1.9%, analysts of the European Bank for Reconstruction and Development predicted growth at a rate of 1.5%. (Business Information Centre "Capital", 2016); the World Bank estimated growth at a rate of 1.1% in 2016 and the inflation rate may reach 8% (National Bank of Kazakhstan, 2016).

One of the key reasons for the economic downturn is fear of investors against the background of the Russian-Ukrainian crisis: oil price downturn and the devaluation of the ruble contributed to the influx of cheap imports from Russia, which in turn put pressure on the domestic industry and led to a reduction in exports. Among the inflationary risks, one could note a significant share of imports in consumption during the transition to inflation targeting regime. However, transition to a flexible exchange rate regime, accession to WTO, implementation of structural reforms, fiscal stimuli can provide support for investment. It should be noted that transition to a free-floating exchange rate reduced the risks of financial stability and reserves for 2015 declined by only 0.8 billion USD, which makes 3% (Figure 1).

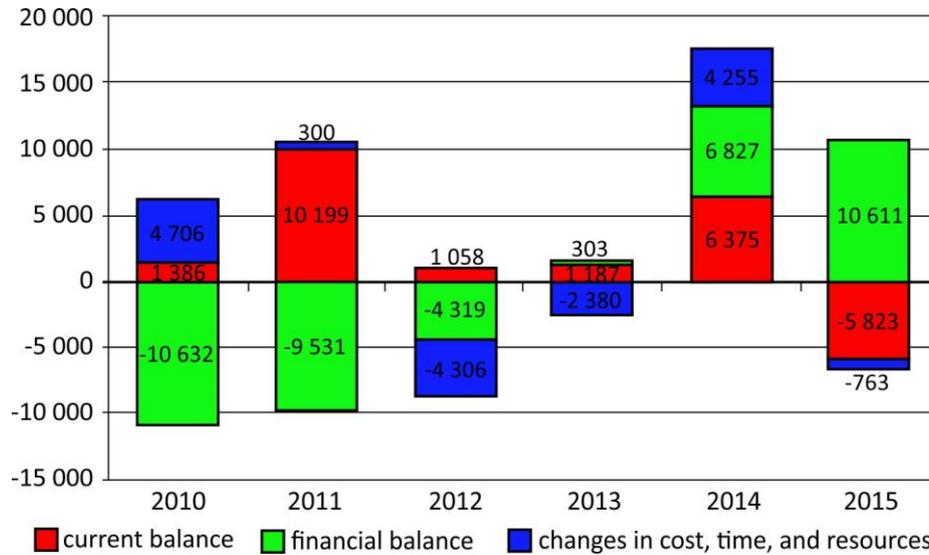


Figure 1. Payment balance of the Republic of Kazakhstan

GDP growth slowdown can also be explained by the decline in oil production up to 80.8 million tons, keeping in mind the planned amount of 81.8 million tons (by 1.2%); coal and lignite production - by 1.9%, non-ferrous metals - by 5.7%; slowdown in household demand; slowdown in external demand, which resulted in the reduction of exports by 6.2%.

At the same time against the backdrop of worse external conditions, the country's economic growth is provided by maintaining domestic demand and investment activity, by increase in agriculture, construction industry and in a number of other industries.

Domestic demand growth is provided through high growth in the services sector, the largest increase is currently observed in trade (8.1%), communications (8.5%), transport and storage (7.2%).

Dynamics of investment in fixed assets in 2014 was characterized by a slight increase. The growth amounted to 4.2% against 6.9% in 2013. The main reason is decline in investment in the manufacturing industry, which also determines slowdown in output growth as regards processing industries. Investment activity is mainly provided by the companies' own funds, their general share made 56.8%.

One should note significant increase in housing investment. The volume of investments increased by 18.0% compared with 2013 and amounted to 613.5 billion tenge. The total area of commissioned residential buildings made 7,516,500 square meters, which is 9.8% higher than during the same period of 2013. Due to the growth of investment in construction, the volume of assembly works increased by 11.4% and amounted to 3.3785 trillion tenge.

In January-June 2015, investment in fixed assets amounted to 2.6875 trillion tenge, which was 4.4% higher than during the relevant period in 2014 (Government meeting, 2015).

Economic slowdown in conjunction with deferred investments and expansion of businesses on the one hand, and the small amount of available

capital and lack of funding in tenge on the other, would restrict business growth of the Kazakh banks in 2016.

Experts expect asset quality reduction in the Kazakh banking sector, with an increase in the share of problem loans (overdue by more than 90 days) from 8.3% to 11-13% by the end of 2016 (National Bank of Kazakhstan, 2016). Funding costs will increase from 2.1% in 2015 to 3.0-3.5% of the loan portfolio in 2016. The increase in reserve costs, along with low profits amid adverse economic conditions could lead to a decrease in the capacity of the Kazakh banks to generate capital from domestic sources and will increase the need for further equity injections from shareholders. However, one should note limited willingness and ability of shareholders to increase the capital of banks.

According to analysts, in 2016 the pressure on funding and liquidity indicators of the Kazakh banking system will continue.

The corporate sector might focus on lending under government support programs, which implies less risk compared to traditional costs in the corporate segment, as the debt burden for borrowers is significantly lower due to low interest rates, subsidized by the state.

Demand for corporate loans will be provided by small and medium enterprises in a number of sectors, such as trade, infrastructure construction, agriculture and consumer goods. This is determined by the fact that large companies with significant cash reserves, especially those working in primary industries, can attract investment in the world financial markets; therefore they have limited need for financing on the part of the Kazakh banks.

GDP growth slowdown and devaluation of tenge will inevitably lead to a certain decline in borrowers' status. Historically high concentration on individual sectors and borrowers is another factor leading to the increase in credit risk in the banking sector of Kazakhstan. Analysts expect growth in the share of problem loans from 8.3% as of March 1, 2016 to 11-13% by the end of the year.

It should be noted that rapid growth of the loan portfolio, which is not accompanied by the relevant increase in the quality of underwriting and risk management systems, can cause accumulation of hidden risks.

According to the original scenario, loan losses in the Kazakh banking system that decreased to 2.1% in 2015, may increase in 2016 by approximately 3.0-3.5%. This figure will exceed losses on loans in 2010-2015 because in previous periods, Kazakh banks recognized problem loans behind time. The authors of this study believe that credit losses in Kazakhstan will be somewhat lower than the projected figures for the banking systems of Russia and Azerbaijan, but higher than in other comparable countries.

Limited support from shareholders and low earnings have a negative impact on capitalization of the country's banks. According to analysts, weak ability of the Kazakh banks to generate profits may further decrease due to the negative influence of two factors: net interest margin may continue to decline because of strong competition for the opportunity to provide services to creditworthy borrowers; increase in provisioning costs caused by asset quality deterioration will have a negative impact on the profit performance of banks, especially fast-growing, due to credit payment period against the backdrop of a slowdown in credit growth.

Weak ability of banks to generate capital from domestic sources, limited number of other sources of capital, along with reduction in capitalization due to KZT devaluation will determine the need for support from shareholders with a view to absorb potential growth of problem assets and provisioning costs.

Deposits remain the main source of funding for the Kazakh banks; at the same time, volatility of retail deposits is maintained due to the reduced depositors' confidence in the Kazakh economy and in the national currency. Smaller banks are especially susceptible to risks associated with the withdrawal of deposits or with any possible outflow of deposits caused by panic in the market.

### **Discussion and Conclusion**

Kazakhstan performs modernization of its economic and monetary policy in order to diversify the economy and to improve people's welfare. The Kazakh Government intends to develop export-oriented industries with high added value, with a focus on neighboring markets. Kazakhstan increases investment in infrastructure (Government report, 2016).

The state industrial diversification strategy is focused on the development of four industrial and economic clusters: complex energy-economic cluster; metallurgical and machine-building cluster; agri-food cluster; integrated chemical-economic cluster in South Kazakhstan (Kalimbetov, 2013).

The Prime Minister of Kazakhstan believes that the only way for Kazakhstan to tackle all the challenges currently faced by the global economy and Kazakhstan is to continue economic reforms. Modernization of the economic and monetary policy of Kazakhstan is carried out in parallel to active discussions within the country. In particular, the issue of a possible consolidation of expenditures and accounts between different levels of government is very relevant. Modernization should lead to effective fight against corruption as well as to the possibility of joining the program aiming at preventing and countering base erosion and profit shifting and greater use of the national currency. Ultimately, modernization should lead to diversification of the economy and increase in welfare of the Kazakh people (Government report, 2016).

Kazakhstan's accession to the WTO should become a clear signal to the international community regarding Kazakhstan's commitment to be a stable and predictable partner with the most favorable investment and business climate in the region.

Minister for Investment and Development noted that for the previous 5 years Kazakhstan invested more than US \$ 5 billion in infrastructure. Over the next 3 years, Kazakhstan plans to invest over \$ 10 billion. In 2016, 120 new enterprises will create 14,000 permanent jobs. Thus, 25 projects are being implemented in special economic zones, 30 projects are implemented with participation of foreign investors (Government report, 2016).

### **Implications and Recommendations**

Effective recovery of the Kazakh banking system remains an urgent problem along with the establishment of investment banking. In the context of transition to inflation targeting and KZT devaluation, several problems in the banking system become very relevant. In particular, these include low level of

bank liquidity; recapitalization on a number of banks; decline in demand for foreign currency loans; higher interest rates and shorter loan terms; the lack of funding of innovation and investment projects; banks are not active players in the global capital markets, and do not participate in international projects; almost all banks have a very low return on assets; most banks face the problem of corporate governance.

Bank investments are mainly presented by financial investments and capital investments in intangible assets. At that, most banks do not provide sufficient investment in the real sector of the economy, due to their unwillingness to provide significant and long-term loans, particularly in foreign currency, instability of enterprises, and high risk.

In order to overcome these problems, the policy of the Central Bank should be aimed at:

1. Support for the banking market development, including investment services, convergence of financial and real sectors of the economy, promotion of free flow of financial resources available to entrepreneurs, and for the banks - expansion of income sources;
2. Study of investment services using the experience of individual banks and non-bank financial companies;
3. Creation of conditions for the development of investment management, which is a powerful tool for attracting resources. Features of this tool can be compared not only with brokerage; they can revive the demand for other financial services;
4. Fostering and promotion of public support for the creation of investment banks and investment banking institutions;
5. Unification of investment banks in a consortium with the participation of foreign banks, recognized as professionals in the field of investment business in the international financial market.

State support is required not only to promote the development of specialized financial institutions, but also to elaborate the effective strategy of innovative development through long-term investment loans. Moreover, Kazakhstan lacks democratic institutions aimed at the protection of national and foreign investors.

Important measures also include the introduction of guarantees related to the exchange rate difference on tenge deposits in case of changes in the exchange rate above the threshold, development of cashless payments and steps aimed at reducing the proportion of problem loans.

### Disclosure statement

No potential conflict of interest was reported by the authors.

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