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FALL 2019

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The *Journal* is published by KIMEP University, 4 Abai Prospekt, Almaty, Kazakhstan 050010.

For further information and submissions, please write to the *Journal* at cabj@kimep.kz or to the managing editor, Leon Taylor, at ltaylor@kimep.kz

We thank Gulbanu Kulzhagarova, Akmaral Imambayeva, and Nurlan Uzarbaev for efficient staff support. The title page of this journal is based on a Microsoft Word template.

Table of Contents (Volume 10, Issue 1)

The effect of financial literacy and internal migration on financial inclusion in Kazakhstan

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Abstract: *An increase in financial literacy can improve the welfare of the country. Kazakhstan has not been a subject of research in this topic. Having conducted an original survey (October 2016) throughout the country, I find that financial literacy is low. Therefore, financial participation of the population (that is, financial inclusion) is rather weak. Adapting two probit models, I estimate the effects of financial literacy and internal migration from rural to urban areas on financial inclusion. The results show that financial literacy increases the probability of financial inclusion, in particular of holding a deposit, a debit card, a credit card, or foreign currency. This paper also estimates the marginal effect on financial inclusion of the interaction between financial literacy and living in rural areas, and between financial literacy and migration from rural to urban areas. I find that living in a rural area significantly weakens financial participation. But being financially educated and living in a rural area does not change one's behavior in the financial market on average.* ***JEL codes****: C83, G20, R23.*

Keywords: *Financial literacy, financial inclusion, internal migration, financial products, Kazakhstan.*

1. Introduction

Financial literacy is "the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being" (PACFL, 2008).[1]

Nowadays, when financial products are easily available to a wide range of the population, financial knowledge is especially significant. Many people don't have enough skills to manage their finances effectively. Policymakers are concerned that the lack of financial literacy can affect households' ability to plan for their retirement as well as provide for their children.

Kazakhstan is a young but fast-developing country. Since 1991, it has experienced banking and currency crises, and beneficial policies such as a pension reform in 2013. As the Kazakhstani economy grows, the government should make sure that all consumers know of all tools to improve their economic and financial well-being.

Researchers in Kazakhstan are not yet paying attention to this problem. In this regard, this paper introduces an original study of financial literacy in the country, using an original dataset.

I analyze this question from two perspectives. First, I study the relation between financial literacy and financial inclusion among households. Financial inclusion is the access of individuals and businesses to useful and affordable financial products and services (World Bank, 2017). I

[1] President's Advisory Council on Financial Literacy.

estimate a probit model with financial inclusion as a dependent variable and include the interaction between financial literacy and living in rural areas; thus I check the extent to which a financially educated person living in a rural area uses financial products. Next, I evaluate the effect of internal migration on financial inclusion. I test the marginal effect of the interaction between financial literacy and migration from rural to urban areas on financial inclusion, to see if migration affects the decision of a financially literate person to participate in the market.

The paper is organized as follows: Section 2 provides an overview of previous related studies. Section 3 introduces the data set and methodology for my study. Section 4 explains in detail the empirical results. Section 5 concludes and gives brief suggestions for future studies.

2. Previous Studies

Due to the limited number of studies of my topic, I studied closely related papers in detail. The majority of studies on financial literacy focus on developed countries with advanced financial markets and investment instruments.

Lusardi and Mitchell (2011) survey financial literacy in Germany, the Netherlands, Sweden, Italy, Japan, New Zealand, the United States, and Russia. They conclude that financial literacy is low around the world, and they show age and sex differences in financial knowledge. They also argue that financial literacy influences retirement planning, not the other way around, and that financial education will be most effective if targeted to population subgroups.

Bucher-Koenen and Lusardi (2011) examine financial literacy and retirement planning in Germany. Using data from SAVE (a survey of German households), they find a positive correlation between financial literacy and retirement planning. This result is confirmed by studies of Russia (Klapper and Panos, 2011), Australia (Agnew, Bateman, & Thorpe, 2013), the US (Lusardi & Mitchell, 2011), Canada (Boisclair, Lusardi, & Michaud, 2014) and the Netherlands (Rooji, Lusardi, & Alessie, 2011).

Gustman, Steinmeier, and Tabataban (2010) study financial knowledge and financial literacy at the household level. Using data from the Health and Retirement Study, they examine the relation between cognitive ability (in particular numeric) and wealth, holding income constant. First, they show that the more valuable the pension, the more knowledgeable workers are about their pensions. Second, most measures of cognitive ability are not significant determinants of pension or Social Security knowledge. Third, they don't find evidence that wealth outside of pensions is influenced by knowledge of pensions.

Gibson, McKenzie and Zia (2012) provide the first experimental evidence on the impact of financial literacy training for migrants in New Zealand and Australia. They discuss high-cost remittance for migration corridors. They find that simple financial training led migrants to switch to cheaper remittance channels, but the frequency of remitting didn't change.

This set of questions has rarely been explored thoroughly in developing countries like Kazakhstan. Lee and Kuttyzholova (2016) analyzed financial literacy and retirement planning in Kazakhstan. They surveyed cities and villages across the country and received 830 answer sheets. They determine the level of financial literacy in Kazakhstan and compare it with that in previous studies. In addition, they try to find causality between financial literacy and retirement planning. To measure financial literacy, they used basic questions developed by Lusardi and Mitchell (2005). They find that females and people with low income are the most vulnerable groups in financial planning. Also Lee and Kuttyzholova show that financial literacy and retirement planning are jointly determined in Kazakhstan. The higher the level of financial literacy, the better an individual's retirement can be planned. However, they do not discuss the effect of migration on financial inclusion or financial literacy.

This paper will discuss financial literacy in Kazakhstan from several perspectives. First, it will study the relationship between participation in financial markets and an individual's financial knowledge. Then it will check how migration from rural to urban areas affects financial inclusion.

3. Data and Methodology

3.1 Data

I collected data for this study.[2] In collaboration with the National Analytical Center (NAC),[3] a national survey was conducted during October 2016. I designed the questions for this survey, which is in Appendix 8.1. As the socioeconomic variables were part of the original survey, they were provided by the NAC.

The survey was conducted with personal interviews at the respondent's home, using tablet computers which improved the quality of data. The survey covers all 14 regions of Kazakhstan as well as the cities of Almaty and Nur-Sultan (formerly Astana) — about 140 cities and towns. One to two respondents per family (depending on family size), aged 18 or older, are questioned. The sample is formed by the Kish (1965) method of random probabilistic stratified sampling, which allows researchers to obtain data at the country and regional levels. The statistical error does not exceed 2.1% for the country.

The questionnaire has two parts. The first includes general demographic questions (age, gender, education, marital status, and nationality), questions regarding migration and the residential area (rural or urban), and questions about the individual's financial inclusion. The second part consists of three questions to measure financial literacy (questions 24, 25, and 26 in Appendix 8.1). I followed the S&P Ratings Services Global Financial Literacy Survey and Lusardi and Mitchell's (2005) self-designed survey, since they are benchmarks in the literature and are used in many surveys around the world. These questions assess basic knowledge of fundamental concepts in financial decision-making: risk diversification, interest rate compounding, and inflation. I combined the two surveys and changed the currency from United States dollars to Kazakhstani tenge.

Figure 3.1 displays the distribution of the sample across the country. More than a fifth of the respondents are from Karaganda and South Kazakhstan—10.88% and 10.82%. This is not surprising, since these are the two most populated regions. The next largest areas in sample size are Almaty (7.81%) and Almaty region (7.38%). Only 135 people (4.07% of the sample) were questioned from Nur-Sultan.

[2] The reader can request the data via email.

[3] The National Analytical Center JSC was established in September 2007 at the initiative of the Government of the Republic of Kazakhstan and the National Bank. The NAC provides consultation services in such fields as public administration as well as strategic and economic development. In 2017 it was renamed the NAC Analytica Corporate Fund. www.nacanalytica.com

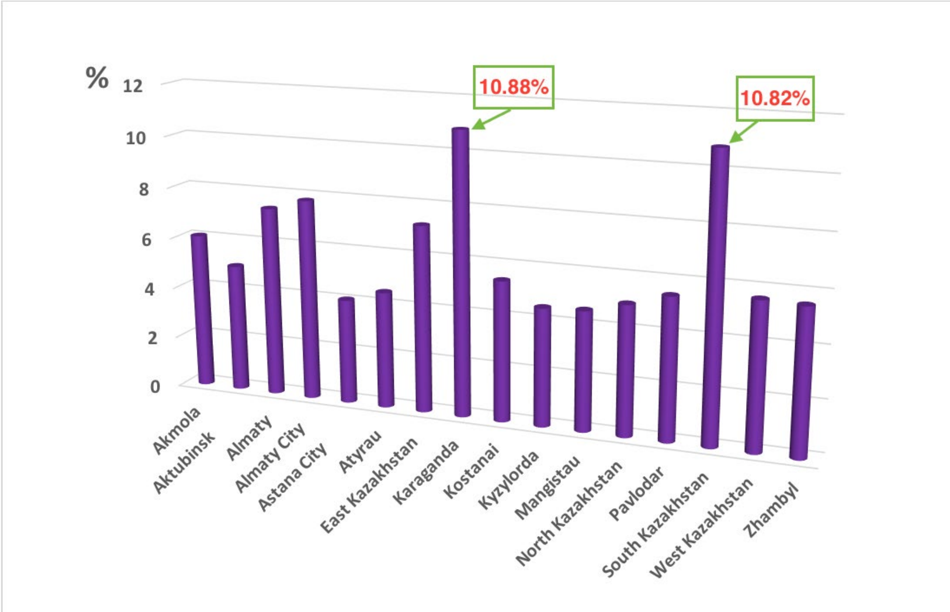


Figure 3.1: Regional distribution of the sample.

The survey includes a question about whether a respondent lives in a rural or urban area, to estimate the interaction with financial literacy. The data show that 59% of the sample lives in urban areas, and 41% in rural areas.

3.2 Financial Inclusion

Participation in financial markets is determined by holding and using financial products. In my case, they are a bank account, a deposit, a debit card, a credit card, stocks and trading stocks, foreign currency, and mutual funds.[4]

From the summary statistics in Table 2 of Appendix 8.3, one can easily see that the debit card is the most popular financial product in Kazakhstan, while mutual funds are not so well-known. Figures 3.2 and 3.3 summarize reasons that an average Kazakhstani does not use several financial products. Most respondents don't open deposits and bank accounts, because they don't have enough money or don’t need financial services. People don't use stocks and mutual funds, because they lack financial knowledge or can't afford them. Kazakhstanis will be better off if they make the most of financial educational programs.

[4] A bank account is a current account that doesn’t imply interest earnings—what in American English is called a “demand deposit account.” A deposit is a savings account.

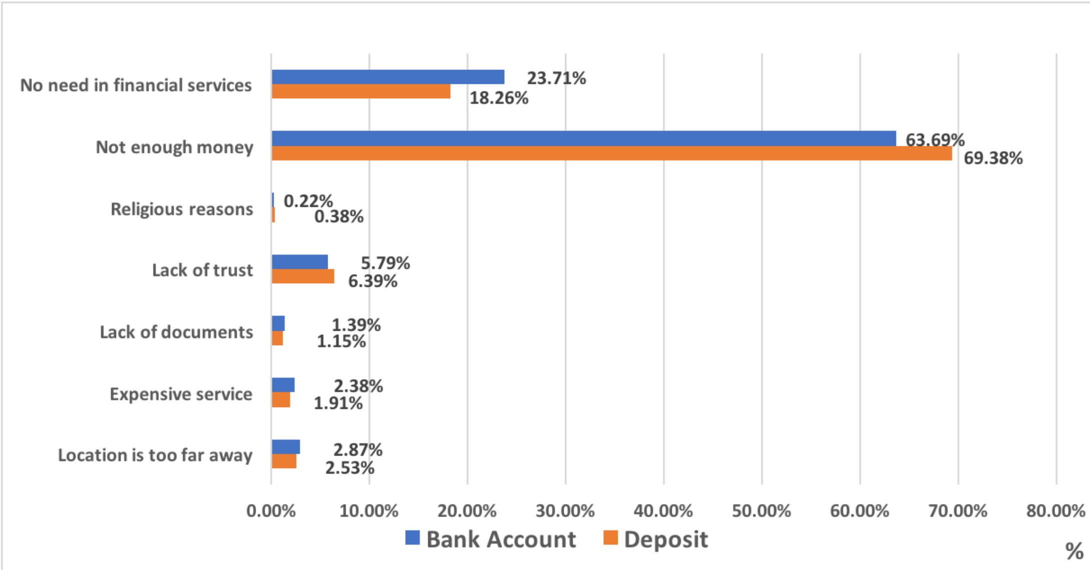


Figure 3.2: Reasons for financial exclusion (deposits and bank accounts).

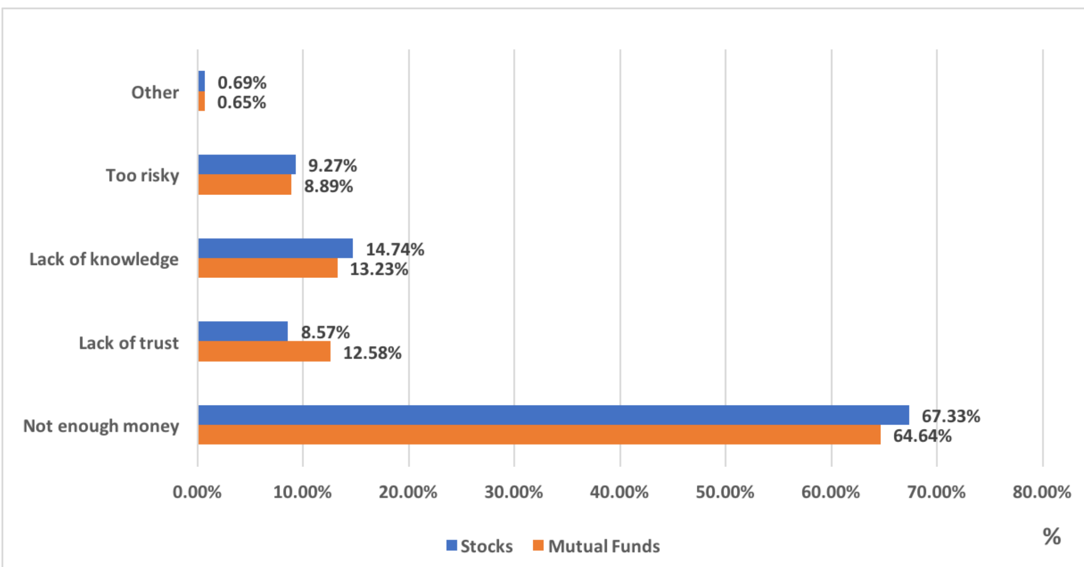


Figure 3.3: Reasons for financial exclusion (stocks and mutual funds).

3.3 Measuring Financial Literacy

Consumers who don't understand interest compounding face higher transaction costs and bigger debts (Lusardi & Tufano, 2015). Meanwhile, those who are financially well-informed are good at planning and saving for retirement (Behrman, Mitchell, Soo, & Bravo, 2010; Lusardi & Mitchell, 2014).

I measure financial literacy through the following three questions, which were combined from two surveys.

1. Suppose you have some money. Is it safer to put your money into one business or investment, or to put your money into multiple businesses or investments?
   a. One;
   b. Multiple;
   c. I don't know.

2. Suppose you need to borrow 100,000 KZT. Which is the lower amount to pay back?
   a. 105,000 KZT;
   b. 100,000 KZT + 3%;
   c. I don't know.

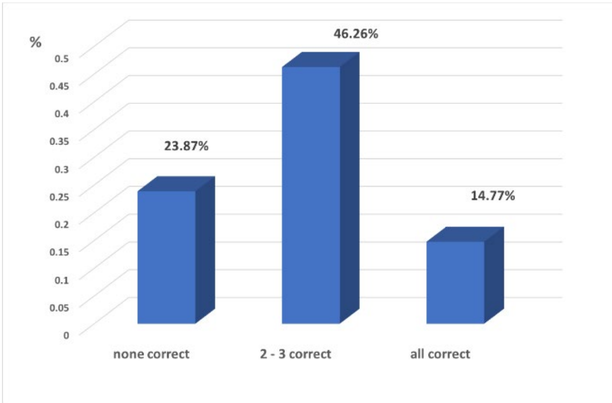
3. Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, how much would you be able to buy with the money in this account?
   a. More than today;
   b. Exactly the same;
   c. Less than today;
   d. I don't know.

The first and the second questions were taken from Standard & Poor's Rating Services' Global Financial Literacy Survey (Klapper, Lusardi, & Van Oudheusden, 2015), and the third question is from an experimental financial literacy module designed by Lusardi and Mitchell (2005) for the 2004 Health and Retirement Study. Their questions became a benchmark for a wide variety of researchers who study financial literacy around the world. The three questions test basic knowledge of risk diversification, interest compounding, and inflation in Kazakhstan.

Figure 3.4 displays the distribution of the answers to these questions by the respondents. An individual is considered as financially literate if he answers two of three questions correctly. Based on this definition, 46.26% of the adults are financially literate in Kazakhstan.

Knowledge of risk diversification and inflation rate is low in Kazakhstan. More than 56% of all respondents (1,865 and 1,861) gave wrong answers. This is consistent with the results of the S&P worldwide survey mentioned above. Interest compounding is better understood.

According to Figure 3.5, even those who use financial services in Kazakhstan don't fully understand the basic financial and numerical concepts. Less than 60% of the clients of financial services answered correctly two or three questions on financial literacy.



	Q1 correct	Q1 incorrect	Q2 correct	Q2 incorrect	Q3 correct	Q3 incorrect
Q1 correct	1453	-	-	-	-	-
Q1 incorrect	-	1865	-	-	-	-
Q2 correct	860	781	1641	-	-	-
Q2 incorrect	593	1084	-	1677	-	-
Q3 correct	743	714	912	545	1457	-
Q3 in correct	710	1151	729	1132	-	1861

Figure 3.4: Distribution of the answers to financial literacy questions.

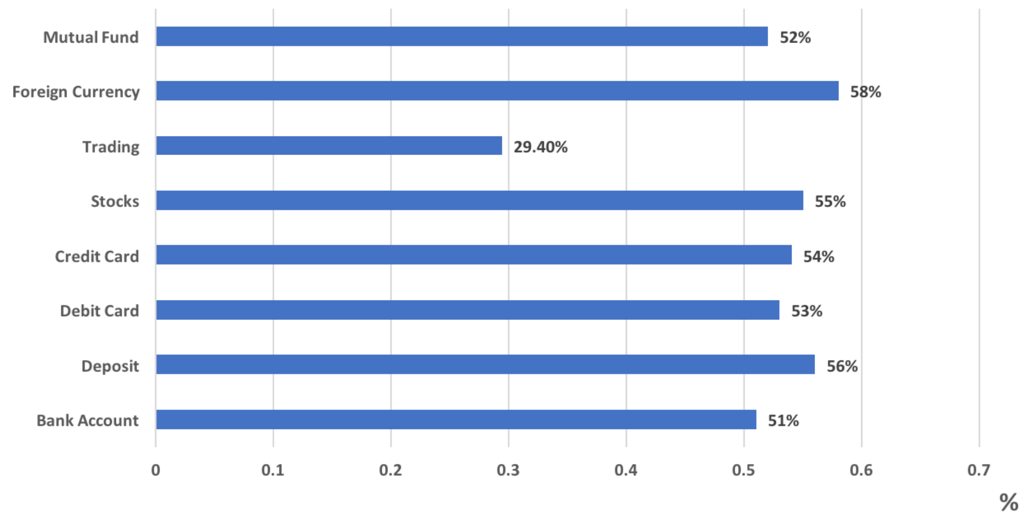


Figure 3.5: Financial literacy level of financial market participants.

3.4 Methodology

This paper studies the effects of financial literacy and internal migration on financial inclusion. Two questions are discussed separately with two econometric models.

First, I check how financial literacy might increase financial inclusion. For that I use a probit model based on this specification of the independent variables:

$$\alpha + \beta\, FL_i + \delta\, FLR_i + \theta\, X_i + \varepsilon \qquad (1)$$

where the dependent variable fininc_i is a dummy variable that indicates financial inclusion (1 if one holds a financial product, 0 if one does not). I have eight products, hence I run eight regressions.

I use a probit model, since my dependent variable can take one of only two values: 0 and 1. Probit applies a standard cumulative normal probability distribution to the dependent variable. It estimates the probability of financial inclusion for person *i* (that is, where the dependent variable fininc_i equals 1) as a nonlinear function of (1).

X_i is a vector of dummy variables for observed demographic characteristics (age, gender, education, nationality, marital status, and whether the living area is rural or urban).

FL_i is a dummy variable for financial literacy. I have created three dummies—FL_1, FL_2 and FL_3—in accordance with the three questions (FL_1=1 if a respondent answers correctly the first question, 0 if the answer is wrong; FL_2, for the second question; FL_3, for the third question).

FLR_i is an interactive term of financial literacy and living in a rural area (also a dummy variable). I include this term to check whether rural residence affects the response to financial literacy.

Regressions results of Model (1) are in Table 3 (Appendix 8.3).

Interaction effects were tested after the probit regressions. Interaction between financial literacy and living in rural areas was statistically significant, but other interactive effects were not.[5]

Next, I check how migration from rural to urban areas affects financial inclusion. From Table 1, 717 people have moved in the last 10 years. According to Figure 3.6, of these 717 migrants, over 35% moved from rural to urban areas. These people are expected to be unusually active in financial markets.

	Frequency	**Percentage**
Permanently residing here	1,577	47.53
More than 10 years	1,024	30.86
5 - 10 years	304	9.16
Less than 5 years	413	12.45
Total	3,318	100

Table 1. Living duration in this residential area.

[5] Graphs of interactive effects were produced using a new command in STATA, *inteff*, which computes the marginal effect of a change in two combined variables. This method was introduced and discussed by Norton, Wang, and Ai (2004). In nonlinear models like logit and probit, *inteff* gives the correct marginal effects and standard errors. The total number of graphs derived is 96 (one graph for each interactive effect for each product), including the second model. Graphs are available on request.

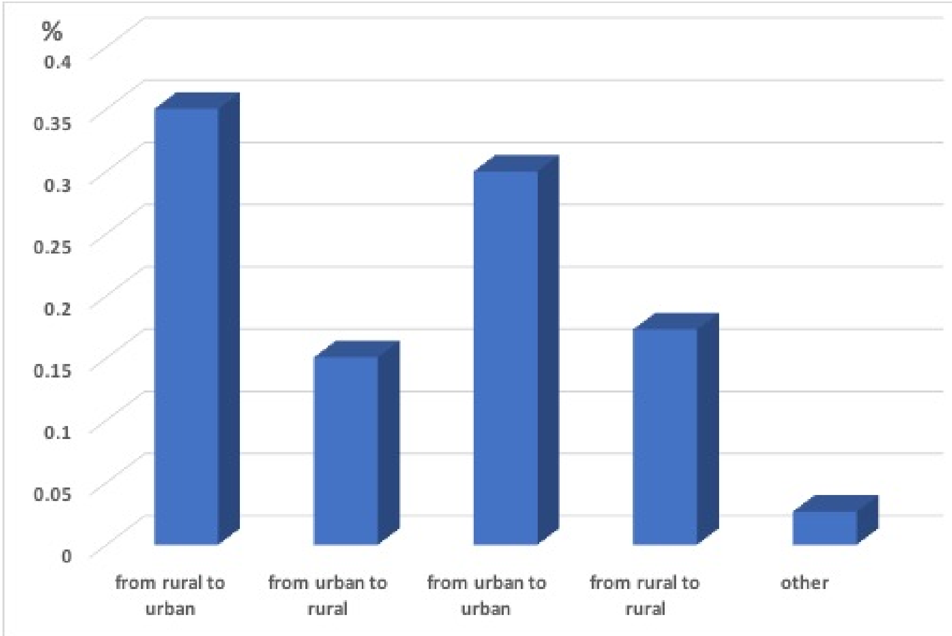


Figure 3.6: Migration in the last 10 years.

My second model includes a dummy variable for migration from rural to urban areas (M_i) and an interactive term for financial literacy and migration (FLM_i). The specification of the independent variables is now

$$\alpha + \beta\, FL_i + \gamma\, M_i + \delta\, FLM_i + \theta\, X_i + \varepsilon \qquad (2)$$

In this model, I reduce the sample to urban residents only. According to the data, 1,965 respondents (59% of all respondents) live in cities.

4. Empirical Evidence

Tables 3 and 4 present the regression results of Models 1 and 2. (See Appendix 8.3.)

Looking at Model 1, the variables of interest are $FinLit_1$, *Rural*, $FinLit_1$ * *Rural*, $FinLit_2$, $FinLit_3$, $FinLit_2$ * *Rural* and $FinLit_3$ * *Rural*. The reference age is over 57/62.

The results show that an individual with a good understanding of risk diversification is more likely to hold a deposit, a debit card, and foreign currency than other people. A basic knowledge of risks affects one's decision to hold foreign currency more than other financial products, perhaps because those who understand tenge devaluation diversify their risks by buying and keeping different foreign currencies. A positive effect of financial literacy on holding a deposit can be explained similarly.

Also, it's more common for Kazakhstanis to use debit cards than it was five to ten years ago. Perhaps they understand financial risk: it is more prudent to carry less cash.

Basic numerical skills significantly increase the probability of holding almost all popular financial products in Kazakhstan. The biggest positive impacts are on having mutual fund shares and debit cards. An average person with knowledge of interest compounding can easily calculate his return from saving money on deposits or investing in mutual funds, and gauge expenses from using a credit card, a debit card, and foreign currency.

The third question, which tests one's knowledge of inflation, turns out to be one of the most difficult to answer. Only 44% gave the correct response. Previous studies had similar results. Understanding inflation encourages one to use a debit card more often and to trade stocks less often.

Table 3 suggests that living in a rural area decreases the probability of financial inclusion. But this is not because a rural individual is less literate: interactive terms $FinLit_1$ * *Rural,* $FinLit_2$ * *Rural,* and $FinLit_3$ * *Rural* don't show significant effects on financial inclusion, except one on trading stocks. The decrease in financial inclusion may be explained by limited access to financial institutions for households in villages and suburbs. Usually, there are no banks or post offices in a rural area in Kazakhstan. However, we can observe the positive effect of $FinLit_2$ * *Rural* on trading. The intuition behind this result is that knowledge of interest compounding makes it more likely that rural residents will trade stocks. That is, $FinLit_2$ increases the response of trading to the *Rural* variable.

Even when one can diversify investment risks, living in a rural area still decreases the probability of trading, by more than four fifths and with statistical significance. At the same time, the interaction between basic skills of interest compounding and living in a rural area has a significantly positive effect on trading. Being able to calculate your return from different investments might increase your interest in trading stocks even if you don't live in a city.[6]

This model didn't show a statistically significant effect of financial literacy and living in a rural area on financial products other than on trading. This can imply that Kazakhstanis suffer from limited access to financial institutions while living in rural areas. Being financially well-informed cannot increase one's inclusion in financial markets if he is constrained by location.

Looking at the demographic characteristics, it can be concluded that women hold fewer stocks and less foreign currency than men. Kazakhs are likely to hold more debit cards and credit cards and less foreign currency than other nationalities on average. Individuals who are married or live with a partner use fewer credit cards and less foreign currency. This might be because married people want to carry less risk and to avoid unnecessary expenditures on a credit card or a currency devaluation, since they need to provide for their families.

From the regression results, I conclude that credit cards are popular for all ages, especially ages 25 to 45. But these people don't like to trade stocks.

College education significantly increases the probability of participation in financial markets. This is consistent with previous research. But from Table 3 we see that getting a college education decreases the probability of trading by almost half, perhaps because people who graduate from a college usually try to work in a full-time job related to their major. However, trading in Kazakhstan is becoming popular among those who can't find full-time work, very often due to the lack of higher education. They can make extra money while trading in the short run.

Now let's turn to probit model (3.2). My variables of interest here are $FinLit_1$, *Migration,* $FinLit_1$ * *Migration,* $FinLit_2$, $FinLit_3$, $FinLit_2$ * *Migration* and $FinLit_3$ * *Migration*. *Migration* indicates only the move from a rural to an urban area.

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[6] The interactive effect between knowledge of inflation and living in a village on trading was omitted in the results for Model (3.1). This is because only two people out of 1,457 who answered correctly the third question, actually trade stocks.

The effects of financial literacy on financial inclusion are consistent with Model (3.1). Financially educated individuals are more likely to hold basic financial products like bank accounts, deposits, debit cards, credit cards, and foreign currencies. Understanding risk diversification has a strong positive effect on trading. This is because people invest in stocks and actively trade them in order to mitigate their risks. However, respondents with knowledge of inflation are less likely to trade. They might prefer to spend their money rather than invest it for a long time.

A person who understands risk diversification and has numerical skills is more likely to hold foreign currency, perhaps because of big fluctuations in the tenge exchange rate since 2015. Knowledge of interest compounding increases the probability of holding a debit card.

From Model (1), I concluded that a rural individual's financial behavior is little affected by his understanding of financial concepts. To check if migration changes this situation, I introduced a new variable—migration from rural to urban areas.

Table 4 shows that such migration significantly decreases the probability of investing in stocks and mutual funds. Of 251 respondents who migrated to urban areas, only two bought stocks and only seven had shares in mutual funds. Initially many of them may not have been familiar with stocks and mutual funds.

Omission of results on trading is explained by the small number of respondents. Out of 47 respondents who were trading, only 33 lived in urban areas, and only two of them had migrated there.

In Model 2, I also test interaction effects. In this case, $FinLit_1$ * *Migration*, $FinLit_2$, $FinLit_3$, $FinLit_2$ * *Migration* and $FinLit_3$ * *Migration* don't show much significance.[7]

5. Conclusion

In a nationwide survey, I measure financial literacy by using three questions that test basic knowledge of risk diversification, interest compounding, and inflation. An individual is considered as financially literate if he answers two of three questions correctly. Based on this definition, 46% of adults of the surveyed group are financially literate. They know less about risk diversification than about interest compounding and inflation. This is consistent with the results of the S&P worldwide survey.

Consequences for financial literacy differ when it comes to gender, age, and education. A total of 48.6% of Kazakhstani men provide correct answers. Financial literacy increases with educational attainment: 46.26% of adults with a college education are financially literate, while only 42% of those with a secondary education answered correctly the given questions.

Overall, financial literacy is important for a user of financial markets in Kazakhstan. But financial literacy is not the only determinant of financial inclusion. As the survey shows, many people don't have enough money to buy stocks or to maintain saving accounts.

The area of residence can also affect financial inclusion. Rural residents use fewer financial products, even if they possess numerical skills and knowledge about risks and inflation, because they have limited access to financial institutions.

Migration does not determine financial behavior. On average, people don't consume more banking products when they move elsewhere. The main reasons for financial exclusion are a lack

[7] The graphs can be provided upon request.

of money and information. Policy makers should consider training the population in financial literacy.

This paper can be extended in several ways. First, one can estimate the effect of financial literacy on insurance and pension funds. Second, one can include expenses of food or electricity as an instrumental variable for income—taking care to avoid endogeneity, since those with higher income might use more financial services despite their illiteracy. Income may affect financial literacy as well. Third, new explanatory variables might include bank locations and access to the Internet.

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6. Summary

English: Based on an original nationwide survey, this study shows that financial literacy is low in Kazakhstan. Rural residents use fewer financial products because they have limited access to financial institutions. However, moving to urban areas doesn't significantly improve financial inclusion. Policy makers should consider training the population in financial literacy.

Russian: Основываясь на оригинальном общенациональном опросе, данное исследование показывает, что финансовая грамотность в Казахстане достаточно низкая. Сельские жители используют меньше финансовых продуктов, в связи с ограниченным доступом к финансовым учреждениям. Однако переезд в город не повышает финансовую вовлеченность. Политикам необходимо рассмотреть вопрос обучения населения финансовой грамотностью.

Kazakh: Жалпыұлттық сауалнамаға сүйене отырып, бұл зерттеу Қазақстанда қаржылық сауаттылықтың төмендігін көрсетеді. Ауыл тұрғындары аз қаржылық өнімдерді пайдаланады, өйткені олардың қаржы институттарына қол жетімділігі шектеулі. Алайда, қалаға көшу қаржылық кірісті айтарлықтай жақсартпайды. Саясат жасаушылар халықты қаржылық сауаттылыққа үйретуді қарастыруы керек.

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8. Appendix

8.1 Survey Questions

1. How long have you been living in this inhabited locality?
   a. Always.
   b. More than 10 years.
   c. 5-10 years.
   d. Less than 5 years.

2. In the past 10 years you (please choose your last move)
   a. Migrated from a village to a city.
   b. Migrated from a city to a village.
   c. Migrated from a city to a city.
   d. Migrated from a village to a village.
   e. Other.

3. Do you have a bank account?
   a. Yes.
   b. No.

4. If no, the reason is (please choose one).
    a. Too far away.
    b. Too expensive.
    c. Lack of documentation.
    d. Lack of trust.
    e. Religious reasons.
    f. Lack of money.
    g. No need for financial services.
    h. Other.

5. If you have an account, have you made any deposit/withdrawal into/from your account in the past six months?
    a. Yes.
    b. No.

6. If you have an account, have you made any payments using mobile phone or the Internet in the past six months?
    a. Yes.
    b. No.
7. Do you have a fixed deposit account?
    a. Yes.
    b. No.

8. If no, the reason is:
    a. Too far away.
    b. Too expensive.
    c. Lack of documentation.
    d. Lack of trust.
    e. Religious reasons.
    f. Lack of money.
    g. No need for financial services.
    h. Other.

9. If you have a deposit account, have you made any deposit/withdrawal into/from your account in the past six months?
    a. Yes.
    b. No.

10. If you have a deposit account, have you made any payments using mobile phone or the Internet in the past six months?
    a. Yes.
    b. No.

11. Do you have a debit card in your own name?
    a. Yes.
    b. No.

12. If yes, have you used it in the past six months?
    a. Yes.
    b. No.

13. Have you made any payments on your debit card using a mobile phone or the Internet in the past month?
    a. Yes.
    b. No.

14. Do you have a credit card in your own name?
    a. Yes.
    b. No.
15. If yes, have you used it in the past six months?
    a. Yes.
    b. No.

16. Have you made any payments through your credit card using a mobile phone or the Internet in the past month?
    a. Yes.
    b. No.

17. Do you hold dollars?
    a. Yes.
    b. No.

18. Do you buy stocks?
    a. Yes.
    b. No.

19. If no, the reason is
    a. Lack of money.
    b. Lack of trust.
    c. Lack of knowledge.
    d. Too risky.
    e. Other.

20. If yes, how often do you trade?
    a. Every month.
    b. Every six months.
    c. Every year.

21. Do you know what a mutual fund is?
    a. Yes.
    b. No.

22. Do you have shares in any mutual fund?
    a. Yes.
    b. No.

23. If no, the reason is
    a. Lack of money.
    b. Lack of trust.
    c. Lack of knowledge.
    d. Too risky.
    e. Other.

24. Suppose you have some money. Is it safer to put your money into one business or investment, or to put your money into multiple businesses or investments?
    a. One.
    b. Multiple.
    c. I don't know.

25. Suppose you need to borrow 100,000 KZT. Which is the lower amount to pay back?
    a. 105,000 KZT.
    b. 100,000 KZT + 3%.
    c. I don't know.

26. Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, how much would you be able to buy with the money in this account?
    a. More than today.
    b. Exactly the same.
    c. Less than today.
    d. I don't know.

8.2 Demographic Information

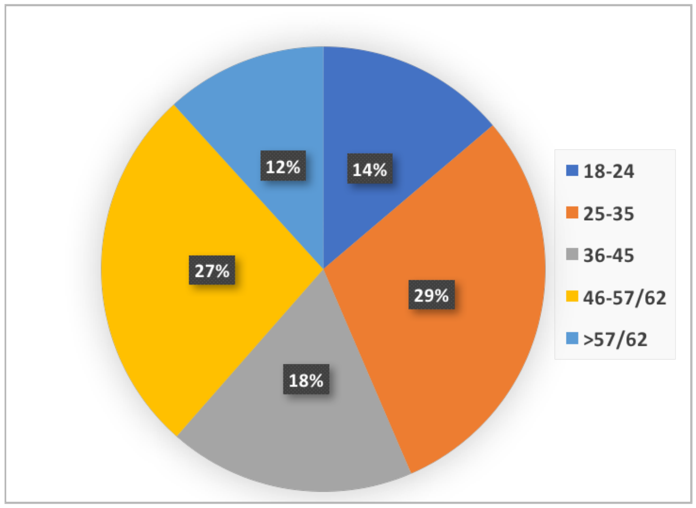

Figure 8.1: Sample male distribution.

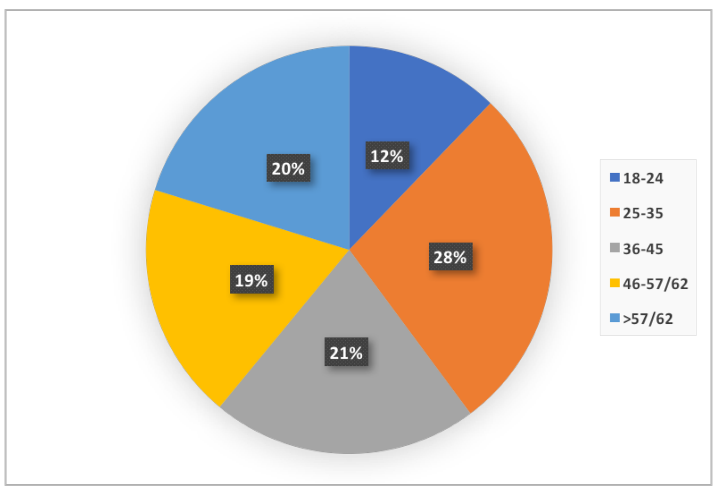

Figure 8.2: Sample female distribution.

8.3 Regression Results

Variable	Mean	Std. Dev.	Min.	Max.	N
Bank Account	0.328	0.469	0	1	3318
Deposit	0.132	0.339	0	1	3318
Debit Card	0.467	0.499	0	1	3318
Credit Card	0.158	0.365	0	1	3318
Stocks	0.015	0.121	0	1	3318
Trading	0.347	0.481	0	1	49
Foreign Currency	0.083	0.277	0	1	3318
Mutual Fund	0.02	0.141	0	1	3318
Fin Lit 1	0.438	0.496	0	1	3318
Fin Lit 2	0.495	0.5	0	1	3318
Fin Lit 3	0.439	0.496	0	1	3318
Rural	0.408	0.491	0	1	3318
Migration from rural to urban area	0.076	0.264	0	1	3318
College education	0.331	0.471	0	1	3318
Female	0.621	0.485	0	1	3318
Age 18-24	0.128	0.335	0	1	3318
Age 25-35	0.284	0.451	0	1	3318
Age 36-45	0.2	0.4	0	1	3318
Age 46-57/62	0.218	0.413	0	1	3318
Age 57/62	0.17	0.376	0	1	3318
Kazakh	0.673	0.469	0	1	3318
Married or w/partner	0.637	0.481	0	1	3318
Divorced or widow	0.192	0.394	0	1	3318

Table 2. Summary statistics.

	Bank Account	Deposit	Debit Card	Credit Card	Stocks	Trading	Foreign Currency	Mutual Fund
$FinLit_1$	0.073	0.156**	0.160***	0.027	0.134	0.579	0.204***	0.092
	(0.060)	(0.070	(0.059)	(0.069)	(0.148)	(0.495)	(0.078)	(0.143)
$FinLit_2$	0.138**	0.130*	0.272***	0.180**	0.056	0.224	0.160**	0.282*
	(0.062)	(0.072)	(0.061)	(0.072)	(0.152)	(0.614)	(0.078)	(0.158)
$FinLit_3$	0.051	0.071	0.179***	0.043	-0.058	- 2.317***	- 0.048	- 0.078
	(0.061)	(0.071)	(0.060)	(0.072)	(0.135)	(0.623)	(0.078)	(0.139)
Rural	- 0.155*	- 0.284***	- 0.039	- 0.053	- 0.084	- 1.748*	- 0.406***	0.259
	(0.080)	(0.109)	(0.077)	(0.097)	(0.204)	(1.052)	(0.132)	(0.183)
$FinLit_1$ * Rural	- 0.014	0.049	- 0.140	0.088	- 0.036	- 5.590***	- 0.036	- 0.039
	(0.097)	(0.125)	(0.093)	(0.112)	(0.251)	(1.311)	(0.148)	(0.209)
$FinLit_2$ * Rural	- 0.088	- 0.039	- 0.024	- 0.090	- 0.217	5.890***	- 0.123	- 0.266
	(0.097)	(0.125)	(0.093)	(0.113)	(0.255)	(0.868)	(0.148)	(0.216)
$FinLit_3$ * Rural	0.071	- 0.115	- 0.074	- 0.068	0.144	0.000	0.193	0.204
	(0.098)	(0.127)	(0.094)	(0.116)	(0.245)	(.)	(0.148)	(0.206)
College	0.372***	0.458***	0.330***	0.216***	0.322***	- 1.753***	0.374***	0.141
	(0.050)	(0.060)	(0.049)	(0.058)	(0.119)	(0.603)	(0.067)	(0.107)
Female	0.079	- 0.032	0.001	- 0.036	- 0.312***	0.716	- 0.128*	- 0.044
	(0.049)	(0.060)	(0.047)	(0.056)	(0.119)	(0.718)	(0.068)	(0.106)
Kazakh	0.074	- 0.053	0.108**	0.128**	0.158	0.823	- 0.135*	- 0.100
	(0.051)	(0.062)	(0.049)	(0.062)	(0.138)	(0.531)	(0.072)	(0.111)
Married or w/partner	0.114	0.004	- 0.043	- 0.154**	0.047	0.728	- 0.178*	0.210
	(0.071)	(0.088)	(0.069)	(0.078)	(0.208)	(0.814)	(0.094)	(0.183)
Divorced or widow	0.070	- 0.099	- 0.076	- 0.158	0.176	- 0.010	- 0.190	0.160
	(0.092)	(0.116)	(0.089)	(0.106)	(0.240)	(1.182)	(0.126)	(0.224)
Age (18-24)	0.130	- 0.153	- 0.067	0.335***	- 0.499	0.655	0.279*	- 0.358
	(0.101)	(0.126)	(0.097)	(0.129)	(0.313)	(1.278)	(0.150)	(0.273)
Age (25-35)	0.153*	- 0.018	- 0.055	0.641***	- 0.314*	1.009	0.321***	0.024
	(0.079)	(0.093)	(0.075)	(0.105)	(0.181)	(0.750)	(0.122)	(0.165)
Age (36-45)	0.114	- 0.032	0.023	0.559***	- 0.343*	1.184	0.373***	- 0.354*
	(0.080)	(0.097)	(0.077)	(0.107)	(0.189)	(0.775)	(0.123)	(0.191)
Age (46-57/62)	0.087	- 0.277***	- 0.066	0.393***	- 0.242	0.487	0.217*	0.025
	(0.078)	(0.099)	(0.075)	(0.106)	(0.179)	(0.974)	(0.124)	(0.157)
Constant	- 0.921***	- 1.205***	- 0.421***	- 1.563***	-2.076***	- 0.343	- 1.514***	- 2.356***
	(0.110)	(0.137)	(0.106)	(0.134)	(0.290)	(1.045)	(0.157)	(0.251)
N	3318	3318	3318	3318	3318	43	3318	3318

Standard errors in parentheses
* $p<0.1$, ** $p<0.05$, *** $p<0.01$

Table 3: Regression results of Model 1.

	Bank Account	Deposit	Debit Card	Credit Card	Stocks	Trading	Foreign Currency	Mutual Fund
$FinLit_1$	0.085 (0.064)	0.156*** (0.075)	0.133** (0.063)	0.013 (0.074)	0.081 (0.161)	21.121*** (2.311)	0.201** (0.083)	0.039 (0.156)
$FinLit_2$	0.138** (0.065)	0.126 (0.077)	0.276*** (0.064)	0.167** (0.077)	- 0.005 (0.163)	7.989 (.)	0.156* (0.085)	0.123 (0.165)
$FinLit_3$	0.017 (0.065)	0.057 (0.076)	0.152** (0.064)	0.052 (0.077)	- 0.059 (0.139)	- 30.609*** (2.180)	- 0.064 (0.083)	0.023 (0.142)
Migration	- 0.256 (0.163)	- 0.028 (0.196)	- 0.156 (0.155)	0.021 (0.182)	- 7.723*** (0.408)	0.000 (.)	- 0.019 (0.221)	- 3.552*** (0.333)
$FinLit_1$ * Migration	- 0.125 (0.194)	- 0.027 (0.212)	0.265 (0.185)	0.094 (0.208)	4.060*** (0.402)	0.000 (.)	0.020 (0.240)	0.253 (0.444)
$FinLit_2$ * Migration	- 0.018 (0.197)	0.096 (0.219)	- 0.063 (0.191)	0.137 (0.213)	4.161*** (0.488)	0.000 (.)	0.005 (0.238)	4.274** (0.322)
$FinLit_3$ * Migration	0.224 (0.202)	0.129 (0.226)	0.169 (0.196)	- 0.027 (0.222)	- 0.343 (0.660)	0.000 (.)	- 0.036 (0.234)	- 0.572 (0.434)
College	0.316*** (0.062)	0.427*** (0.072)	0.302*** (0.062)	0.219*** (0.073)	0.493*** (0.157)	- 32.790*** (3.324)	0.456*** (0.079)	0.214 (0.144)
Female	0.032 (0.062)	- 0.015 (0.073)	- 0.048 (0.061)	- 0.061 (0.072)	-0.475*** (0.151)	21.360*** (2.313)	- 0.133* (0.080)	- 0.037 (0.151)
Kazakh	- 0.050 (0.064)	- 0.104 (0.074)	0.036 (0.062)	0.071 (0.077)	0.099 (0.168)	29.653*** (3.142)	- 0.179** (0.084)	- 0.111 (0.153)
Married or w/partner	0.116 (0.089)	- 0.002 (0.105)	- 0.125 (0.088)	- 0.069 (0.099)	- 0.029 (0.275)	32.551*** (3.926)	- 0.217** (0.110)	0.328 (0.264)
Divorced or widow	0.108 (0.112)	- 0.159 (0.137)	- 0.185* (0.111)	- 0.067 (0.131)	0.139 (0.296)	- 4.965* (2.827)	- 0.203 (0.146)	0.331 (0.316)
Age (18-24)	0.157 (0.127)	- 0.179 (0.150)	- 0.341*** (0.124)	0.544*** (0.163)	- 0.608 (0.443)	27.075*** (3.062)	0.162 (0.176)	- 0.294 (0.492)
Age (25-35)	0.199** (0.099)	- 0.045 (0.112)	- 0.247*** (0.097)	0.751*** (0.136)	- 0.377* (0.218)	0.956 (1.234)	0.241* (0.140)	0.358 (0.258)
Age (36-45)	0.060 (0.104)	- 0.179 (0.121)	- 0.139 (0.102)	0.750*** (0.139)	- 0.356 (0.227)	0.478 (1.187)	0.381*** (0.144)	- 0.043 (0.279)
Age (46-57/62)	- 0.018 (0.101)	- 0.314*** (0.121)	- 0.293 (0.098)	0.588*** (0.138)	- 0.312 (0.218)	0.065 (1.749)	0.122 (0.145)	0.259 (0.252)
Constant	- 0.751*** (0.131)	- 1.106*** (0.158)	- 0.068 (0.127)	- 1.731*** (0.166)	- 1.878*** (0.345)	- 29.142*** (2.817)	- 1.428*** (0.176)	- 2.722*** (0.372)
N	1965	1965	1965	1965	1965	33	1965	1965

Standard errors in parentheses
* $p<0.1$, ** $p<0.05$, *** $p<0.01$

Table 4: Regression results of Model 2.

Capital budgeting decisions and risk management of firms in the United Arab Emirates

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Abstract: *This paper investigates the risk management factors that affect the capital budgeting decisions of firms in the United Arab Emirates. Primary data were collected from questionnaires sent to a sample of 150 firms (101 responded, a response rate of 67.3%). Correlation analysis assessed the relationships between the risk management factors and capital budgeting. Six risk management factors (keep good financial records; profitability index; number of employees; diversified portfolios; finance manager's years of experience; and sound financial forecasts) were found to have significant relationships to capital budgeting. Two risk management factors (adequate insurance, and asset value of the company) were found to have no such significant relationship.* ***JEL codes:*** *G31, M1, M4*

Keywords: *Capital budgeting, risk management, decision making, correlation analysis, United Arab Emirates*

1. Introduction

When preparing budgets for capital projects, managers have to strategically balance the risks involved if they are to earn required returns. According to Singh, Jain, & Yadav (2012), a capital budget is a plan for investing in long-term assets, such as buildings, machinery, bridges, and stadiums. Capital budgeting decisions involve determining potential long-term investment projects that require significant funds. Risk management tries to ensure that the incomes from such projects are high enough to justify the investments.

To minimize an investment's exposure to risks, managers engage in practices such as diversifying their portfolios and using sound forecasting techniques. Risk perception reflects the decision maker's interpretation of the likelihood of risk exposure; it is the decision maker's risk inherent in a particular situation. Thus, among other things, risk management may be affected by the risk attitude and risk perception of business decision makers (Brookfield, 1995).

In the view of Souder and Bromiley (2012), capital budgeting should be undertaken with due care and after critical analysis, since it involves resource allocations that anticipate future cash outflows and inflows which if not properly analyzed could lead to substantial financial loss for the company. Typically, capital budgeting consists of moving from a capital project or equipment request to evaluation, selection, and implementation, with review during and at the end of each step (Keeler, Fleming, & Allport, 2014), while risk management encompasses measures to mitigate risk exposure or limit the risks in particular projects (Rad, 2016). By mitigating risk in capital budgeting, companies can minimize losses. Thus risk management and capital budgeting can improve an organization's ability to create and sustain superior performance (Bennouna, Geoffrey, & Marchant, 2010; Keeler, Fleming, & Allport, 2014).

Risk in capital budgeting has three levels: the project's stand-alone risk, its contribution-to-firm risk, and systematic risk. Stand-alone risk measures a project's potential without factoring in the potential risk that it adds to the company's assets and other projects. Contribution-to-firm risk measures the project's potential effect on other projects and assets. Systematic risk assesses the project's effects on the organization as a whole (Keller, 2014; Li & Wu, 2009). Typically, the analytical methods used for risk analysis in capital budgeting include sensitivity analysis, scenario analysis, simulation analysis, correlation analysis, and decision trees.

In the United Arab Emirates (UAE) as in other parts of the world, businesses undertake capital projects after carefully analyzing the potential risks involved and taking adequate measures to reduce them. This paper investigates how companies in the United Arab Emirates make capital budgeting decisions in the context of risk management. This study focuses on stand-alone risk. Data were collected from UAE companies and correlations were analyzed to investigate the impacts of risk management factors on capital budgeting. The remainder of this paper is organized as follows: Section 2 summarizes background about the UAE. Section 3 presents a literature review on capital budgeting. Section 4 discusses this study's methodology. Section 5 discusses the results and analysis, while Section 6 succinctly concludes the paper.

2. Background

The UAE is in the eastern part of the Arabian Peninsula and covers part of the Gulf of Oman and the southern coast of the Persian Gulf (World Bank, 2016). The country is comprised of seven emirates (Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al Quwain, Fujairah, and Ras Al Khaimah) and achieved its formal independence as a federal state on December 2, 1971. The UAE is bordered by Saudi Arabia to the west and south, Qatar to the north, and Oman to the east (please see Table 1 for selected basic information about the UAE). The country is the world's eighth largest oil producer and maintains a free market economy (UNdata, 2016). Despite the impact of the 2009 financial crisis and the 2015 fall in oil prices, the country's economy has been resilient, maintaining an estimated real GDP growth rate of 2.7% in 2016 (World Bank, 2016). The UAE is one of the world's fastest growing tourism destinations, and it accounts for 0.5% of global tourism. Tourism contributed 5.2% to the country's GDP in 2016 (World Travel & Tourism Council, 2017). According to the World Bank (2016), the recent global capital flows into the UAE suggest that the country is attracting international investments into a variety of asset classes. In fact, sovereign and private investors from around the world are attracted to real estate, upstream oil and gas projects, and other infrastructure projects. The question is: what risk management factors are considered by companies when investing in the UAE?

3. Literature review

Capital investment decisions have received increased research attention over the past few decades with a focus on firms of different sizes, in various industries, and in various countries (Bennouna, Geoffrey, & Allport, 2010; Pike, 2005; Dutta & Fan, 2012). Some studies focused on firms of local dimensions, while others concerned multi-national corporations (MNC).

While some studies have focused on investment decisions and financial theory (e.g., Brookfield, 1995; Drury & Tayles, 1997; and Arnold & Hatzopoulos, 2000), other studies have focused on behavioral aspects of capital budgeting (Berry, 1984; Pike, 2005). Most of these studies indicate an increase in the use of sophisticated capital budgeting techniques in developed countries. However, little research has been devoted to capital budgeting in less developed countries.

Using data from a survey of 32 manufacturing and trading companies listed on the Colombo Stock Exchange, Nurullah & Kengatharan (2015) investigated capital budgeting of companies in Sri Lanka. The study revealed that net present value (NPV) was the most preferred capital budgeting method, followed closely by the payback (PB) method and the internal rate of return (IRR). Sensitivity analysis was the dominant tool for incorporating risk in capital budgeting.

Singh, Jain, and Yadav (2012) examined the capital budgeting of companies in India. Using responses from a questionnaire of 166 nonfinancial companies, data were collected from the period 2001-2011. The study found that sophisticated techniques and sound capital budgeting were common among Indian firms. All respondent firms used discounted cash flow (DCF) techniques. IRR was used by more than three quarters of the sample companies, while NPV was used by half. Real options were also used by half.

In a study of capital investment in the United States, Souder and Bromiley (2012) found that firms with profits below expected levels were more risk-averse. The study also concluded that rather than undertaking long-term capital investment, the firms lobbied either to induce the government to reduce regulations or to frame other companies as anti-competitive to increase their own short-term profits.

Language	Arabic is the official language. But Persian, English, Hindi and Urdu are also commonly spoken
Independence:	December 2, 1971
Administrative Capital	Abu Dhabi
Largest City	Dubai (2 million in population)
Population	9.27million (2016 estimate)
Population growth rate	2.47% (2016 estimate)
Unemployment rate	3.8% (2014 estimate)
Literacy (% of population Age 15+)	94 (2015 estimate)
Poverty (% of population below national poverty line)	19.5 (2003 estimate)
GDP	667.2 billion US$ (2016 estimate)
GDP growth rate	2.7% (2016 estimate)
Inflation rate	3.4% (2016)
Telephones (fixed lines)	2.28 million (2016 estimate)
Telephones (mobile cellular):	19.9 million (2016 estimate)
Internet users	5.374 million (2016 estimate)
Infant mortality	10.3 (2015 estimate)
Maternal mortality rate (per 100,000 live births)	6 (2015 estimate)
Life expectancy at birth (years)	77.5 (2015 estimate)
Health expenditures (percent of GDP)	2.6% (2014 estimate)
Hospital bed density (per1,000 population)	1.1 (2012 estimate)

Table 1. United Arab Emirates: Selected recent basic information.

Source: UNICEF, 2016 (www.unicef.org); World Bank, 2016 (http://data.worldbank.org)
Note: Number in parentheses indicates year.

Similarly, Arnold and Hatzopoulos (2000) analyzed the extent to which the most significant UK corporations were employing modern investment appraisal techniques. Using responses from 96 structured questionnaires which were sent to finance directors of the sample companies, they found that UK companies increasingly used discounted cash flow methods and formal risk analysis techniques when investing in capital.

Finally, Dutta and Fan (2012) analyzed conditions in which centralized and decentralized capital budgeting work best. For projects where the manager needed innovation, decentralization was more effective if incentive contracts were in place to share the profits created by individuals. But for projects requiring limited innovation from management, centralization worked better.

4. Methodology

This study examines the interplay between risk management and capital budgeting decisions in the UAE. Specifically, it investigates how risk management factors affect the manager's intention to undertake capital projects. A total of 150 questionnaires were sent to representatives of companies in the UAE (please see Appendix for the questionnaire). Of the 150 questionnaires, 101 were accurately completed and returned (a response rate of 67.3%). The questionnaires measured risk management in capital budgeting. The risk factors were represented on a scale of 1 to 5, with 1 being "Not important" and 5 being "Extremely important." Respondents were selected based on their financial decision-making capabilities in the companies. Most were finance controllers, budget directors, etc. The population sample consists of companies from the manufacturing and construction sectors. The data were collected between April 2014 and November 2015. A sample questionnaire is in the appendix.

5. Results and Analysis

Table 2 presents the factors and their definitions, while Table 3 presents the Pearson correlation matrix of the various factors. Pearson correlation provides the most common approach for capturing the linear relationships between variables. The correlation is positive if both variables move in the same direction and negative if they move in opposite directions. A t-test assessed whether correlations differed from zero at the 5% level of statistical significance. Six factors significantly correlated with capital budgeting decisions (CBD): FNR (0.393), PRI (0.294), EMP (0.253), DVP (0.233), EFM (0.162), and SFC (0.108). Table 2 identifies the abbreviations.

FNR indicates good financial record-keeping by the companies. FNR serves as a proxy for a good accounting system which records and tracks all transactions in any capital project. It serves as a control system to ensure that the budgets for capital investments are not overspent. Consequently, companies are more likely to invest in capital projects that generate positive cash flows if they have an accounting system ensuring that all financial records are properly managed.

Factor	Definition
CBD	Capital Budgeting Decisions
FNR	Keep good financial records
DVP	Diversified Portfolios
AIN	Adequate Insurance
SFC	Sound Financial Forecasts
PRI	Profitability Index
EMP	Number of Employees
EFM	Finance Manager's Years of Experience
ASV	Asset Value of Company

Table 2. List of factors.

PRI represents the profitability index associated with a capital project. It can be a proxy for discounted cash flow methods used in capital budgeting analysis, such as NPV and IRR. The more likely that a capital project will earn a profit, the higher the possibility that the project will be selected by decision-makers.

EMP represents the number of employees in a company. Its positive correlation with capital budgeting decisions suggests that companies with more employees are more likely to undertake capital projects because they have the staff needed to complete the project, assuming that the workers have the needed skills.

Another factor that correlates positively with CBD is DVP, which measures the degree to which the company maintains a diversified portfolio of capital projects. Portfolio diversification is a necessary condition for mitigating risks in all areas of investments, and companies in the study tend to diversify their portfolios in terms of capital projects. For example, a company may build roads and bridges, while it may also have the expertise to design and construct sewage systems or to procure heavy machinery.

EFM represents the number of years of experience of the finance managers in capital budgeting. Its positive correlation with capital budgeting suggests that finance managers with more years of experience are more competent in capital investment. As with any skill, years of experience positively correlate with a person's competence. The analysis suggests that among finance managers, more years of experience contribute to better capital investment, and vice versa.

The term SFC indicates the use of sound financial forecasts. It may serve as a proxy for quantitative risk analysis techniques (such as sensitivity analysis, scenario analysis, Monte Carlo simulation, and decision tree analysis). As would be expected, companies carry out sound financial analysis and forecasts of capital projects to determine potential risks and returns before investing. By using sound financial forecasts, companies are more likely to make better capital investment decisions.

	EMP	FNR	DVP	AIN	SFC	PRI	CBD	ASV	EFM
EMP	1	0.098	0.158	-0.083	-0.058	0.053	.253	.808	.272
FNR	.098	1	.430	.260	-.135	-.084	.393	-.004	.125
DVP	.158	.430	1	.035	.141	.041	.233	.124	.208
AIN	-.083	.260	.035	1	.021	.207	.096	-.063	.026
SFC	-.058	-0.135	.141	.021	1	.595	-.108	.102	-.053
PRI	.053	-.084	.041	.207	.595	1	-.094	.138	-.055
CBD	.253**	.393**	.233**	.096	.108*	.294**	1	.116	.162*
ASV	.808	-.004	.124	-.063	.012	.138	.116	1	.113
EFM	.272	.125	.208	.026	-.053	-.055	.162	.113	1

Table 3. Pearson correlation matrix.
*Correlation is significant at the 0.05 level (2-tailed).
**Correlation is significant at the 0.01 level (2-tailed).

Finally, two factors, asset value of the company (ASV) and adequate insurance (AIN) did not make the 5 percent level of significance, so they might not affect capital budgeting of companies that were not in the sample. One would have expected that companies with larger assets would be more likely to invest in capital projects, but surprisingly this study did not find such a relationship. Perhaps firms with larger asset value had already invested heavily in their most valuable projects and consequently had fewer incentives to invest in more projects**.** Additionally, adequate insurance coverage did not affect the decisions of the companies when considering capital projects.

6. Conclusion

This study investigates risk management factors that affect the capital budgeting of UAE firms. Using field data from a sample of 101 firms, the study used Pearson correlation analysis to test the relationships between the risk management factors and capital budgeting decisions. The risk management factors found to be statistically significant are: keeping good financial records (FNR), the profitability index (PRI), the number of employees (EMP), a diversified portfolio (DVP), the finance manager's years of experience (EFM), and sound financial forecasts (SFC). In contrast, there was no significant relationship between capital budgeting and either adequate insurance (AIN) or the asset value of the company (ASV). As capital investments require substantial upfront costs, companies need to be assured that the potential to earn significant returns on such investments exists. The value of incorporating risk management factors into capital budgeting is to highlight their impact on project success. Most previous studies of capital budgeting have found that risk factors are significant determinants of return on investments. The results of this study confirm that the information contained in the capital budgeting process does significantly capture risk factors. For transitional economies such as Kazakhstan and other CIS countries, this study suggests that risk mitigation strategies in capital budgeting are more likely to improve the performance of capital projects.

The findings of this study are limited by the fact that the data do not include other sectors besides manufacturing and construction. Future studies should include data from all sectors of the economy, including banking and energy. Another limitation is that the study is confined to one country (UAE). Since UAE is a member of the Gulf Cooperation Council (GCC) countries, future research should be undertaken to enlarge the sample size by including other GCC countries. In addition, similar studies should be done in any of the GCC countries and a comparative analysis performed. Despite these limitations, this research adds to the body of knowledge on capital budgeting in general, and in the UAE context in particular by identifying the most important risk management factors considered during the capital budgeting process.

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7. Summary

English: This study investigates the risk factors used by firms in the UAE in their capital budgeting decision. Six risk factors (keep financial records; profitability index; number of employees; diversified portfolios; finance manager's years of experience; and sound financial forecasts) were identified to significantly affect the capital budgeting process. The findings suggest that firms in the UAE and transitional economies such as Kazakhstan are more likely to have a higher return on investments when these risk factors are considered when making capital budgeting decisions.

Russian: В этом исследовании исследуются факторы риска, используемые фирмами в ОАЭ при принятии решения о составлении бюджета капитала. Шесть факторов риска (ведение финансовой отчетности; индекс прибыльности; численность работников; диверсифицированные портфели; многолетний опыт финансового менеджера и надежные финансовые прогнозы) были определены, чтобы оказать существенное влияние на процесс составления бюджета капитала. Полученные данные свидетельствуют о том, что фирмы в ОАЭ и странах с переходной экономикой, таких как Казахстан, с большей вероятностью получат более высокую отдачу от инвестиций, если учитывать эти факторы риска при принятии решений по бюджетированию капитала.

Kazakh: Bul zerttew BAÄ fïrmalarınıñ kapïtaldı josparlaw şeşiminde qoldanatın qawip faktorların zertteydi. Kapïtaldıñ byudjetin qalıptastırw procesine aytarlıqtay äser etetin altı qawip faktorı (qarjılıq esepti jürgizw; tabıstılıq ïndeksi; qızmetkerler sanı; ärtaraptandırılğan portfelder; qarjı menedjeriniñ köpjıldıq täjirïbesi jäne durıs qarjılıq boljamdar) anıqtaldı. Däleldemeler BAÄ jäne Qazaqstan sïyaqtı ötpeli ékonomïkadağı fïrmalar kapïtaldı byudjetke salw twralı şeşim qabıldağan kezde osı qawip faktorları eskerilgen kezde ïnvestïcïyalardan joğarı payda tabadı dep boljaydı.

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9. Appendix A
Survey Questionnaire

Please respond to the following items

1. Your age in years ____________________
2. Your gender Male ______________ Female _________________
3. Your nationality UAE__________Non-UAE_____________
4. Your marital status:
   ________ Single ________ Married________ Divorced________ Widow
5. Your highest educational level
   __________ Below Bachelor degree__________ Bachelor degree
   __________ Graduate Diploma __________ Master Degree
   __________ Doctoral Degree
6. Your position in the company
   __________ Financial Controller
   __________ Financial Manager
   __________ Senior Accountant
   __________ Financial Analyst
   __________ Budget director
   __________ Accountant
7. How long have you been in your current position?

   1= 1-5 years

   2 = 5-10 years

   3 = 10-15 years

   4 = 15-20 years

   5 = more than 20 years

8. Industry of your company:

   1 = banking

   2 = manufacturing

   3 = engineering/construction

   4 = other

9. Number of employees working in your company:

   1= 1-50

   2 = 50-100

   3 = 100-150

   4 = 150-200

   5 = more than 200

10. Total Assets of your company (USD):

    1= less than $1 million

    2 = from $2-$5 million

    3 = from $5-$10million

    4 = from $10-$15million

    5 = more than $15 million

11. Please indicate by checking the appropriate column to identify the various activities used in risk management strategies in your company.

	NOT IMPORTANT **1**	**SOMEWHAT IMPORTANT** **2**	**NEUTRAL** **3**	**VERY IMPORTANT** **4**	**EXTREMELY IMPORTANT** **5**
1) Maintaining adequate financial records					
2) Maintaining diversified investment portfolio regularly					
3) Maintaining adequate insurance coverage					
4) Maintaining sound forecasting techniques					
5) Conducting profitability index to determine which project will provide highest value					

Perspectives

The new court of the Astana International Financial Centre: promoting the rule of law or giving up on the rule of law?

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Abstract: *In 2015, Kazakhstan set up the AIFC, a new international financial center located in the country's capital. Financial services companies that decide to establish themselves there will profit from an advantageous tax system and from modern financial regulation as well as from commercial laws that are based on English law and are different from those of the rest of this Central Asian state. AIFC law will also be applied by the center's own English judges and arbitrators. The objective is to appeal to investors and to turn Kazakhstan into an attractive financial hub for the region. Additionally, this initiative may improve the rule of law in the country, serving as an example for local judiciary and regulators. However, for a fruitful cross-fertilization between the AIFC and local institutions and in order to contribute to the real development of the country, the AIFC and local stakeholders must make an effort to see each other as partners and not as isolated legal systems and institutions.* ***JEL Code:*** *O3*

Keywords: *International Financial Centers, Rule of Law, Institutions, International Courts and Tribunals, Applicable Law, Recognition of Foreign Decisions, Kazakhstan, Central Asia*

1. Introduction

In 2015, Kazakhstan announced that it would set up a new offshore or international financial center in the country's capital. This interesting initiative tries to follow the steps of similar financial centers in the Persian Gulf (see below). The confessed goal of the center is to attract investors, especially financial service providers that can help Kazakhstan become a reliable financial hub for Central Asia. However, the center's own financial and commercial laws and regulations, as well as its own dispute resolution mechanisms, may also provide a good example for the rest of the country, which needs to foster the rule of law. Kazakhstan's own banking regulators, government officials, judges, and lawyers may learn much from the experience of the judges and officials who have been hired from abroad, if the latter also make an effort to establish a dialogue and a two-side learning relationship with the country that is hosting them, instead of remaining an isolated institution.

2. Offshore Financial Centers and Offshore Courts

The International Monetary Fund broadly defines offshore financial centres as "any financial centre where offshore [financial] activity takes place." Basically, offshore finance is "the provision of financial services by banks and other agents to nonresidents.

Such nonresidents are usually foreign businesses: entities which are either not locally incorporated or whose main activities take place elsewhere or both.

Also in accordance with the International Monetary Fund, offshore financial centers must meet the following four criteria: (i) orientation of business primarily toward nonresidents; (ii) favorable regulatory environment, including favorable employment and visa regimes; (iii) a low or zero tax rate; and (iv) offshore banking as an entrepôt business.[1]

However, this definition of offshore finance does not differentiate between those financial markets of sovereign states—where offshore finance services may be provided—and those cases where a sovereign state creates an offshore financial center within its territory but with its own laws and dispute resolution system, which differ from those of the rest of the host country that provide offshore financial services. The latter are sometimes referred to as "financial free zones."[2]

Two traditional and well-known financial centers, hubs, or districts are New York's Wall Street and the City of London, but these are territorially part of and are integrated into the constitutional and regulatory framework of their respective countries. Many offshore centers are sovereign states in their own right, such as Panama or Andorra. Other centers are in overseas territories or in jurisdictions that, for historical reasons, are part of or are under the sovereignty of another nation state, as in Gibraltar or the Cayman Islands. Even after the 1999 devolution to China, Hong Kong could also be said to belong to this latter category.

[1] International Monetary Fund (2008), p. 17. *Offshore financial centers, a report on the assessment program and proposal for integration with the Financial Sector Assessment Program*, Monetary and Capital Markets Department and the Legal Department of the International Monetary Fund Retrieved from https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Offshore-Financial-Centers-Report-on-the-Assessment-Program-and-Proposal-for-Integration-PP4271)

[2] Federal Decree of the UAE 35 of 2004, To establish a Financial Free Zone in Dubai.

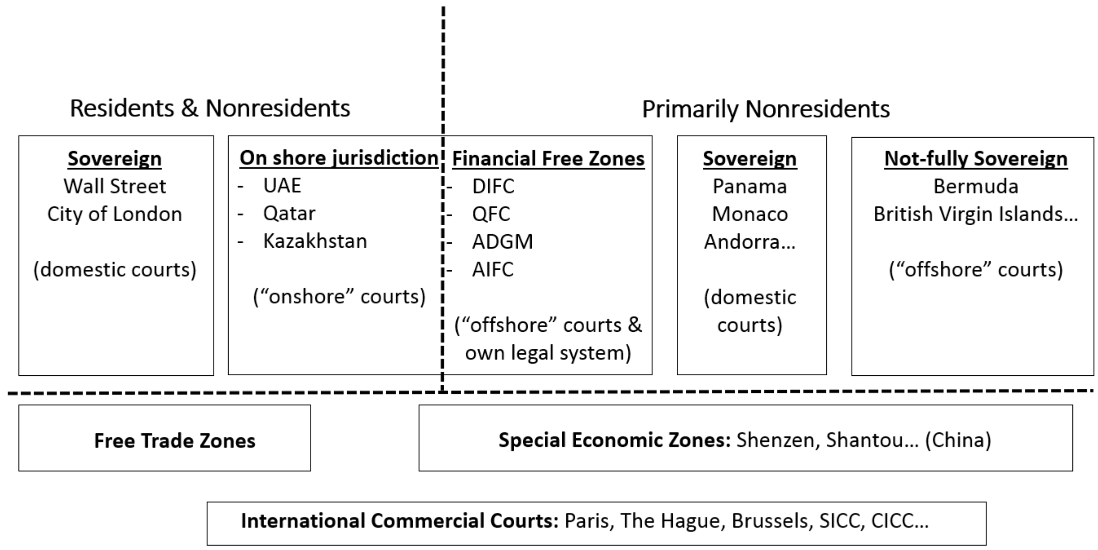

Figure 1: Anatomy of offshore finance and offshore courts.

The term "offshore courts" is sometimes used simply to refer to the domestic courts and tribunals of offshore financial centers. Thus, the courts of some Caribbean jurisdictions may commonly be referred to as "offshore courts."[3] In addition, the courts of financial free zones are often referred to as "offshore courts" too, in order to distinguish them from the "onshore courts," which are the domestic courts and tribunals of the host country where the financial free zone is located.

On the other hand, special economic zones can be defined as "demarcated geographic areas contained within a country's national boundaries, where the rules of business are different from those that prevail in the national territory."[4] They are small or well-sized territories such as sea ports or whole provinces, where different laws and regulations are enacted and enforced from those of the rest of the country. Nevertheless, such special legislation usually concerns commodity trade, custom duties, worker permits, VAT, etc (Figure 1).

Further to the above, there is a visible trend in Asia and the Middle East to establish financial free zones that are properly speaking hybrids between offshore financial centers and special economic zones. Some examples of these hybrids could be international financial centers such as the Dubai International Financial Centre (DIFC, established in UAE in 2004[5]), the Qatar Financial Centre (QFC, established in Qatar in 2005[6]), the Abu Dhabi Global Market (ADGM,

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[3] Retrieved from www.offshorealert.com

[4] Farole, T., & Gokhan, A. (2011). *Special economic zones, progress, emerging challenges and future directions*. Washington, D. C.: The International Bank for Reconstruction and Development/The World Bank.

[5] Federal Decree of the UAE 35 of 2004, To establish a Financial Free Zone in Dubai. DIFC Courts. Retrieved from https://www.difccourts.ae/

[6] Qatar Financial Centre Law 7 of 2005 (amended by Law n. 14 of 2009). Qatar International Court and Dispute Resolution Centrex. Retrieved from https://www.qicdrc.com.qa

established in UAE in 2013[7]), or the Astana International Financial Centre (AIFC, established in Kazakhstan and launched in 2018[8]).

These hybrids would share with special economic zones the feature of a special legal regime whose application is limited to a small or simply nominal territory.[9] Therefore, from a legal perspective, they are artificially created jurisdictions within another jurisdiction. On the other hand, these kinds of international financial centers would share with offshore centers the fact that their goal is mainly the provision of offshore corporate and financial services to foreign clients, not necessarily related to the international trade of goods.

Despite their great amount of natural resources, the governments of Persian Gulf countries as well as the government of Kazakhstan may be aware, in different degrees, of the need to attract more investment and to diversify their economies, in order to avoid cyclical economic crisis each time that the price of mineral resources falls in the markets. This diversification involves attracting foreign businesses interested in economic sectors other than minerals. To this end, all kinds of foreign investors need to be reassured that their assets are duly protected. The stronger and the more familiar the legal and adjudicatory system of the host country, the more reassured those foreign investors will feel.

In some cases, these financial centers also try to capitalize on one of the intrinsic cultural features of the countries where they are located—Islam—for the purposes of attracting entities willing to use financial instruments that are compatible with *Sharia* law. Islamic finance is widely practiced in Persian Gulf countries and Islamic finance legislation is being introduced in some Central Asian countries.

Since foreign and sophisticated investors and other stakeholders such as legal consultants are used to political stability and to a strict understanding of the rule of law and need to be reassured that those investments are secure, the governments that sponsor these new financial centers may have calculated that it is less costly— politically or otherwise—to set up new, limited, and insulated financial institutions with their own robust financial legal system and judiciary, instead of having to undertake major legal, social, or political reforms nationwide.

3. The Rule of Law in Kazakhstan

Kazakhstan ranks low in most indexes that assess the strength of the rule of law in different countries. Thus, in the 2018 Corruption Perception Index made by Transparency International, Kazakhstan occupies the place 124 out of 180.[10] In the 2017-2018 Judicial Independence Index of the Global Competitiveness Report (i.e. the World Economic Forum), this country ranks 79th out of 137.[11] In the Rule of Law Index of 2019 of the World Justice Project, the place is 65 out of 126.[12] In the 2017 Judicial Independence (WEF) Index of the World Bank, Kazakhstan receives a

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[7] Federal Law of the UAE 8 of 2004 concerning the Financial Free Zones. Abu-Dhabi Global Market Courts. Retrieved from www.adgm.com

[8] Constitutional Statute of the Republic of Kazakhstan on the Astana International Financial Centre, n. 438-V ZRK of 7 December 2005 (amended in 2017). AIFC Court and International Arbitration Centre. Retrieved from www. aifc-court.kz and www.aifc-iac.kz

[9] DIFC: 110 hectares; ADGM: 114 hectares. The AIFC has been established on the site of the former Expo 2017 (25 hectares).

[10] Retrieved from https://www.transparency.org/cpi2018

[11] Retrieved from http://www3.weforum.org/docs/GCR2017-2018/03CountryProfiles/Standalone2-pagerprofiles/WEF_GCI_2017_2018_Profile_Kazakhstan.pdf

[12] Retrieved from https://worldjusticeproject.org/sites/default/files/documents/WJPROLI2019_0.pdf

grade of 3.64, where 1 is "heavily influenced" and 7 is "entirely independent."[13] However, the Kazakhstani government is implementing several measures to improve situations such as corruption or poor professional training.[14]

Additionally, institutions such as the OECD or the American Chamber of Commerce have repeatedly asked for solutions to the problem of corruption and disregard for the rule of law in Kazakhstan, although they also believe that progress is being made.[15] Anti-bribery campaigns, plans to set up investment courts and to provide more training for judges and state officials,[16] a new Arbitration Law,[17] and now the Astana International Financial Centre may all be part of this effort. In addition, powerful or well-funded entities such as the American Bar Association, the German Federal Ministry for Economic Cooperation and Development, and the European Union have their own Rule of Law programs for Kazakhstan and for the entire Central Asian region.[18]

4. The Court of the Astana International Financial Centre

The AIFC was launched in Nur-Sultan (formerly Astana), the newly named capital of the Republic of Kazakhstan, in July 2018. The AIFC combines features of territorial administrative subdivisions, technologically advanced business facilities, financial regulators and flexible dispute resolution mechanisms.[19] It has regulatory and judicial jurisdiction over corporations established in it and it has been expressly modeled[20] after similar initiatives in the Persian Gulf, such as the abovementioned DIFC. The creation of the AIFC is also in line with other world tendencies such as regulatory competition and innovative English-speaking sections of domestic courts, set up with a view to diverting legal business away from traditional litigation hubs.

[13] Retrieved from https://tcdata360.worldbank.org/indicators/h5ebaeb47?country=BRA&indicator=669&viz=line_chart&years=2007,2017

[14] Sayapin, S. (2019). *Critical analysis, strict discipline and personal responsibility: some reflections on strengthening the independence of judiciary in Central Asia*. Retrieved from https://www.academia.edu/38923685/_Critical_Analysis_Strict_Discipline_and_Personal_Responsibility_Some_Reflections_on_Strengthening_the_Independence_of_Judiciary_in_Central_Asia?auto=download

[15] OECD Investment Policy Reviews: Kazakhstan 2017, p. 16. Retrieved from https://read.oecd-ilibrary.org/finance-and-investment/oecd-investment-policy-reviews-kazakhstan-2017_9789264269606-en#page17 American Chamber of Commerce White Paper 2018, p. 2. Retrieved from https://drive.google.com/file/d/1zIxJi9rDF7sCybKz1J8jZR2dEdfo7EsZ/view

[16] 100 Steps, Section II: Ensuring the rule of law. Retrieved from https://strategy2050.kz/en/page/message_text2014/

[17] Law of the Republic of Kazakhstan No 488-V of 8 April, 2016 on arbitration. Retrieved from http://adilet.zan.kz/eng/docs/Z1600000488

[18] Retrieved from https://www.americanbar.org/advocacy/rule_of_law/where_we_work/europe_eurasia/kazakhstan/programs/; https://www.giz.de/en/downloads/giz2016-en-promotion-rule-of-law-central-asia-kazakhstan.pdf; https://eeas.europa.eu/sites/eeas/files/eu_rule_of_law_initiative_for_central_asia_0.pdf

[19] AIFC Court. Retrieved from https://aifc-court.kz/; AIFC International Arbitration Centre. Retrieved from https://aifc.kz/structure/international-arbitration-centre

[20] Address by the President of the Republic of Kazakhstan. (2014). National plan: one hundred concrete steps to implement the five institutional reforms: step number 24. Retrieved from https://strategy2050.kz/en/page/message_text2014/

Figure 2. AIFC bodies. Source: www.aifc.kz

Kazakhstan has claimed that the AIFC will strengthen the rule of law in this Central Asian republic.[21] This would be key, not only to attracting sophisticated investors but also to fighting corruption and improving the domestic legal system, which not only needs to develop but is probably too advanced to be fully respected or properly applied by state officials, particularly by judges. The government of Kazakhstan might hope that the AIFC, as a super-modern mini-jurisdiction of common law, might in time pull up the rest of the country behind.

As already mentioned, a peculiar added characteristic of only a group of these hybrids is the establishment of various dispute resolution mechanisms such as civil and commercial courts or regulatory tribunals and alternative dispute resolution centers. Such dispute resolution mechanisms are part of the legal structure of these hybrid financial centers and must be seen as a secondary or collateral legal service offered to their participants and to the business community in general. They also serve as enforcers of their more favorable or technically advanced legal regime.

The existence of these dispute resolution mechanisms raises other and distinct legal issues in areas such as jurisdiction, applicable law, international judicial cooperation, recognition of foreign judgments and arbitral awards within their territory, as well as the recognition and enforcement of offshore judgments and arbitral awards outside the financial hub but within the territory of the host state or abroad.

Within this set of legal issues, other interesting questions can be posed, such as the relationship between these sophisticated offshore courts and the English-speaking judges and arbitrators, trained in common law, that these centers have hired, on the one hand, and the local and potentially less sophisticated judiciary of the host country, on the other hand, when it comes to the practicalities of domestic and reciprocal recognition and enforcement of offshore judgments and awards.

[21] Address by the President of the Republic of Kazakhstan. (2014). National plan: one hundred concrete steps to implement the five institutional reforms. Retrieved from https://strategy2050.kz/en/page/message_text2014/

Another relevant issue is how foreign courts are supposed to characterize court rulings and arbitration awards issued by the courts and arbitration tribunals of these financial centers, for the purposes of recognition and enforcement. In some of these centers, the enacted legislation expressly declares that their courts are independent from and not part of the local judicial branch (e.g. AIFC[22]). In other cases there is an express mention of the fact that the offshore courts are part of the judiciary power of the state, including a reference, in the case of the DIFC Courts, to the fact that its judgments are issued in the name of the sovereign.[23] In both cases the question is to what extent foreign courts are obliged—under their domestic legislation or under existing international treaties—to treat such rulings and awards as any other judicial or arbitration decision originating in that country.

5. The AIFC as a Legal Transplant

Three things may summarize the reasons for setting up the AIFC and the strategy followed by the government of Kazakhstan in establishing this new offshore financial center. They may also be key in understanding the relevance of the AIFC for the future of the rule of law in Kazakhstan. The three aspects are: a "call effect" in relation to similar international financial centers; the import of foreign and foreign-trained personnel; the import or creation of a new legal and adjudicatory system.

(a) The call effect

The "call effect" is simply an acknowledgment that Kazakhstan is trying to capitalize on the apparent success that similar initiatives have had, especially in the Persian Gulf. Former President Nazarbayev made an express reference to the DIFC when he first mentioned the future creation of the AIFC, and the DIFC has attracted more than 3,000 business entities which are already incorporated or registered within its territory in accordance with its own laws, as well as a workforce of almost 23,000 people working within its territory and in accordance with its own employment regime.

Such degree of investment and business activity in Dubai, directly or indirectly facilitated by the DIFC, probably weighed heavily in the decision to set up the AIFC, with the great economic and political support that the Kazakhstani government has been giving to it. If, in the mid-term, this call effect does not materialize in a sufficient degree of new investments in the form of financial service companies that set up subsidiaries or branches within the AIFC, the initial enthusiasm may fade and the experiment will not be so fruitful, from the perspective of the potential improvement for the rule of law in the whole country.

In this regard, it might be said that Kazakhstan is not Dubai and Central Asia is not the Persian Gulf, which has become a convenient and true crossroads between Europe and the Far East. Despite the new opportunities brought by the Belt and Road initiative and the increasing visibility of Kazakhstan for the rest of the world, Nur-Sultan, its capital, is far from the most important capital in the world and has an incredibly inhospitable weather for a good part of the year, so it is doubtful that it can match Dubai as an obvious destiny for the banking community. Furthermore, the establishment of financial service companies is arguably not the best kind of investment for a country because financial intermediation with low taxation may not leave a lot of money in the country where the financial service companies are established.

[22] Art. 13.2 AIFC Constitutional Statute of 2015.
[23] Art. 3.5 Law 12 of 2004 with respect to the Judicial Authority of the DIFC (amended in 2011).

On the other hand, there are indeed similarities between Kazakhstan and those Persian Gulf countries whose own new offshore financial centers may have inspired the AIFC, and such similarities may make it reasonable to predict a positive future. Neither Kazakhstan nor the Persian Gulf countries belong to the "Western" world but, in different degrees, to the Islamic civilization, bearing in mind that such civilization has been heavily influenced by the West in recent centuries. They all have a colonial or semicolonial past. They have a history of autocratic governments and do not seem determined to embrace the kind of liberal democracy Europe and North America are used to, despite the fact that, in some cases, their constitutional architecture apparently says otherwise, as well as their participation in international organizations and their being signatories of the most important treaties on human rights and civil and political freedoms.

However, some Persian Gulf countries are, from a constitutional perspective, hereditary monarchies, whereas the Republic of Kazakhstan is a *sui generis* democracy, where the role of the charismatic "First President" Nursultan Nazarbayev is impossible to overestimate. The four territories under study are also countries that rely heavily on their immense wealth in natural resources. This has been the engine of their economic progress but, so far, contrary to other equally blessed nations, it has not been a "curse" leading to major human tragedies or armed conflicts in their midst, as has happened in Africa. Nevertheless, it may be behind many cases of corruption and undue treatment of foreign investors, at least as far as Kazakhstan is concerned.[24]

(b) Import of foreign trained personnel

Although a significant number of the AIFC top officials are locals, some, as well as all the currently appointed justices at the AIFC Court, are foreigners, with prevalence of British nationals and British-trained judges with a lot of experience in similar positions. This is obviously meant to reassure potential investors by letting them know that they will be "at home away from home," with English speaking, common-law-trained, incorruptible super-judges and other officials.

In the case of the dispute resolution mechanisms of similar offshore financial centers in the Persian Gulf, some justices and other officials are now locals. This may indicate that those initially foreign courts and arbitration mechanisms are increasingly domesticizing themselves. If this also happens in the case of the AIFC, it may be positive for Kazakhstan, which will have profited from the foreign experience and foreign norms. If, on the other hand, the AIFC is seen as an unwelcome guest, with few ties to the local judiciary and to the local legal community at large, the latter may not profit from whatever the AIFC brings.

(c) A new legal and adjudicatory system

In the case of AIFC law and the AIFC Court, it may not be appropriate to talk about a legal transplant but of the import of a whole "foreign" legal system.[25] In fact, one of the most striking features of the AIFC, in the wake of its Persian Gulf predecessors, is the fact that they can duly be described as common law jurisdictions insulated within another, bigger, full-fledged and sovereign civil law jurisdiction. The application of English-based laws and regulations within the AIFC may have been perceived and used by its founders as one more way to assure future investors and financial companies of the viability of their experiment: Working at the AIFC would be like working in the City of London.

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[24] Corruption Perception Index. Retrieved from www.transparency.org; United Arab Emirates (Dubai and Abu-Dhabi): 21/180; Qatar: 29/180; Kazakhstan: 122/180.

[25] Watson, A. (1993). *Legal transplants: an approach to comparative law*, Athens, Georgia: University of Georgia Press. I rely here on the first edition, which appeared in 1974.

Despite the big fuss about the application of English law in Kazakhstan, the latter is actually not going to be applied within the AIFC, and the founding legal instruments make it clear that the AIFC laws and regulations will be made by the AIFC governing bodies. The founding AIFC Constitutional Statute simply says that AIFC laws "may be based" on the law of England and Wales.[26]

Truth to tell, the AIFC Court will also be able to operate like a common English court in the sense that it will be able to apply its own precedents and those of "other" common-law courts, with special reference to the case law of similar offshore financial centers.

On the other hand, AIFC officials and justices now promoting the AIFC all over Kazakhstan may have also realized the potential that the sheer application of an alien legal system has for alienating the local establishment. Therefore, they are stressing the truth: AIFC law is not English law and the AIFC Court will not be applying English law but the laws and regulations made by the AIFC governing bodies, as authorized by the legal instruments that founded the AIFC and that are also part of the national legal system: the AIFC Constitutional Statute[27] and a corresponding reform to the Constitution of the Republic of Kazakhstan.[28]

The application of English law by judges and officials hired from common-law countries may be seen as an added advantage for foreign investors and for their legal advisers but it may make more sense in the case of the Persian Gulf offshore centers. The close relationship between Persian Gulf countries and the United Kingdom goes a long way back but this is definitely not the case of Kazakhstan, which has always been in the orbit of Russia. However, all of these countries belong to the civil law tradition, although for different historical reasons. In the case of Persian Gulf countries, they were influenced by the Civil Code of Egypt, which in turn was based, to some degree, on the Napoleonic code. In the case of Kazakhstan, its private law derives from the Russian and Soviet legal tradition, although it has gone to great efforts to modernize itself during the first decades after becoming independent in 1991.

With respect to the court and arbitration system of the AIFC, a difficult balance will have to be struck to facilitate a positive legal cross-fertilization: On one hand, the AIFC Court and its court rulings have to be insulated to the extent that domestic courts cannot review its contents and thus defy its whole purpose; on the other hand, there must be sufficient communication between the AIFC and local institutions, so that those court rulings also have proper effects outside the AIFC—e.g., where the defendant does not have assets within the AIFC—and so that all stakeholders can learn from each other.

6. Conclusions: Giving Up on the Rule of Law?

It is hard to avoid the temptation of thinking that, in creating the AIFC, with its own insulated legal system and its own courts to enforce that legal system, Kazakhstan is telling foreign investors and the world at large that, no matter how imperfect the Kazakhstani laws may be and no matter how much they may be disregarded by State officials and domestic courts, they should still establish themselves in Kazakhstan because the AIFC now provides a "mini-jurisdiction"

[26] Art. 4.1.2), Constitutional Statute of the Republic of Kazakhstan on the Astana International Financial Center, n. 438-V ZRK of 7 December 2005 (amended in 2017).
[27] Constitutional Statute of the Republic of Kazakhstan on the Astana International Financial Center, n. 438-V ZRK of 7 December 2005 (amended in 2017).
[28] New art. 2.3.1 introduced by the Constitutional Law of the Republic of Kazakhstan N. 51-VI 3RK, of 10 March 2017.

where the laws, the courts and all other officials are going to be state-of-the-art Western-style institutions tailored to their needs and applicable only to them, if they will just decide to relocate to this new "country," in the middle of the Central Asian steppe.

It is fair to ask whether the effort of implementing such laws and mechanisms would not be better invested in ordinary legal and judicial reforms for the whole country and whether these initiatives fit well into its complicated constitutional law system, which still have some way to go in terms of their democratic deficit, separation of powers, and respect for the rule of law. Where lawyers and businessmen usually trust the domestic court system, it may be more practical to just open English speaking sections of ordinary commercial courts, with broad rights of audience for foreign lawyers, as is being done in European and Southeast Asian jurisdictions.

If the above were true and especially if the laws and institutions of Kazakhstan did not catch up in due time, the AIFC and the AIFC Court might in fact be evidence that the government of Kazakhstan has given up on the rule of law for the entire country, opting instead, to a large extent, for the import of an alien legal system and alien enforcers.

One hopes that it may go the other way around, with the AIFC becoming a successful example of cross-fertilization where local legislators, officials, and judges learn from Western experts and officials with many decades of expertise in commercial law in the most innovative financial markets of the world. This would help Kazakhstan in its traumatic transition from a centralized communist economy to a market economy from which all its citizens can benefit—not just the ruling elite, linked to the government and to the affluent oil industry. In this regard, the AIFC is doing a lot to cement a fruitful and amicable relationship with Kazakhstani institutions. The AIFC Court is also very actively reaching out to the legal and academic world of the country.[29]

The AIFC Court and the other offshore courts may therefore prove to be a powerful tool which will in time pull up the entire legal and judicial system of the country if there are good relations between the offshore and the onshore institutions. If such relations are fluent and harmonious, there could be good reciprocal influences. If, on the other hand, local courts show themselves too jealous of their own jurisdiction, there could be complications.

International commercial arbitration and investment arbitration are often criticized for being opaque and unaccountable. In the case of the Court of the AIFC, this criticism may prove unfair because the rules of this new offshore court seem to guarantee publicity. Furthermore, while much of it does not belong to the system of ordinary courts of Kazakhstan, it is still part of the judiciary power and is under the supervision of a sovereign nation. There is another common criticism of international commercial dispute resolution: elitism. The fact is that only sophisticated and resourceful corporations have real access to the resolution mechanisms sometimes. Only time will tell if this criticism can be made of the new Court of the AIFC or if ordinary Central Asian businesses can profit from this interesting initiative.

Since English is by all means the lingua franca of international business, having courts with English speaking staff and being sensitive to international commercial practices is by all means a good idea. English law is also common as applicable law in international contracts, so judges familiar with this legal system can also be extremely helpful, especially in Persian Gulf countries, with their long history of political and economic relationships with the UK. The cosmopolitan population of expats in the UAE and Qatar may also see with relief the presence of these English speaking courts, although it may also strengthen the Anglo-Saxon cultural grip on the world.

Nevertheless, there are fewer expats and English speakers within the business community of Kazakhstan, even with the rich mineral resources of the country. There are fears that this may

[29] Retrieved from http://aifc-court.kz/press-releases

be another failure like that of the Almaty Financial District, where just a bunch of people will again profit from the public funding invested in a new but too ambitious project.[30] The procedural advantages of English-style litigation – such as discovery and the precedent system – may add to the attractiveness of these mechanisms but may discriminate against other litigants from the host country, who may not be able to afford establishing themselves within this new financial center, nor wish to voluntarily submit to its jurisdiction.

Although experiences such as litigation and arbitration at the Dubai-based DIFC courts seem to have been successful – or at least popular, given the number of cases already heard[31] – it is still too soon to know how robust is the design of initiatives such as the courts and arbitration center of the AIFC, which opened its doors as recently as January 2018, with the negative experience of the failed Kazakhstan Stock Exchange and the Almaty Regional Financial Centre.[32]

Finally, such initiatives must not only be put in the context of the trend to create fiscally favorable and sophisticated financial centers but also within the tendency to establish special international commercial branches of ordinary domestic courts in several European and Asian jurisdictions, where lawyers from overseas have a right of audience and are allowed to practice and plead in English – which was traditionally the case in former British colonies, anyway – among other practical advantages.

The English language can also be a disadvantage for some local parties in Kazakhstan because English speaking lawyers may charge much higher fees than local ones. These initiatives may have also been put in place to compete with traditionally attractive international commercial courts like those of New York and London, especially in a European post-Brexit scenario, where some "continental" governments and local bars are planning how to divert some of the legal and litigation business which has traditionally been monopolized by London courts and practitioners.

Such "English style" business courts have already been established or announced in Paris, Frankfurt, Brussels, and Amsterdam. In Southeast Asia there are also interesting initiatives like the Singapore International Commercial Court,[33] launched in 2015, and the China International Commercial Court,[34] launched in 2018 within the broader efforts of the Belt and Road Initiative.[35]

Despite the great expectations raised by the AIFC and the AIFC Court, negative outcomes are therefore also possible. Providing the AIFC manages to attract enough business activity to this relatively isolated part of the world, there is the risk that, rather than strengthening the rule of law, this financial center will become a self-contained cocoon, completely detached from the rest of the country, legislating for the elite, providing "justice for the rich," run by extremely well paid expats with very little fruitful contact with locals and without real cross-fertilization for the benefit of the institutions of the host country. The economic model and social stratification of the abovementioned Persian Gulf nations might be an example of this, with their privileged natives, the poor and discriminated immigrants and the temporary and wealthy Westerners.

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[30] Retrieved from https://www.fdiintelligence.com/Locations/Asia-Pacific/Kazakhstan/Is-Kazakhstan-s-new-financial-center-for-real

[31] In 2017, the DIFC Courts handled 520 claims, the majority of which were employment related. The DIFC Court with a higher number of cases is the Small Claims Tribunal. Most DIFC claims are settled before going to trial. Retrieved from https://www.thenational.ae/business/difc-courts-cases-up-41-in-2017-led-by-small-claims-tribunal-1.706095

[32] Retrieved from https://www.fdiintelligence.com/Locations/Asia-Pacific/Kazakhstan/Is-Kazakhstan-s-new-financial-centre-for-real

[33] Retrieved from https://www.sicc.gov.sg/

[34] Retrieved from http://cicc.court.gov.cn/html/1/219/193/195/index.html

[35] Retrieved from https://www.ebrd.com/what-we-do/belt-and-road/overview.html

On a positive note, the AIFC and its officials seem to be really trying not only to advertise the AIFC abroad but also within Kazakhstan, establishing relationships with the local judiciary and other stakeholders. Much will depend not only on the general attractiveness of the country for foreign investors but on the ability of AIFC to properly implement its laws and regulations.

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7. Summary

English: The new Astana International Financial Center is meant to turn Kazakhstan into an attractive financial hub for foreign investors. Its own and modern legal system and dispute resolution mechanisms also have the potential to modernize the legal system of the rest of the country, but only if there are positive interactions at the institutional level.

Russian: Новый Международный финансовый центр «Астана» намеревается превратить в финансовый центр привлекательный для иностранные инвесторы Казахстан. Свои современная система юридическая и спорные разрешающие механизмы могут модернизировать систему юридическую страны если бы были положительные взаимодействие в уровень установления.

Kazakh: «Астана» Жаңа Халықаралық Қаржы Орталығы Қазақстанды шетелдік инвесторлар үшін тартымды қаржы хабына айналдырмақ. Олардың заманауи құқықтық жүйесі және дауларды шешудің тетіктері, егер қалыптасу деңгейінде оң өзара әрекеттесулер болса, елдің құқықтық жүйесін жаңғырта алады.

Editorial board