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Mechanisms for Refining Fiscal Rules and Ways to Ensure Compliance with the Rules

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The paper examines the concept of fiscal rules in a broad sense, provides an international overview of the mechanism for introducing and implementing fiscal rules, effective ways to ensure compliance with them to maintain the sustainability of public finances. It also analyzes Kazakhstan's experience in implementing fiscal rules, identifies problems, and provides recommendations for improving fiscal rules in Kazakhstan, in particular, with regard to compliance with fiscal discipline, improving mechanisms for monitoring and control over compliance with the rules, imposing responsibility for violation of rules, and increasing transparency of the fiscal policy. The implementation of these recommendations can make fiscal rules in Kazakhstan more effective.

Key Words: fiscal rules, procyclicality, government debt, structural balance, non-oil deficit, sovereign funds.
JEL Classification: H30, H61, H63, H69.

1. Preamble

Nowadays, many countries are facing the problem of budget deficits, which may lead to an increase in government debt, growing inflation and other negative consequences. Therefore, ensuring fiscal discipline is becoming a key task for sustainable economic growth and well-being. In light of recent unexpected events and new shocks caused by various factors, such as the downturn in business activity due to the pandemic, commodity cycles and geopolitical shocks, achieving fiscal discipline is a non-trivial task. As the budget deficit increases, measures are required to ensure the sustainability of public finances. Many countries are implementing fiscal rules in response to the problem of growing deficits. This trend is reflected in the increasing number of countries using fiscal rules, as well as in the growing number of studies devoted to this issue.

Research on the formulation and implementation of fiscal rules has been conducted for a long time, but there is still no consensus on their impact on the economy. The main interest of researchers is focused on the impact of fiscal rules on volatility and procyclicality of the budget balance. Despite the lack of consensus, in recent years there has been a trend in the number of countries introducing fiscal rules at the legislative level to increase budgetary responsibility. This mechanism is designed to improve the fiscal discipline and effectiveness of economic policy. In particular, such mechanisms help increase transparency of the fiscal sphere, which allows residents and investors to better understand the fiscal position of the country. This, in turn, can, if necessary, contribute to the painless implementation of fiscal consolidation, since it increases confidence in the government and its economic policy.

The purpose of this paper is to examine historical development of the mechanism for introduction and implementation of fiscal rules, analyze world practice and Kazakhstan's experience in this area, identify problems and shortcomings, and elaborate recommendations for effective compliance with formally implemented fiscal rules in the country.

2. Literature Review and Theoretical Background

The concept of fiscal rules as a tool for regulating public finances has a long history, dating back to ancient times. In the 4th century BC, the ancient Greek philosopher Aristotle emphasized the importance of maintaining a balanced budget and warned against increasing public debt.

Despite the lack of formal status, Aristotle's idea became the starting point for the further development and improvement of the concept of fiscal rules. In the 18th century, David Hume, the Scottish luminary, criticized the practice of financing budget deficits, focusing on the potential risks of inflation and the threat of undermining public confidence in the government. He advocated fiscal conservatism, emphasizing the need for governments to "live within their means" and avoid accumulating excessive debt.

During the Gold Standard, fiscal principles were more formalized, as maintaining currency stability required governments to adhere to strict fiscal constraints. Governments had to avoid running budget deficits, so that this would not lead to reduction in gold reserves and depreciation of the currency, and to avoid increasing public debt, so that this would not limit their ability to exchange currency for gold.

After the end of World War II, the global economy faced new challenges and many countries abandoned the Gold Standard. This era was dominated by the ideas of J. M. Keynes, who supported an expanded role of the government in the economy and expansionary fiscal policy. As a result of Keynesian measures, fiscal rules became more flexible and oriented towards the goals of stimulating economic growth and full employment. The 1960s were relatively stable, characterized by compliance with the implicit fiscal rule imposed by the existing monetary regime (Laidler & David, 1985). The 1970s were marked by a crisis caused by the combination of Keynesian economic policies and the oil crisis, which eventually led to a sharp increase in prices. After the collapse of the Bretton Woods system, advanced economies experienced widening fiscal imbalances. Strong increases in government spending were not accompanied by a commensurate improvement in revenue performance; on the contrary, tax revenues declined due to the slowdown in economic activity. As a result, these countries experienced a long-term increase in budget deficits and debt burdens, and governments in developed countries were encouraged to take measures to reduce deficits and debt burdens by cutting public spending and implementing fiscal rules (Masson & Mussa, 1995). In the 1980s, general fiscal rule guidelines were in place in nine countries, including four advanced economies (Davoodi et al., 2022).

In the early 1990s, interest in fiscal rules was sparked by the Maastricht Treaty, which set debt and deficit criteria for accession to the European Union. This was driven by the effectiveness of the fiscal rule framework in the context of union coalitions, as it limits budget waste and ensures sufficient fiscal discipline (Gaspar & Amaglobeli, 2019).

In such contexts, supranational fiscal rules are adopted in addition to national ones and are binding on all member countries of these organizations (Budina et al., 2012). As of the end of 2021, supranational fiscal rules were in force in 53 countries (Davoodi et al., 2022).

Episodes of global crises serve as an impetus for the development, implementation or abolition of fiscal rules. Thus, after the 1998 crisis, fiscal rules began to be actively implemented in developing countries with the aim of fiscal policy reformation. As a result of the 2008 global crisis and the decline in commodity prices in 2014-2015, many countries began to revise their fiscal rules. In 2020, the budget deficit in 90% of countries exceeded the limits of fiscal rules. This happened due to the need to increase government spending to support the economy and population in the context of the COVID-19 pandemic (Davoodi et al., 2022). According to the IMF, by the end of 2022, the number of countries explicitly or implicitly applying fiscal rules increased to 105, of which 35 were advanced economies and 70 were emerging markets (Davoodi et al., 2022). Thus, despite early references to fiscal rules, the main trends in their development were observed after the 1990s, when developed countries began to expand the use of rules and over time improved the mechanism for their implementation, gave them flexibility depending on the situation, and strengthened the monitoring of compliance with the rules.

One of the first academic papers to offer a formal definition of fiscal rules is Alesina and Perotti (1995). The authors define a fiscal rule as a formal or quasi-formal constraint that is imposed on government fiscal decisions to ensure long-term budget sustainability and prevent unsatisfactory public finance outcomes. In more recent studies, the term "fiscal rule" takes on clearer definitions: a set of rules, constraints, and principles established to govern the fiscal policy

and the financing of the state budget in order to ensure stability, sustainability, and efficient management of public finances. Rules may vary depending on specific economic conditions, the political environment, and strategic goals of the government. Thus, during economic downturns (e.g. Belgium in 2000) or during changes in political regimes (e.g. the United Kingdom in 2002, Canada in 2005), rules were relaxed or had been abolished.

In terms of terminology, a fiscal rule may be called by different names depending on the country. For example, in the Netherlands it is called a budget norm, in the European Union it is called a benchmark, in Indonesia it is called a guiding principle, and in New Zealand it is called a principle. The term rule is rarely used for legislative purposes, as it can be perceived as a rigid constraint that is difficult to comply with.

According to the criterion of the object of regulation, fiscal rules are divided into two types: borrowing rules, which regulate the amount of government borrowing, and reserve rules, which regulate the amount of government reserves. (Kopits & Symansky, 1998).

Borrowing Limit Rules:

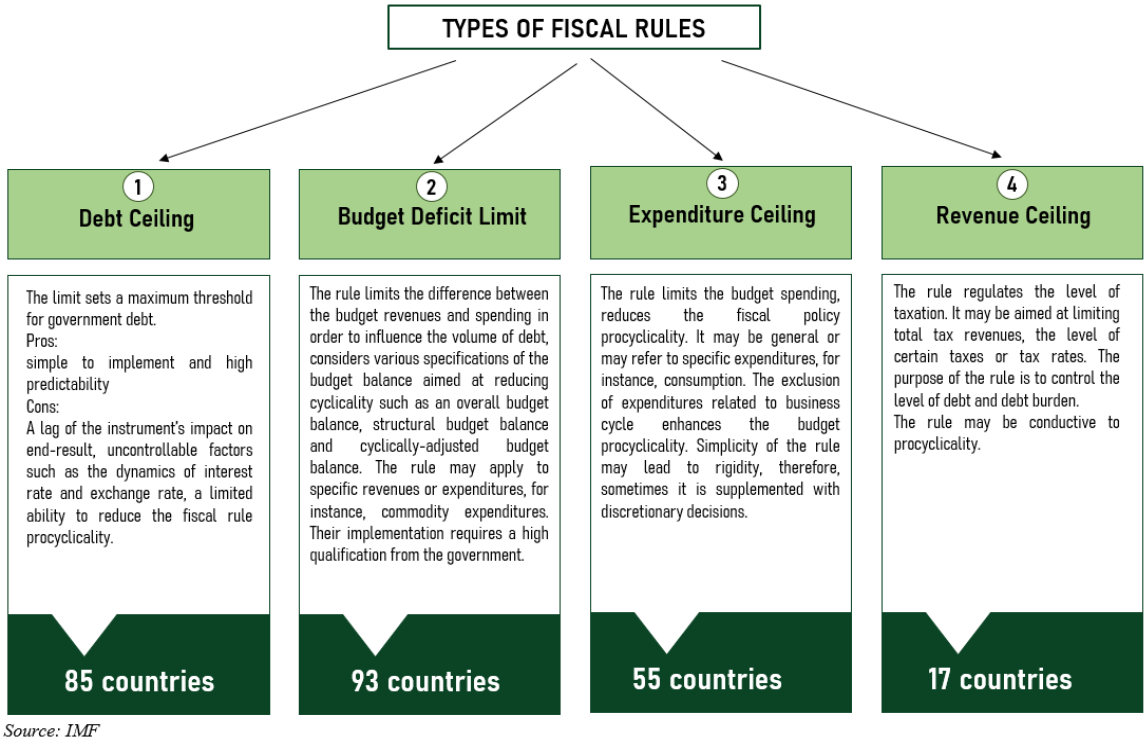
1. Prohibition of government borrowing from domestic sources. This type of rule prohibits the government from borrowing money from its residents or companies and can be an effective way to curb debt growth, but it can also limit the government's ability to finance important expenditures such as education, health care, and infrastructure.

2. Prohibition of government borrowing from the central bank. This type of rule prohibits the government from borrowing money from the central bank and helps prevent inflation, but it can also limit the government's ability to finance budget deficits.

3. Restricting government borrowing by setting a limit on its share of revenues or expenditures. This type of rule limits the amount of government borrowing as a percentage of past revenues or expenditures and helps control debt growth, but can also limit the government's ability to finance important expenditures during periods of economic downturn. Examples of such rules include: limiting the amount of government debt to the amount of gold and foreign exchange reserves, limiting the cost of servicing and repayment of government debt to 15% of state budget revenues, and others.

Figure 1

Types of Fiscal Rules and the Number of Countries that Implemented a Certain Type of the Rule



Source: IMF

Reserve conservation rule – setting a target level for the reserves of extra-budgetary reserve funds (such as social security funds, sovereign wealth funds, etc.). This rule requires the government to maintain a certain level of reserves in extra-budgetary reserve funds in order to ensure that they can continue to pay benefits in the future. An example of such rules is the Chilean fiscal rule, according to which the government must generate a primary surplus each year in order to provide savings for sovereign wealth funds that will finance social security expenditures when copper resources are exhausted.

Fiscal rules by budget indicators are divided into four types (Budina et al., 2012): debt limit rules, deficit limit rules, expenditure limit rules, and revenue limit rules (Figure 1).

The IMF Report entitled "Fiscal Rules and Fiscal Councils: Recent Trends and Performance during the COVID-19 Pandemic" (2022) says that about 70% of countries with fiscal rules have a debt ceiling rule combined with operational constraints on aggregate annual budget figures. Debt ceiling rules are particularly common in developing countries, with more than 80% of countries having them. Expenditure ceiling rules are becoming increasingly popular and are often set as a ceiling on annual expenditure growth. Revenue rules are less common, partly reflecting the fact that governments have less control over annual revenues. About three-quarters of advanced economies have expenditure ceiling rules, while less than a third of emerging market and developing countries have adopted expenditure rules (Brazil, Mongolia, Paraguay, etc.).

In countries where the extraction and export of raw materials are key industries, fiscal rules are characterized by a number of features. When developing such rules, countries primarily strive to achieve two goals: uniform consumption of resource wealth and approval of the cut-off price. The structural budget balance rule is most consistent with these goals. It is based on the permanent income hypothesis, which assumes that household consumption depends on their long-term income, not on current income. Uniform consumption of the estimated volume of resources protects the fiscal policy from cyclical fluctuations. A non-resource budget deficit can be covered by fixed transfers from the already accumulated reserve from the sale of natural resources or part of the current income from the sale of natural resources. The practical implementation of the structural budget balance rule comes down to the key task of finding the long-term (equilibrium) price of the resource (Skrypnik, 2016). An example of such rules is the Chilean rule, whereunder the structural budget deficit should not exceed 1% of GDP. In this case, the structural budget deficit is calculated on the basis of expected structural income, i.e. income from the raw materials sector at their long-term price.

Any one of the four types of fiscal rules addresses various budget parameters in one way or another. The choice of a particular type of fiscal rule may vary depending on the specific circumstances of a country and the reason for its implementation.

The main rationale for establishing fiscal rules is to ensure macroeconomic stability. In some Western European countries and in Japan, balanced fiscal rules were introduced primarily to support economic stabilization in the post-war years. Restrictions on government borrowing from all sources (as in Indonesia), especially from the central bank, were seen as a way to maintain stability, removing the main source of monetary base creation and hence inflationary pressure (Kopits & Symansky, 1998). In Costa Rica, a balanced budget rule was proposed to eliminate deficits caused by the electoral cycle. In New Zealand and Switzerland, fiscal rules were introduced to consolidate the results of previous efforts to reduce budget deficits and to prevent future increases in government debt, for example, caused by an ageing population.

There are several studies in the literature that identify institutional and economic factors that explain why countries adopt fiscal rules. Elbadawi, Schmidt-Hebbel & Soto (2015) in a study of 89 countries over the period of 1975–2008 identify five categories of potential determinants of the choice of fiscal rules:

– political and institutional factors;
– conditions of fiscal policy;
– monetary and foreign exchange regimes;
– forms of the financial market development;

– general level of the country's development.

According to the authors, inflation targeting countries and, to a lesser extent, countries with fixed exchange rate system have a stronger incentive to adopt fiscal rules. The second and most important finding was the absolute importance of all the identified political and institutional variables that determine fiscal rules: democracy, federalism, checks and balances, political stability.

Combes et al. (2014) analyze the impact of inflation targeting and fiscal rules on fiscal stance and inflation in 152 countries, including advanced and developing economies, over the period of 1990–2009. The authors find that inflation targeting and fiscal rules improve a country's fiscal behavior and reduce average inflation when they are used in combination rather than separately. However, the sequence of their implementation also matters. Countries that adopted fiscal rules before adopting inflation targeting have performed better in ensuring macroeconomic stability.

Apeti et al. (2023) in their study based on panel data of 57 resource-rich countries for the period of 1976–2021 find support for the hypothesis that fiscal rules reduce the procyclicality of government spending. However, the effectiveness of fiscal rules on fiscal discipline depends on their type. Fiscal rules based on expenditure ceiling or deficit limits are the most effective. The authors also note that the effectiveness of fiscal rules depends on their quality, i.e. they must be clearly spelled out and have clear mechanisms for monitoring and sanctions in case of non-compliance.

3. International Practice of Implementing and Using the Fiscal Rules

In global practice, the mechanism for implementing and enshrining fiscal rules is quite diverse. Thus, fiscal rules can be enshrined in the constitution, law, regulation, political guidelines, or international treaty. In Germany, the balanced budget rule is enshrined in the constitution and confirmed in budget laws. Fiscal rules proposed in Costa Rica, Switzerland, and the United States also require a constitutional amendment. Most U.S. states where fiscal rules are in effect have constitutional requirements for a balanced budget approved by the state referendum. In other states, fiscal rules are based on legislation adopted at the state level. In Indonesia, the fiscal rule is a political commitment but has no legal force, and the Ministry of Finance adheres to this rule when drafting and implementing the budget.

Regardless of the form of consolidation of fiscal rules, their development and successful implementation require a high degree of efficiency and professional qualifications from the government. Otherwise, this instrument may prove to be ineffective (Skrypnik, 2017).

Another alternative to ensure the effective implementation of fiscal rules may be the creation of independent fiscal institutions, such as national councils, financial councils, etc. (B. Eichengreen et al., 1999).

A fiscal or financial council is a body that advises the government on fiscal policy. Its powers may range from making recommendations to making decisions. In recent years, councils with formal advisory functions have become increasingly common.

International practice shows that, depending on the specific circumstances and traditions of a particular country, fiscal rules can be effectively enforced even by an organization close to or part of the government. However, a certain degree of independence of the supervisory authority is desirable to ensure compliance with the rules. In addition, the more complex the set of rules, the greater the need for a technically competent supervisory authority. For example, in order to improve the discipline of compliance with the rules, many EU countries have established specialized fiscal councils. Concentrating efforts on improving the discipline of compliance with the rules is a general trend, which, however, is accompanied by attempts to make them more flexible (Skrypnik, 2017).

The number of fiscal boards has doubled over the past decade. Many were created to monitor new fiscal rules or to respond to external pressures following major shocks. The pandemic has put rules-based fiscal systems to the test. As a result, waiver clauses have been widely

activated, allowing for temporary suspension of fiscal constraints. This has provided flexibility in providing emergency financial support to households and firms (Davoodi et al., 2022). There are a number of studies in the recent literature that support the benefits of well-implemented fiscal rules. For example, Caselli and Reynaud (2018) show in their study covering a large dataset of over 140 countries between 1985 and 2015 that the average country's budget deficit was 2.1% of GDP in the absence of fiscal rules, compared to 1.7% of GDP in the presence of fiscal rules.

Céspedes and Velasco (2013) examined the implementation of fiscal policy in 32 resource-rich countries during the periods of economic growth and recession. The authors found that fiscal policy during the commodity price boom of the 2000s, compared to the boom of the 1970s, was generally more countercyclical, particularly in Latin America and the Middle East. This was facilitated by factors such as improved institutional environments, the use of fiscal rules, and changes in the exchange rate regime. The mechanism for implementing fiscal rules for resource-exporting countries is closely related to the concept of sovereign wealth funds. The researchers found that in countries with sovereign wealth funds, fiscal policy is much less susceptible to cyclical fluctuations (Youssef et al., 2018). The fiscal rule allows resource-exporting countries to smooth out economic fluctuations caused by changes in commodity prices and reduces the volatility of macroeconomic indicators, making the economy more resilient. In this regard, the experience of Chile, Norway and Russia is of particular interest.

Chile's Experience. Chile was one of the first countries to implement a fiscal rule after the government achieved a significant reduction in public debt from 165% of GDP in 1985 to 20% of GDP in 2000. Chile implemented an informal fiscal rule in 2001, which was formally enshrined in law only in 2006 (Fiscal Responsibility Law). According to this law, the cyclically adjusted primary budget balance must be in surplus of 1% of GDP, and since 2010, the structural budget deficit must not exceed 1% of GDP. The structural budget deficit is calculated on the basis of expected structural revenues, that is, revenues from the commodity sector at their long-term price. Chile uses a fiscal rule based on the structural fiscal balance to mitigate the effects of price fluctuations in copper, the country's main export item.

The Autonomous Fiscal Council (previously known as the Fiscal Advisory Council) is responsible for providing the Chilean government with GDP and long-term copper price forecasts, which are used to calculate budget expenditures. Chile's fiscal rule requires the government to generate a primary surplus each year to fund sovereign wealth funds that will finance social security spending when copper resources run out. (Wyplosz, 2011).

Chile has two sovereign wealth funds: the Economic and Social Stabilization Fund and the Pension Reserve Fund. Their main purpose is savings and stabilization. During the COVID-2019 pandemic, Chile used the Economic and Social Stabilization Fund to provide rapid support to the population in three areas: increasing funding for the health system, implementing measures to protect workers from loss of income, and supporting small and medium-sized enterprises through preferential tax measures. Such extensive support measures led to violations of fiscal and monetary rules, just as in some other countries.

In 2022, a third fund was created to finance expenses related to natural disasters.

Overall, the relatively successful Chilean experience in introducing and implementing fiscal rules until 2020, according to Wyplosz (2011), Fuentes et al. (2021), can be attributed to several factors:

1) consolidation of rules at the legislative level, which, together with strong institutional and economic foundations, contributed to the sustainability of the economy;

2) the presence of an independent financial board that is involved in the budgeting process, which helps ensure that spending is balanced over economic cycles;

3) transparency of the budget preparation process, which is ensured by the publication of the cyclically adjusted budget calculations and detailed explanations for the public.

Norway's Experience. The Norwegian economy relies heavily on oil and gas exports. The oil and gas industry is under government control and provides the majority of the country's income. In order to preserve oil and gas revenues for future generations, the State Petroleum Fund

was established in Norway in 1990, which was transformed into the Government Pension Fund in 2006. The fund began to be filled in 1996 and, since the pandemic of 2020, has financed almost 20% of budget expenditures. According to the Government Pension Fund Act, which regulates the use of the Fund's resources, transfers from the fund can only be made to the state budget after a decision by the parliament.

In 2001, Norway introduced a fiscal rule to ensure that oil revenues are distributed correctly according to their expected profitability. The guiding principles of the fiscal rule are:

1) a budget deficit limitation rule, which stipulates that in the long term the non-oil budget deficit should be close to the expected average return on the Fund's assets (estimated at 3% of its assets); the budget deficit is calculated on the basis of the structural fiscal balance;

2) reserve rule, which requires budgetary measures to maintain the real value of the fund for the benefit of present and future generations. Particular attention should be paid to smoothing out fluctuations in the economy to ensure reasonable capacity utilization and low unemployment (Report to the Storting (white paper) The National Budget, 2023).

Norway's experience is often seen as a successful example of implementation of a fiscal rule mechanism for the purpose of effective resource revenue management and macroeconomic stability. Thus, key factors in the success of the Norwegian fiscal rule are: (Official Norwegian Reports NOU, 2015):

1) fiscal discipline. Norway's average budget deficit in the pre-pandemic period did not exceed the established limits, moreover, the government does not use revenues from the oil sector to finance the budget deficit, but the expected real return on the Fund's assets. This makes fiscal policy disciplined and resilient to external shocks;

2) stability of fiscal rules. Since 2001, the rules have not changed significantly, but when the fiscal rules were introduced, the expected real return of the fund was set at 4%, and since spring 2017 the estimate has been reduced to 3%;

3) correct calibration. The upper limit of Norway's structural deficit rule is set so that to ensure both long-term fiscal sustainability and intergenerational equity in the use of resource revenues (Eyraud et al., 2018);

4) transparency. The Norwegian Parliament holds public hearings on the approval of the annual budget and also holds discussions related to the budget audit report. A wide range of stakeholders have the opportunity to influence the priorities and areas of audit of the use of public funds. Key budget documents are publicly available online. Norway has a score of 81 out of 100 in the Open Budget Index (2021 data) and has been among the top countries with high transparency scores for several years in a row[1].

Russia's Experience. At the end of 2003, Russia adopted fiscal rules, which also became the basis for creation of the Stabilization Fund. The rules stipulated that if the base price for Urals crude oil exceeded US$20 per barrel, additional revenues from oil and gas exports should be allocated to the Stabilization Fund. However, over the past two decades, fiscal rules in Russia have undergone a number of changes. They have become more flexible and take into account the current situation on the oil market and are aimed at gradually reducing the non-oil and gas budget deficit and dependence on oil and gas revenues.

Since 2017, a fiscal rule has been in effect in Russia, enshrined in the Federal Law of the Russian Federation of July 29, 2017 No. 262-FZ "On Amendments to the Budget Code of the Russian Federation in Terms of the Use of Oil and Gas Revenues of the Federal Budget". According to the rule, the maximum amount of federal budget expenditure is determined as the amount of:

– the base volume of oil and gas revenues calculated at the base price of oil and gas and the forecast exchange rate of the ruble; this volume represents the expected budget revenues from oil and gas exports;

[1] www.internationalbudget.org/open-budget-survey

– the volume of non-oil and gas revenues calculated during the preparation of the budget law; this volume represents the expected budget revenues from other sources, such as taxes, fees and duties;

– spending on servicing the government debt; this volume represents budget expenditures on paying interest on government bonds.

The reference oil price is the average annual oil price of US$40 per barrel in 2017 prices, subject to annual indexation by 2% starting in 2018 (Eurasian Economic Policy, 2020).

The effectiveness of fiscal rule in Russia depends on how low the base oil price is. According to Vlasov and Khazhgerieva (2022), in the current version of the fiscal rule, the base oil price of US$40 per barrel is conservative because it is below the breakeven price of marginal oil producers, which are considered to be the US shale companies. Such a conservative price contributed to the accumulation of funds in the National Welfare Fund and ensured the sustainability of government spending at low oil prices.

In Russia, the smoothing mechanism for oil and gas revenues based on the base oil price ceased to work after February 2022. In July 2022, the Russian Ministry of Finance proposed modifying the fiscal rule and raising the cutoff price to US$60 per barrel when calculating base oil and gas revenues, as well as fixing the production volume at 9.5 million barrels per day[2]. This proposal caused controversy among experts who believe that the new budget rule will contribute to the volatility of key macroeconomic indicators, GDP in particular, and will limit the scope for countercyclical policies.

In general, the Russian experience of applying fiscal rules and the establishment of sovereign funds allowed smoothing out economic fluctuations until 2022 and created conditions for conducting a countercyclical budget policy (Vlasov & Khazhgerieva, 2022; Andreev, 2022). At the same time, at present, in the absence of the ability to accumulate external assets, the previous fiscal rules have proven ineffective, and in the future, new fiscal rules may be developed and implemented, for example, rules for saving oil and gas revenues within the country while concurrently using the debt market to smooth out budget revenues (Andreev, 2022).

4. Mechanism of Fiscal Rules Implementation in Kazakhstan

Kazakhstan, like many other developing oil-producing countries, has a procyclical fiscal policy and is susceptible to the “Dutch disease”. This is related to the fact that oil revenues make up a significant part of the state budget of Kazakhstan. Thus, during the period from 2018 to 2022, the share of oil revenues in the state budget averaged 34%. In this regard, for Kazakhstan, fiscal rules are an important instrument of fiscal policy that eliminates macroeconomic volatility, as well as the risks and consequences of the “Dutch disease” by accumulating in “good” times and increasing public spending on the development of non-oil sectors of the economy in times of crisis.

In 2000, Kazakhstan carried out an important reform of the budget system aimed at reducing the economy’s dependence on oil revenues and ensuring the country’s sustainable development in the long term. As part of this reform, the National (Oil) Fund of the Republic of Kazakhstan (NOF) was created, which accumulates the country’s oil revenues[3]. The key functions of the NOF are stabilization and savings. To perform the savings function, a minimum balance is established in the NOF, and to implement the stabilization function, it is assumed that a guaranteed transfer will be allocated to the national budget.

Thus, the fundamentals of the mechanism for implementing fiscal rules in Kazakhstan were laid in 2001, when excess tax and other mandatory payments from organizations in the raw materials sector began to be transferred not to the budget but to the NOF. However, a clearer formulation of the receipts and withdrawals of funds from the NOF was formalized in 2005 in the first Concept of the Formation and Use of the NOF Funds for the Medium Term[4]. For the first time, such concepts as non-oil deficit, base oil price, guaranteed and earmarked transfer from the

[2] https://www.vedomosti.ru/economics/articles/2022/07/18/931917-minfin-zakupat-valyutu
[3] Presidential Decree of the Republic of Kazakhstan dated August 23, 2000 No.402.
[4] Presidential Decree of the Republic of Kazakhstan dated September 1, 2005 No. 1641.

NOF were mentioned in this Concept. The guaranteed transfer from the NOF to the budget was limited to one third of the NOF assets at the end of the year preceding the year of drafting of the national budget. The main problem was the mechanism for determining the base oil price when planning the national budget.

In 2010, the second Concept[5] defined new approaches to the formation and uses of the NOF resources. The main innovations included the fixing of a guaranteed transfer in the amount of US$8 billion per year; the prohibition of other expenses, including targeted ones, as well as the prohibition of the acquisition of securities; lending and the use of government and quasi-government assets as collateral; setting a minimum balance of the OF at 20% of the projected GDP value at the end of the relevant financial year. The definition of the "base oil price" was excluded from the Concept. At the same time, the first "explicit" fiscal rules to limit spending on debt servicing and the non-oil deficit began to be formulated:

– annual spending on servicing the government debt must not exceed the NOF's fixed contingent investment income of 4.5%;

– spending on servicing and extinction of the government debt over a ten-year period on average must not exceed 15% of budget revenues including a transfer from the NOF;

– non-oil deficit should be no more than 3% of GDP by 2020.

The third version of the Concept[6] was adopted in 2016 and was later amended on several occasions. The main fiscal rules enshrined in the third version of the Concept were:

– a gradual reduction of the guaranteed transfer from the NOF;

– determination of the purposes for which targeted transfers will be allocated by decision of the President (anti-crisis programs during the periods of economic downturn or slowdown in economic growth, non-recoupable socially significant projects of national scale, strategically important and infrastructure projects in the absence of alternative sources of their financing);

– setting a "cut-off" oil price at US$40 per barrel;

– a gradual reduction of the level of non-oil deficit to 6.0% of GDP by 2025;

– limitation on the use of the NOF: a minimum balance of 30% of the forecast value of GDP at the end of the relevant year;

– spending on servicing and extinction of the government debt should not exceed 15% of the national budget revenues, including transfers from the NOF;

– the volume of the Government's debt and the external debt of quasi-government sector entities must not exceed the total amount of NOF foreign currency assets.

According to Ybraev et al. (2022), the fiscal rules contained in the Concept until 2020, although useful for accountability purposes, were not designed to promote long-term economic growth and structural transformation of the economy. Fiscal rules that are truly countercyclical in nature were introduced in the third Concept in December 2020. These include: setting a cut-off price, which is a conservative price to prevent excessive withdrawals from the NOF, and setting the level of the non-oil deficit (Ybraev et al., 2022).

In September 2022, a new Concept of Public Finance Management of the Republic of Kazakhstan until 20307 was adopted[7], which defines a set of main and auxiliary fiscal rules aimed at ensuring budget sustainability and reducing the volatility of fiscal policy. The main fiscal rules include:

1) the guaranteed transfer rule: the guaranteed transfer should not exceed the volume of receipts to NOF from oil sector organizations projected at the oil price (cutoff price); the cutoff price will be adjusted for the growth in oil production; if the production level exceeds 90.5 million tons per year, the cutoff price will be adjusted downwards; from 2024, the size of the guaranteed transfer is projected to be no higher than 2 trillion tenge;

2) expenditure rule: a limit is set on the growth rate of the national budget expenditures for the planning period at the level of long-term economic growth multiplied by the inflation target;

[5] Presidential Decree of the Republic of Kazakhstan dated April 2, 2010 No. 962.
[6] Presidential Decree of the Republic of Kazakhstan dated December 8, 2016 No. 385.
[7] Presidential Decree of the Republic of Kazakhstan dated September 10, 2022 No. 1005.

the growth rate of planned expenditures will also be limited by non-oil budget revenues and the guaranteed transfer from the NOF to the national budget projected at the "cut-off" price, the earmarked transfer, as well as the deficit planned taking into account the established limits;

3) a gradual reduction of non-oil deficit to the level not exceeding 5 % of GDP in 2030.

In general, the analysis of the experience of implementing fiscal rules in Kazakhstan showed that the fiscal rules in the country are formal in nature, often change and are mostly not observed. Alpysbaeva et al. (2021) note that at the end of 2020, out of 12 existing fiscal rules, 5 rules were not observed, two rules were close to being violated, and in general these rules did not have countercyclical features, since they did not take into account the state of the current economic growth cycle.

Ahmadov et al. (2017), Tuleuov et al. (2021), Alpysbaeva et al. (2021), Ybraev et al. (2022), Abilov et al. (2023), as well as the authors of this paper, based on a retrospective analysis of fiscal policy parameters and their comparison with economic cycles (Zhakupova and Khanetova, 2023), in their previous study came to the conclusion that procyclical fiscal policy prevailed in Kazakhstan until 2022, which led to high volatility of the budget balance. The lack of countercyclical nature of fiscal policy indicates that the fiscal rules were ineffective or not followed.

An empirical analysis of alternative fiscal rules in the context of oil price shocks in Kazakhstan has shown the importance of maintaining a countercyclical fiscal policy to mitigate the negative effects of oil price shocks. For example, according to the study by Ybraev et al. (2022), when fiscal policy is procyclical and fiscal rules are absent (or not followed), aggregate output contracts by about 0.19% in response to a short-term negative oil price shock of one standard deviation. In contrast, when fiscal policy is countercyclical and pursued in accordance with a fiscal rule based on the structural fiscal balance, aggregate output increases by about 0.13% in response to the same shock.

Abilov et al. (2023), based on the construction of a DSGE model, came to the conclusion that for Kazakhstan, fiscal rules aimed at limiting the growth of government spending at a long-term level of GDP growth and the use of the fixed transfer rule are the most effective, their compliance will lead to an improvement in the macroeconomic environment, and the government will achieve the goal of designing a countercyclical fiscal policy.

Taking into account the conclusions of studies conducted both by foreign and domestic authors, it is necessary to point to the special role of countercyclical fiscal rules in reducing the dependence of the tenge exchange rate and budget revenues on oil price volatility. At the same time, their effectiveness depends on their strict observance. Moreover, clearly defined countercyclical fiscal rules and mandatory adherence to them contribute not only to improving the country's fiscal behavior, but also to reducing the average level of inflation when combined with the inflation targeting policy introduced in Kazakhstan in 2015.

Thus, summarizing the international practice of introducing and implementing fiscal rules, as well as the results of research by foreign and domestic authors, we can draw the following conclusions and give recommendations for their effective implementation in Kazakhstan.

1. Simplicity and transparency. Fiscal rules must be clear and transparent to all stakeholders, including government, business and the public. This requires that the rules be written in clear, understandable language, without the use of complex terminology, and that the process of their development and implementation be open and accountable.

2. Strengthening fiscal discipline. It is important that the government has an interest in adhering to the fiscal rules and has the resources to implement them. To strengthen fiscal discipline, sanctions for breaches of the rules should be established. This should include assumptions on release from liability and a protocol for returning to long-term goals, i.e., provide for clear exceptional scenarios due to serious turbulence that could lead to a formal temporary suspension or deviation from the principles of fiscal rules. Since the violation of the rule is a temporary phenomenon, the relevant instruments and measures should also be considered in terms of their temporary nature.

3. Fine-tuning the countercyclical mechanism. Fiscal rules should be aimed at smoothing out economic fluctuations in response to external shocks, including reducing the budget deficit during periods of economic downturn. For these purposes, Alpysbaeva et al. (2021), Zhakupova and Khanetova (2023) proposed introducing fiscal rules that target the structural fiscal balance. However, given the complexity of calculating the structural fiscal balance, we believe that at the first stage it is sufficient to target the non-oil fiscal balance.

4. Establishment of an independent authority for monitoring and control over compliance with fiscal rules. Such authority will assist in independent assessment of compliance with the rules and enhance their effectiveness, and will conduct regular monitoring of fiscal rules effectiveness. This will allow for timely identification and elimination of shortcomings in the fiscal rules mechanism.

5. Increasing the independence and expanding the powers of the NOF Management Council. Currently, the Council is not an independent body, since its composition is approved by the President and consists of members of the Presidential Administration, the Government, and the National Bank. In order to increase the independence of the Council, it is necessary for it to include independent, highly qualified experts who must be appointed by the Parliament.

6. Transparency and accountability of the process of allocating transfers. This requires, in particular, ensuring openness of the information on the distribution of transfers, including criteria for the effectiveness of the use of targeted transfers, and conducting regular monitoring of their use, the results of which should be widely publicized.

Conclusion

Fiscal rules are particularly important for resource-rich countries, as they can be a key tool in managing revenues from resource extraction. These rules promote sustainable financial management by preventing risks associated with commodity price fluctuations. They can also help establish stabilization funds, providing the country with reserves for periods of falling prices and ensuring long-term economic stability.

The experience of Chile, Norway and Russia shows that fiscal rules can be an effective tool for ensuring sustainable development of countries with rich natural resources. These rules help prevent excessive growth of the government debt and the NOF, and also contribute to larger investments and economic growth. Fiscal rules are an effective tool, but their successful implementation requires a high level of political will and public support.

In Kazakhstan, since 2005, there have been attempts to introduce fiscal rules: having the NOF's minimum balance, limiting the growth of budget expenditures, reducing the non-oil deficit, allocating the guaranteed transfer from the NOF. However, over time, they were continuously subject to changes, were not complied with or had been violated, causing the prevalence of the procyclical nature of Kazakhstan's fiscal policy. To overcome the procyclicality of fiscal policy, it is necessary to ensure compliance with fiscal rules, which requires a high level of political will, professionalism and transparency.

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Development Prospects for Insurance Annuity and Life Insurance

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The paper is devoted to the analysis of the current state of the life insurance market and its individual classes. The international experience of the life insurance industry development is reviewed; the position of Kazakhstani life insurance companies (LICs) is analyzed. The description of three main classes is given, the dynamics of insurance premiums is assessed and outstanding issues existing in Kazakhstan life insurance practice are raised. The article is prepared in the format of a review in order to draw attention to the problems of the life insurance market and discuss the prospects for its development.

Key Words: life insurance, pension annuity, accident and health insurance, life insurance companies.

JEL Classification: G22, H55, J26.

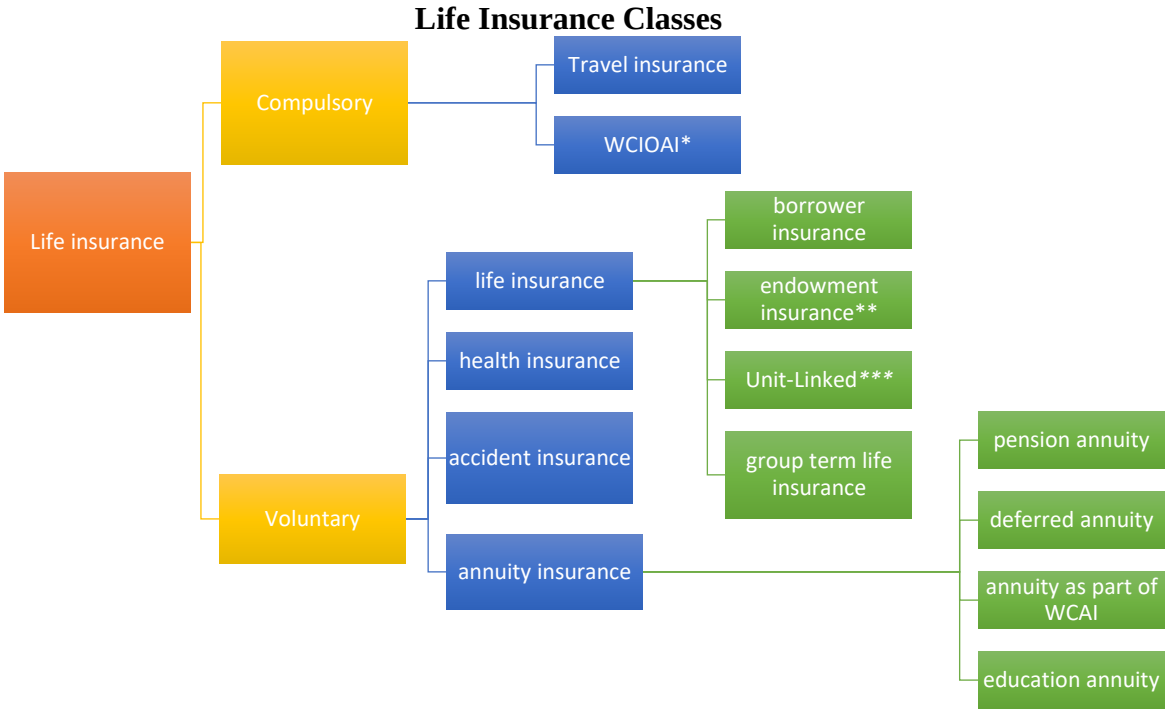
Preamble

Insurance market instruments are widely used to ensure financial security and reduce the degree of potential damage in the event of an insured event. In everyone's life, there are unfavorable situations that can lead to undesirable consequences associated with loss of income or the occurrence of unforeseen expenses. Financial consequences arising from the implementation of various risks can be covered from the insurance fund accumulated through insurance premiums to the insurance company. This is especially important in the case of complete or partial loss of working capacity. The principle of operation of the insurance industry is the transfer of insurance premiums, one-time or periodic, to the insurance company, which, in turn, guarantees cash payments in the event of an insured event or in other situations specified by terms and conditions of the policy.

Insurance plays a vital role in ensuring socio-economic stability and from the standpoint of social protection of the population, the life insurance industry is especially important. According to the Law of the Republic of Kazakhstan dated December 18, 2000 No. 126 "On Insurance Activities", life insurance is a set of types of insurance that provide for insurance payouts in the event of the death of the insured or their survival until the policy expiry date or until a certain age. In addition, the life insurance industry includes insurance within the framework of the state educational accumulative system (SEAS), which provides for savings for the education of a child.

The life insurance industry is composed of a number of insurance classes, including compulsory insurance of employees against accidents in the course of performance of their work duties and 4 classes in the voluntary form of insurance: life insurance, annuity insurance, life insurance under the SEAS and pension annuity insurance, each of them being further divided into subclasses (Figure 1).

Figure 1



* WCIOAI – Workers Compensation Insurance and Occupational Accident Insurance (compulsory insurance of employees against accidents in the course of performance of their work (official) duties);

** Endowment insurance is a type of life insurance that allows the policyholder to accumulate a certain amount; in case of an insurant's death, the contracted amounted is payable to the person specified in the contract: contracts are made in the tenge and foreign currency;

***Unit-Linked is an investment product that allows investing monies in various assets (shares, bonds, mutual funds, ETFs) within the life insurance contract and is a hybrid of classical endowment life insurance with an investment component.

Workers Compensation Insurance and Occupational Accident Insurance was introduced to ensure the protection of employees at work. Initially, this type of insurance was classified as compulsory insurance through general insurance companies, and the insurance contract was concluded for a year and did not take into account the need for lifelong payments in case of serious injuries to the employee received at work. Only after some time, this type of insurance was referred to the life insurance industry, since injuries at work are mostly associated with damage to health and life of an employee. At the transition stage, in order to insure employees against accidents at work, life insurance companies (LICs) also concluded such contracts for 1 year, without fully assessing the insurance risks. Currently, adjustments have been made, whereunder LICs are obliged to make payouts within the framework of insurance events until the insured person has fully restored his or her ability to work, and not only within a year.

Only a part of voluntary life insurance products can be fully classified as voluntary, since often, individual products are upsold by other related financial organizations to obtain additional profit. A striking example is life insurance of a borrower when receiving a loan from a bank, which de jure is a voluntary form of insurance, but in fact, borrower's refusal of insurance will mean refusal to provide a loan by the bank.

Annuity insurance is a type of accumulative insurance, where after the policyholder has accumulated a certain amount or has lived to a certain age, the funds from the annuity fund will be paid to the insured for several years or for life. In the Republic of Kazakhstan, there are several types of annuity insurance, one of which is a pension annuity. This paper presents an overview of the life insurance industry, an analysis of its current state in general and individual classes, international experience in the development of the life insurance industry and life insurance, as

well as the prospects for life insurance in Kazakhstan. The paper presents the results of the analysis of collection of "net" premiums for three main classes of life insurance. By "net" premiums, the authors mean the difference between gross collected premiums and expenses under insurance contracts: reinsurance costs, payment of fees, and termination of contracts.

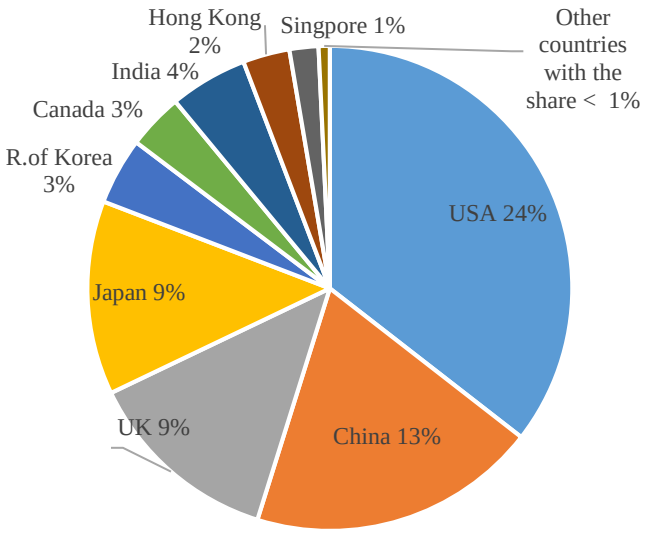
International Experience in the Field of Life Insurance

The global life insurance market is showing steady growth, driven by the continued need for financial protection and partly by the ageing population. High wages and interest rates in developed countries create favorable conditions for growth and profitability for companies operating in the life and annuity segments. These factors offset the pressure from high inflation. This segment is expected to show growth in the coming years, with premiums increasing by 1.5% in 2024, driven by factors such as higher investment returns and reduced payments on the COVID-19-related liabilities (Swiss Re Institute, 2023). Risks to the global life insurance market include weak global economic growth due to tighter monetary policy, inflation, and the risk of credit rating downgrades.

The leader in the life insurance market on a global scale is the United States; the country's share is 24% of the global figure (Figure 2). Such market size is explained by the fact that in the United States, life insurance and, in particular, pension annuities, are very popular among the population and are widely used to ensure a stable income in retirement.

Figure 2

A Country-by-Country Breakdown of Insurance Premiums in Life Insurance Business



Source: compiled by the authors based on the report of Swiss Re Institute, 2023

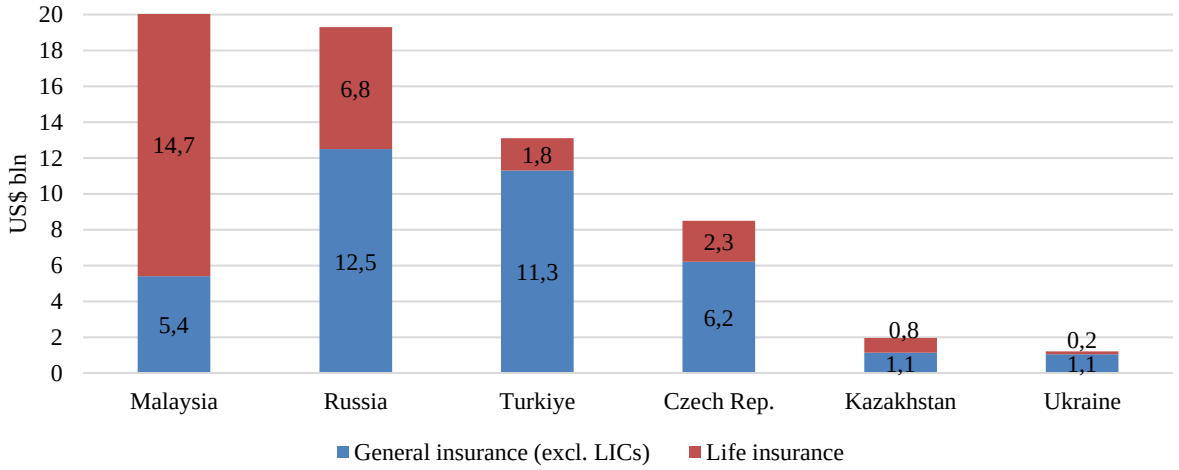
The next largest markets in this industry are China (13% of global volume), the UK (9% of global volume) and Japan (9% of global volume). Annuities are also popular in Europe. The Republic of Korea, Canada, Hong Kong and Singapore are significant market players, each accounting for between 1.5 and 3% of global insurance premiums (Figure 2).

Among developing countries, the largest volume of premiums is received by the markets of India (3.5%), Malaysia (0.5%) and Russia (0.2%).

In Russia, life insurance accounts for 35% of premiums of the total insurance volume; in 2022, the volume of premiums in this segment amounted to almost US$7 billion, which is due to a significant increase in premiums for endowment life insurance (an increase of 58.6%).

Figure 3

Volume of Premiums in Life Insurance in Terms of Emerging Markets, in 2022



Source: compiled by the authors based on the report of Swiss Re Institute, 2023

In developing countries such as India and Brazil, the volume of pension annuities is growing, which is associated with an increase in average life expectancy and the need to ensure financial stability in retirement.

In Kazakhstan, the volume of life insurance premiums in 2022 amounted to US$818.9 million, or 42% of the total volume of insurance premiums in the country (Figure 3), which is by 0.7% less than the same indicator of the previous year. Negative trend in the premium growth indicates the existing difficulties in this insurance sector.

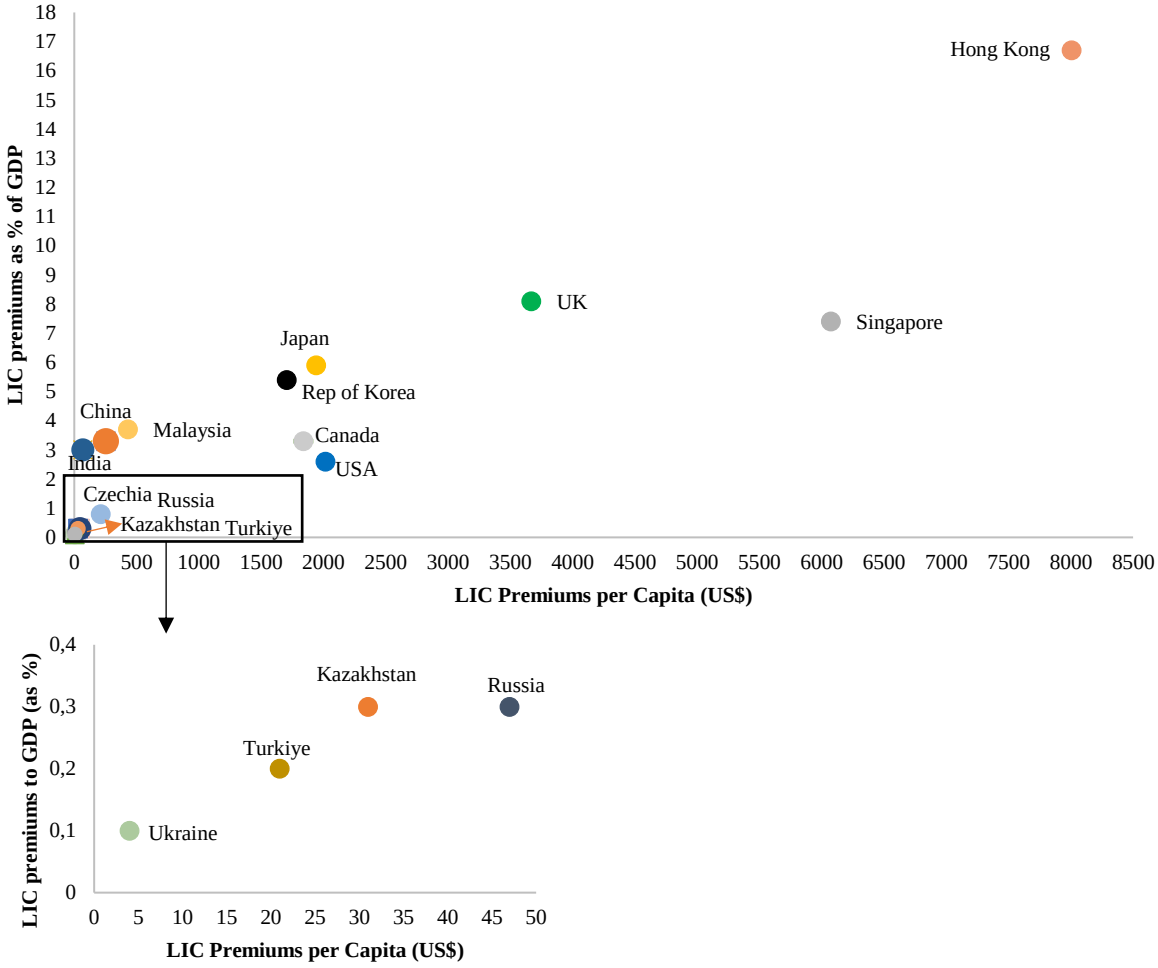
Given the different sizes of the economies of countries, their growth rates and population sizes, such indicators as the ratio of life insurance premiums to GDP and to population are more representative. In 2022, Hong Kong was a noticeable leader in these indicators, where the volume of life insurance premiums per person is US$8 thousand, and as a percentage of GDP is 16.7% (Figure 4). The United States, the overall market leader, has average ratios of LIC premiums to GDP (2.6%) and population (US$3,700), which is explained by the size of the economy. In China, for the same reasons as in the United States, these figures are lower than the global market and amount to US$255 per person and 2% of GDP. In Kazakhstan, the LIC premiums to GDP ratio is 0.3%, and there are US$31 in insurance premiums per capita. These figures are significantly behind the global trend. However, among countries with developing economies in Eastern Europe and Central Asia, these figures are average.

The factors influencing the life insurance market, determining its direction and growth rate, vary significantly across countries. For example, in the US, life insurance is often linked to investments through capital growth policies, while in Europe, traditional insurance products are more common. In the UK, products aimed at protecting and ensuring financial stability of families are popular. In Germany, mortgage-linked insurance is popular. In Asia, especially in Japan and the Republic of Korea, there is an expansion in insurance products in the area of health care and diseases that require long-term treatment. In developing countries, the emphasis is more on affordability and basic needs of the population. In Latin America, life insurance is often linked to pension plans, and in Brazil, products aimed at covering risks from loans and mortgages are also developing. In Africa, life insurance plays an important role in social protection, and some countries also face challenges in providing access to insurance for the poorest segments of the population. Common to all is the move to digital technologies and hybrid products to improve customer service and streamline processes. According to reports, there has been significant growth in digital life insurance in a number of countries (China, India), where companies are actively implementing innovative approaches to attract younger customers. There is also a general focus on development of products that combine life insurance with other financial instruments, reflecting the desire for more integrated, flexible and innovative financial solutions for customers. For

example, some companies offer variable annuities, where income depends on investment performance. This allows retirees to participate in the potential growth of investments while providing a basic level of financial protection. The development of hybrid annuities is typical in developed financial markets such as the US, UK, Germany, Japan and Canada. In these countries, insurers are actively experimenting with innovative products, including investment aspects, to provide customers with more flexible and personalized options.

Figure 4

LIC Premiums to GDP and the Population Size, a Country-by-Country Breakdown, 2022



Source: compiled by the authors based on the report of Swiss Re Institute, 2023

Life Insurance Market in Kazakhstan

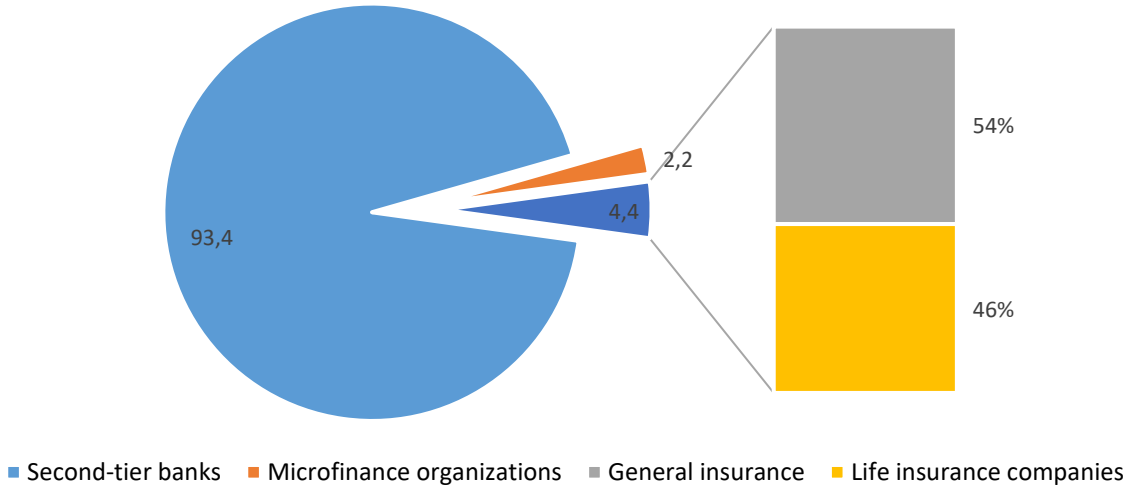
At present, the life insurance industry in Kazakhstan composes an insignificant share of the financial market, and the growth rate of the industry remains low compared to global indicators. The importance of this industry in Kazakhstan is underestimated and, in some cases, neglected.

At the same time, insurance and life insurance, in particular, are one of the key components of the financial system and the economy as a whole. Insurance organizations, acting as financial intermediaries, stimulate economic growth due to the multiplier effect. This effect is associated with the ability of the industry to accumulate insurance premiums and the possibility of transforming the generated “long” monies into long-term investments.

The main players in the financial market of Kazakhstan are second-tier banks. Compared to the banking sector, assets of other financial organizations are noticeably lower. The share of insurance companies accounts for only 4.4% of total assets of the financial sector as a whole (Figure 5).

Figure 5

Financial Sector Assets at October 1, 2023



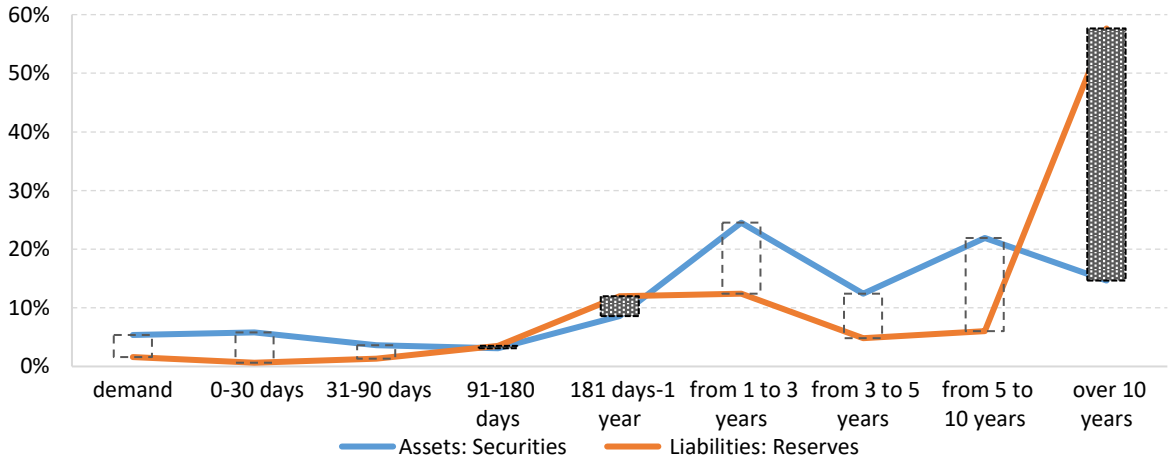
Source: NBK

As of October 1, 2023, assets of the life insurance companies amounted to 1.03 trillion tenge, which is slightly less than those of general insurance companies: the ratio of the share of assets is 46% and 54%, respectively. At the same time, out of the presented financial market participants, only life insurance companies have long-term liabilities. Life insurance companies have mostly long-term liabilities, so they are one of the few sources of "long" money in the economy. In this regard, the preservation and development of business of these companies is crucial from the standpoint of diversifying cash flows to the economy of Kazakhstan.

The maturity dates of assets and liabilities of most Kazakhstani life insurance companies (78%) do not match. Thus, due to the specifics of business of life insurance companies, most of their liabilities in the form of reserves to cover losses under insurance contracts have a maturity of over 10 years (Figure 6), while assets are dominated by securities with a maturity of up to 5 years. A significant negative gap in the long term determines the incomplete use of the existing life insurance company's potential in terms of long-term stable funding, which is so necessary for the financial market at present.

Figure 6

Asset-to-Liability Ratio of LICs, by Maturities, Bln Tenge



Lines show a share of corresponding category by maturity of the total as at October 1, 2023;
white bar – excess of assets over liabilities;
grey bar – excess of liabilities over assets

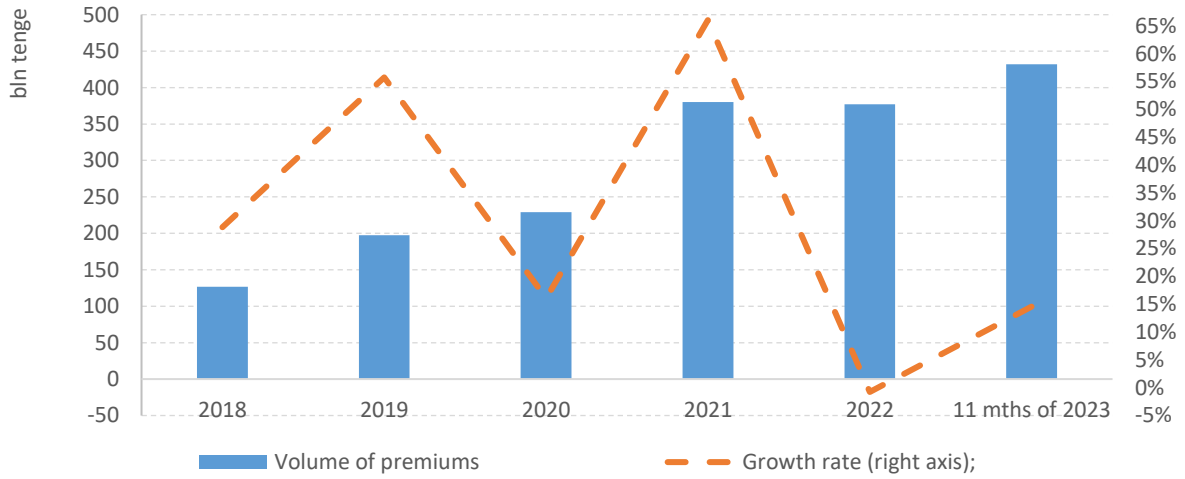
Source: NBK

Gap in the maturity of assets and liabilities may lead to loss of profit of the life insurance company and credit risks. Life insurance companies are sensitive to liabilities in the case of a negative gap, when the terms of assets are shorter than the terms of liabilities, which, given the possible upward change in rates, may potentially lead to a decrease in margin and loss of profit of the life insurance company. This may negatively affect the volume of insurance reserves. Given that insurance reserves reflect the amount of life insurance company's liabilities under concluded insurance contracts with deferred payments, the management of insurance reserves is pivotal and involves investing accumulated funds in assets with appropriate rates of return in order to provide clients with the necessary payouts in the future. In this regard, the most optimal for life insurance companies would be a match between the terms of reserves and assets.

One of the main indicators of the life insurance company's performance is the volume of premiums collected. It is from the insurance premiums (contributions) paid by policyholders under insurance contracts that insurance reserves are subsequently created. The volume of insurance premiums and their growth reflect the development of the insurance industry, its attractiveness and popularity. The life insurance market began to develop rapidly even before 2021. Even in the pandemic year of 2020, growth was exceeding 16% (Figure 7). Starting from 2022, the growth rate has slowed down. Nevertheless, the growth rate in 2023 is estimated to correspond to the growth rate of the pandemic year of 2020.

Figure 7

Volume of Insurance Premiums Collected, Bln Tenge



Source: NBK

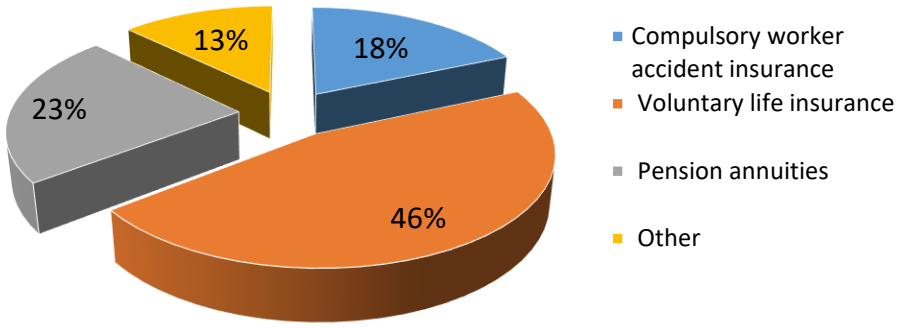
It should be noted that collection of premiums for life insurance is subject to seasonal fluctuations. The main collection of premiums occurs in the winter and summer months. For example, about 35 billion tenge was collected in June 2023, or 17% of the total amount collected over 6 months.

The collected insurance premiums do not remain in full in the portfolio of an insurance organization, some of them are ceded to reinsurance, some are distributed in the form of commissions, etc.

The main share of the volume of premiums received comes from voluntary life insurance (Figure 8).

Figure 8

Share of Premiums Collected During Three Quarters of 2023, by Main Classes of Insurance



Source: NBK

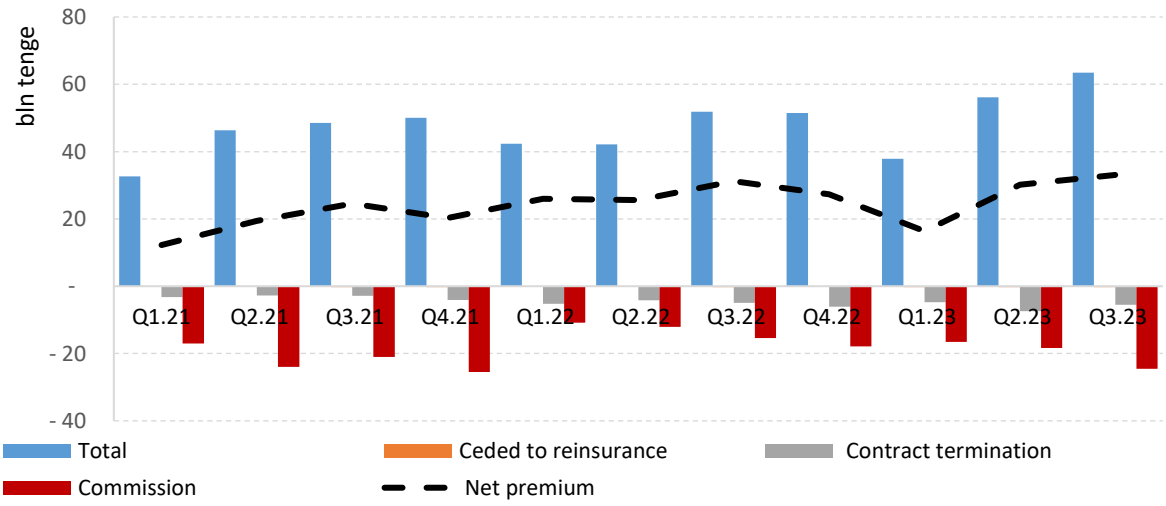
The share of voluntary life insurance premiums in the total volume of insurance premiums collected in the first three quarters of 2023 in the LICs was 46%. However, the voluntary nature of this type of insurance is rather formal. In essence, this market segment is captive. The main instrument of "voluntary" insurance is life insurance of borrowers upsold by banks when originating loans. At the same time, such insurance services are provided by LICs associated with banks. In world practice, life insurance is used for long-term borrowings, for example, when providing a mortgage loan. Such product is of interest to both borrowers and financial institutions, since it reduces the risks of loan default and social tension in the event of borrower's death due to the lack of necessity for the financial institution to sell collateral.

However, at present, mortgage loans have limited demand, and lending is growing only in the consumption sector. In Kazakhstan, cases of life insurance when applying for unsecured loans have become more frequent. This insurance is "embedded" into the loan body loan and increases its cost. With the growth of consumer lending by banks, life insurance of borrowers is also growing.

Financial institutions, by upselling insurance services to borrowers, receive additional income in the form of a commission fee, the amount of which in some periods exceeds 50% of insurance premiums (Figure 9). Therefore, it is obvious that the main motive for selling such products is not the desire of banks to reduce their operational risks and increase loan repayment, but to earn additional money from clients, and at one time, without waiting for the end of the loan term.

Figure 9

Dynamics of Premiums under Voluntary Life Insurance Based on Expenditure Items



Source: NBK

This class of insurance also includes other types of endowment insurance, their volume is not significant, but they also have risks. These include the so-called investment life insurance (unit linked). This class requires obtaining an additional license and building extra capital. It should be noted that one of the unit-linked products is investment insurance in foreign currency, whereunder life insurance companies offer increased returns linked to the US dollar exchange rate. Within the framework of investment insurance in foreign currency, some life insurance companies offer an effective interest rate of up to 4% per annum for up to 15 years, which makes this product more attractive compared to bank foreign currency deposits, for which the interest rate is no higher than 1%. However, a natural question arises about ensuring the declared return with the current duration of assets. It should be understood that there are practically no financial instruments in the international market that can provide a return of at least 4% with a horizon of 15 years. At the same time the need to maintain compliance with liabilities and assets is critical, especially for life insurance companies offering insurance products with high rates of return, which in the future may face the inability to meet their obligations.

The second class related to the life insurance industry, in terms of the share of premiums collected, is pension annuity insurance. The share of pension annuity premiums amounted to 23% of the total volume of insurance premiums collected over three quarters of 2023. This type of insurance has been the growth driver in the life insurance market for ten years and the main source of long money in the Kazakh economy.

Pension annuity was introduced into the pension system as a tool that ensures the lifelong payment of retirement benefits, and is an alternative to the pension fund, which will make retirement benefit payments to contributors only until the depletion of pension savings (on average, up to 82 years).

The pension annuity may be inherited in the event of the death of a policyholder by his/her heirs only during the guaranteed period specified in the contract. After the guaranteed period, the premium transferred from the Unified Accumulative Pension Fund (UAPF) remains in the LIC, and subsequently, in accordance with the principles of insurance, policyholders who have not lived to middle age (according to the life expectancy tables) “finance” policyholders who have survived middle age, including from the unused premium remaining in the LIC. In this regard, for the normal and economically sustainable functioning of this mechanism, it is necessary and sufficient to ensure:

– an outreach of insurance and therefore affordability of pension annuity for an overwhelming number of people;

– economic attractiveness of this instrument for people compared to payouts from a pension fund.

The premium figures demonstrate the evolution in the regulation of this product, which, of course, carries a certain social burden.

Until 2017, the volume of pension savings transfers to pension annuity accounts in the LICs was insignificant. Given the growth in pension savings and an increase in the number of retiring individuals, there was a gradual increase in the volume of transfers from pension funds to LICs. From this time, a step-by-step introduction of stricter regulatory requirements began, limiting the functioning of the pension annuity due to an increase in the cost of annuity, reduction in its availability and economic attractiveness for people. Namely:

– introduction of compulsory minimal indexation of insurance benefit payments (by 5% annually) without reducing the period of payments;

– a prohibition for one-time payouts up to 30% of the amount transferred;

– merger of pension funds and a moratorium for withdrawals from the UAPF;

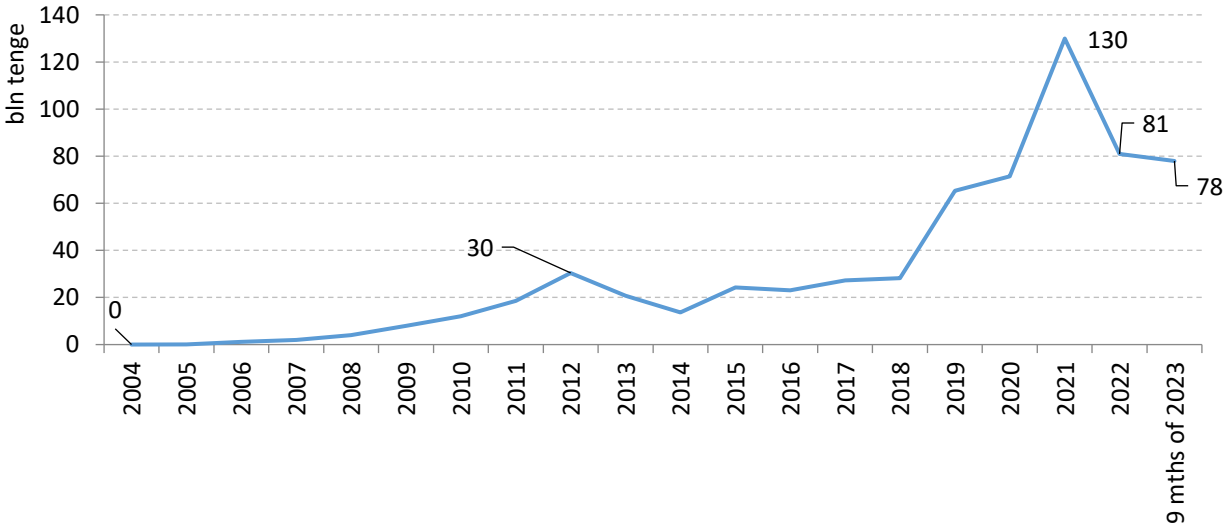
– a possibility of withdrawing a portion of pension savings in excess of the limit for improving housing conditions or treatment, while the threshold amount for such withdrawals is lower than the threshold for transferring to the life insurance fund to pension annuity accounts;

– a possibility of returning funds from LICs to the UAPF.

Since 2005, the total amount of pension savings transferred to the LCIs to pension annuity accounts has reached about 550 billion tenge (Figure 10). At the same time, about 300 billion tenge are transfers from pension funds, the remaining amount is secondary transfers from one LCI to another.

Figure 10

Dynamics of the Volume of Collected Premiums under the Pension Annuity



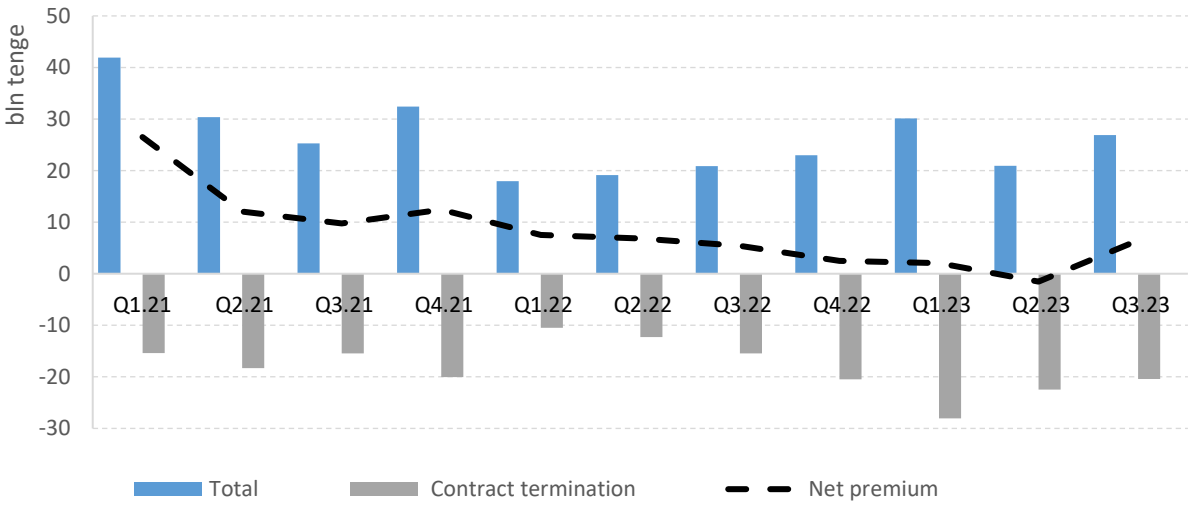
Source: NBK

It is worth mentioning that the opportunity for individuals to apply for a deferred annuity at age 45 (before reaching the retirement age) was introduced, and the threshold level for transferring to a life insurance contract was reduced, however, despite the opportunities provided, the volume of pension annuities increased only slightly.

The implemented regulations lead to a contraction of the pension annuity market, transfers to life insurance contracts from the Unified Accumulative Pension Fund are decreasing, and only secondary transfers from one life insurance contract to another remain in the market (Figure 11). Thus, in the second quarter of 2023, the volume of terminated pension annuity contracts exceeded the volume of premiums collected.

Figure 11

Dynamics of Pension Annuity Taking Account of Expenditure Items

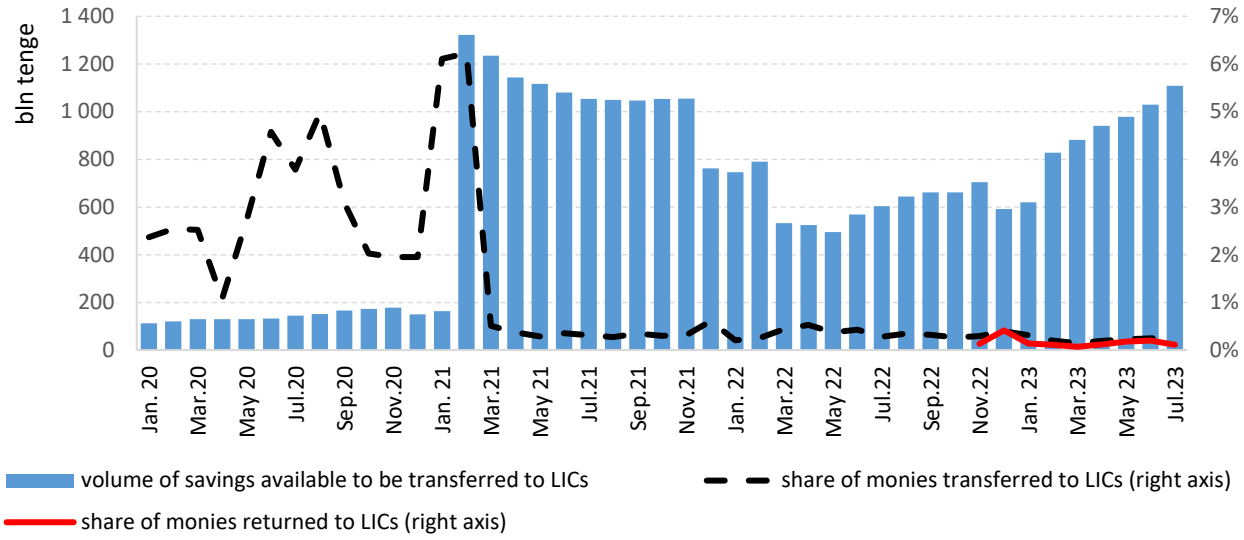


Source: NBK

In 2021, amendments were made that, in addition to transferring funds to a LIC under a pension annuity contract, also allow Kazakhstanis to redirect their pension savings in excess of a certain amount to improve housing conditions or pay for medical treatment. After the introduction of permission to withdraw a part of pension savings for the purchase of real estate and medical treatment, the volume of transfers to the LICs into pension annuities has significantly decreased (Figure 12).

Figure 12

Monies Available to be Transferred to LICs and the Share of Transfers



Source: NBK

There are currently several options for Kazakhstanis to use their pension funds: (1) continue to accumulate funds in an account with the UAPF; or (2) if pension savings exceed a certain sufficiency threshold, withdraw part of the pension savings to improve housing conditions or pay for medical treatment; or (3) transfer the accumulated pension funds to a LIC to purchase a pension annuity. At the same time, there is imbalance in the sufficiency thresholds, the level of which varies depending on the purposes of withdrawing funds from pension accounts. The imbalance is stemming from the existing difference in approaches to determining the threshold values for transferring pension savings in a LIC to pension annuity accounts and available for withdrawal to improve housing conditions or medical treatment.

The calculation of the threshold value for entering into a pension annuity is made taking into account the following factors:

- probability of death before a certain age threshold;
- gender (male or female);
- availability of professional contributions;
- payouts discounting;
- ensuring a certain profitability level;
- payouts until death;
- minimum payout amount is 70% of the subsistence level.

In the case of partial withdrawals for improving housing conditions or medical treatment, when calculating the sufficiency threshold for withdrawing pension savings, which in essence should be similar to the sufficiency threshold for transferring to an LIC, other factors are employed:

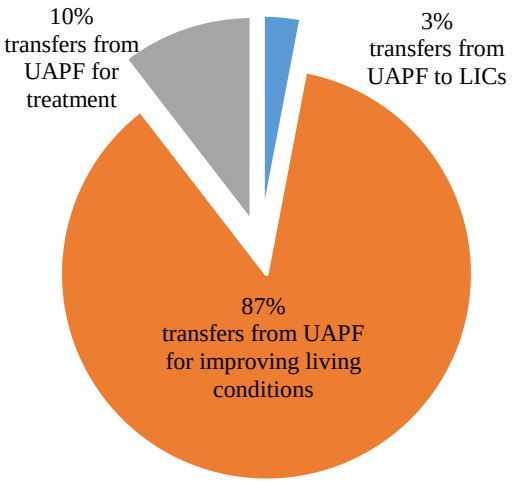
- only female gender (as women tend to live longer);
- payouts discounting;
- ensuring a certain profitability level;
- limiting age for payouts is 82 years old;

– minimum payout amount as the difference between the maximum of the minimum wage or minimum retirement benefit and the basic retirement benefit in the minimum amount.

The difference in approaches leads to the fact that it is more profitable for men under 48 and women under 57 to transfer their pension savings that exceed the sufficiency threshold for purchasing real estate or medical treatment, since in this case the threshold for the transfer is lower than the threshold for purchasing a pension annuity contract from a LIC. For example, in 2023, the sufficiency threshold for entering into a deferred pension annuity upon reaching the age of 45 is 7.3 million tenge for men and 9.1 million tenge for women. At the same time, the sufficiency threshold for partial withdrawal of pension savings for improve housing conditions or medical treatment for this age is 6.95 million tenge. Under these conditions, the UAPF contributors will be inclined to withdraw funds to invest them in real estate, without waiting for the accumulation of pension assets to the threshold level sufficient for entering into a pension annuity. The imbalance of sufficiency thresholds puts the pension annuity sector on unequal terms.

Figure 13

Pension Payouts in 2021-2023



Source: compiled by the authors based on the data from the UAPF

It is also important that the option of unlimited withdrawal of a part of pension savings for improving housing conditions or treatment, provided to Kazakhstanis reduces the ability of the funded pension system to provide an adequate retirement benefit in the future. The size of the future pension will be determined based on the amount of the contributor's accumulated pension monies and will most likely be maintained no higher than the corresponding threshold of sufficiency for a partial withdrawal.

Since the introduction of the possibility of partial withdrawal of pension savings, i.e. during the period from 2021 to October 2023, 3.35 trillion tenge were withdrawn for the purpose of improving living conditions (the UAPF, 2023), which is 87% of all withdrawn pension savings (Figure 13). While the monies transferred to a LIC during this period accounted for an insignificant share – 3% of all monies withdrawn from the UAPF or 116.3 million tenge. The option of using pension savings to improve living conditions had a significant impact on the mortgage lending market (Financial Stability Report, 2021). In addition, partial withdrawals from the UAPF for a home purchase affected the dynamics of prices in the real estate market. In 2021, there was a significant increase in prices in the housing market in both national and foreign currencies (Financial Stability Report, 2021). These monies could potentially become a catalyst for the inflow of investment capital into the economy through the life insurance industry, since the insurance reserves of life insurance companies are a source of long money.

Given that the issues of the pension system and the adequacy of future pensions are socially significant, a preliminary assessment of the long-term impact of the proposed reforms on all participants in the pension system, including the insurance market in terms of pension annuities, is necessary. Given the existing imbalances, according to the authors of the study, there is a need to review existing approaches and develop a unified approach to determining the sufficiency thresholds for withdrawal of monies from the UAPF, which will not cause social tension and will help ensure adequate retirement benefits in the future.

The third significant class of the life insurance industry is compulsory insurance of employees against industrial accidents (CIIA). This class of insurance accounted for 18% of insurance premiums collected in the industry as a whole during three quarters of 2023. The CIIA plays an important socially significant role, which consists in protecting not only employees who

are paid appropriate compensation in the event of loss of ability to work as a result of injuries at work, but also in protecting the property interests of employers. Conclusion of CIIA agreements with each employee helps the employer to avoid litigation with employees who are injured during the performance of official duties.

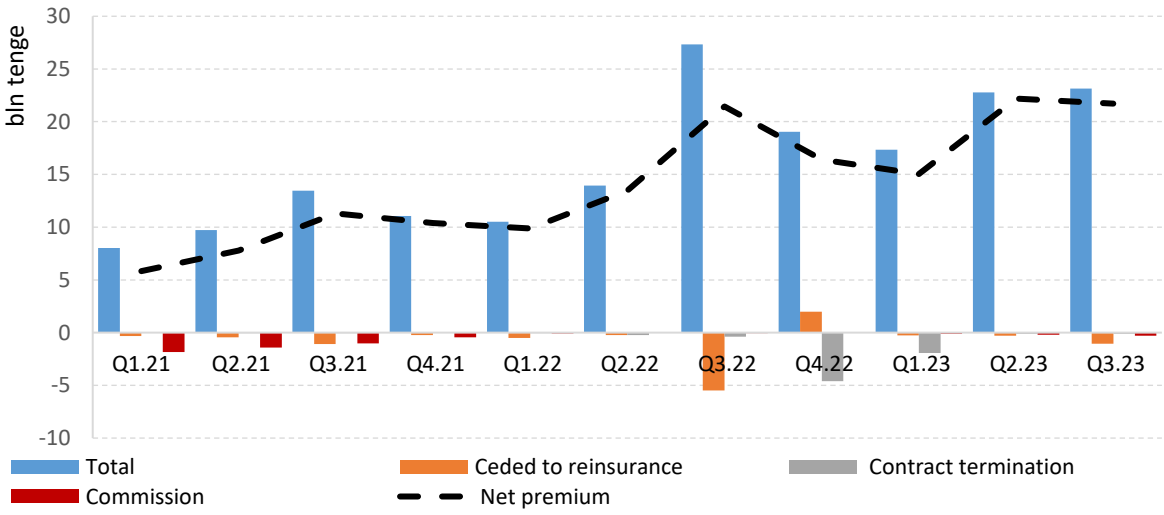
According to the law, any employer, with the exception of state institutions whose employee insurance is not regulated by the Law of the Republic of Kazakhstan dated February 7, 2005 No. 30 "On Compulsory Insurance of Employees against Accidents during the Performance of their Work (Official) Duties", is obliged to insure their employees against accidents at work. The insurance contract allows the employee to get compensation for lost income in the event of injury at work leading to a loss of professional ability to work by 30%-100%, as well as in the event of an occupational disease leading to a loss of professional ability to work by 30% – 100%, and the death of the employee at work.

This market segment is growing in general, which indicates an increase in the economic security of Kazakhstanis. The volume of net premiums, excluding reinsurance expenses, contract termination and commission expenses, in the third quarter of 2023 amounted to over 23 billion tenge (Figure 14).

WCIOAI contracts are concluded for a year, but payments are made until the employee's full recovery or retirement as a result of the loss of professional ability to work. Previously, insurance companies underestimated the risks associated with the extension of the loss of professional ability to work, which led to insufficiency of created insurance reserves. Starting from January 1, 2024, the requirements for WCIOAI insurance reserves have been strengthened, and insurance organizations are obliged to create additional provisions even under existing contracts, taking into account the increase in obligations associated with the extension of payouts.

Figure 14

Dynamics of Premiums under WCIOAI Taking Account of Expenditure Items



Source: NBK

Payouts to injured workers and their dependents are indexed to inflation on an annual basis, which leads to an increase in the costs of insurance companies when inflation accelerates. Forecasting the level of inflation in the long term for insurance companies carries significant risks due to the lack of ability to predict inflation with any certainty. This becomes especially important when inflation is expressed in double digits. This fact can also lead to an underestimation of reserves, since a small error because of the "length" of liabilities can lead to significant deviations in their assessment.

Despite the fact that this type of insurance is beneficial both for employer and for worker, and has existed in the market since 2005, there are still employers who, despite the mandatory nature of this requirement, do not insure their employees. An approximate estimate of the coverage of organizations with this type of insurance is no more than 60-70% at the time of writing this paper.

Other insurance classes presented in the line of life insurance, which include life insurance within the framework of the state educational savings system, health insurance, accident insurance, and compulsory travel insurance, have not become widespread. The volume of premiums collected in these classes is insignificant. This may be due to the lack of interest of policyholders in purchasing this product or the fact that some products have appeared in the market not so long ago. For example, life insurance within the framework of the state educational savings system was introduced only in September 2022. Due to the small volumes of premiums collected for other life insurance classes as well as insufficiency of available data for analysis, the authors did not conduct a review of the risks inherent in them.

Conclusion and Recommendations

Life insurance is one of the promising areas of development of the financial sector as a whole, taking into account the possibility of attracting long-term money. Liabilities of insurance companies, as a rule, have maturities of about 10 years or more, which necessitates investing accumulated insurance reserves in assets with a comparable duration. Life insurance reserves can become a source of financing for long-term investment projects, allowing them to generate the return that covers their liability to policyholders, and with a government guarantee.

The following can be proposed regarding the development of life insurance market:

1) strengthen financial security of the population by stimulating the conclusion of long-term life insurance contracts (such as the accumulation of an additional retirement benefit, etc.;

2) increase the attractiveness of pension annuities compared to payouts from the Unified Accumulative Pension Fund by unifying approaches to calculating sufficiency thresholds for withdrawing a part of pension monies to improve living conditions and for entering into pension annuities, or

3) introduce a pension annuity, which is a tool for providing people with a lifelong pension, in a mandatory format. Then, according to the authors, the concept of risk redistribution will be fully implemented (risk anti-selection will be eliminated and prevented), and the cost of the annuity will be reduced due to expenses due to its maximum coverage;

4) transfer the WCIOAI to a pool basis while reducing the level of insurance premiums by 25%-30% on average. This approach will minimize and redistribute employer's risks, especially of large industrial enterprises, more efficiently. At the same time, require the employer to allocate the freed-up portion of funds (premiums for the employer become 25-30% cheaper) to finance activities related to increasing the level of safety at enterprises and improving working conditions;

5) improve the method of calculating payouts under the WCIOAI. Payouts should be more predictable and not cause large uncertainties due to fluctuations in inflation, which is included in the calculation of payout. When calculating payouts, similar to a pension annuity, the indexation rate can be concurrently clearly specifieed in the contract.

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Framework of Primary Dealers in the Government Debt Market. Specifics of Functioning and Prospects for Implementation in the Government Securities Market of the Republic of Kazakhstan

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The paper presents an overview of international experience in implementing the framework of primary dealers. The reasons for deploying this framework, the associated benefits and disadvantages, as well as the format of its functioning were studied. The paper examines the main obligations and privileges of primary dealers, as well as other features of the functioning of the institute in different countries. The main reasons for the need to deploy this framework in the Kazakh market are given, and the steps of the National Bank and the Ministry of Finance in this direction are described.

Key Words: primary dealers, market of government securities of the Ministry of Finance of the Republic of Kazakhstan.

JEL Classification: H63.

Preamble

The introduction of the framework of primary dealers implies providing exclusive access to the issuer's primary auctions to a limited number of participants in exchange for fulfilling a number of obligations in the primary and secondary markets.

The framework of primary dealers is an integral part of modern financial systems and plays a key role in the issuance and placement of government securities (GS). Its presence allows the government to effectively manage its debt, optimize the structure of loans and ensure stability of the financial market. This is especially important in the context of volatile economic environment.

The presence of primary dealers reduces risks for the government and investors. The presence of primary dealers' obligations to maintain liquidity smoothes out price fluctuations and ensures market stability. This reduces the likelihood of financial crises and increases the confidence of both local and foreign investors in GS.

The framework of primary dealers creates conditions for attracting investors. Thanks to the stability and transparency they bring, the government securities market becomes more attractive. This, in turn, helps reduce the cost of borrowed funds for the government. Thus, the framework of primary dealers is an integral part of building a healthy and stable government securities market, it affects the efficiency of government debt management, liquidity provision and reduction of financial risks. The deployment of this framework supports the financial sector development, contributing to the economic growth and the country's attractiveness for portfolio investors.

International Experience

The primary dealer system was first introduced in the United States in 1960. Since the mid-1980s, the use of the framework of primary dealers has become widespread in Europe, and since the mid-1990s, in developing countries (India, Republic of Korea). However, a number of countries with fairly developed economies do not use the primary dealer system (Australia, New Zealand, and Switzerland), although they have an active secondary market for government securities. A common feature of such countries is a large share of investments by foreign investors.

A number of developing countries also do not use primary dealers (Costa Rica, Chile, Latvia, and Saudi Arabia) due to insufficient market capacity to ensure an effective competitive environment and an insufficiently diversified investor base to fulfill obligations to carry out market

activities. According to a research by the International Monetary Fund and the World Bank, the framework of primary dealers is used in various countries to solve two main problems:

1) stable offering of GS in primary auctions, thus allowing an uninterrupted financing of the state budget;

2) increasing liquidity of the secondary GS market ensuring the growth of confidence from trade participants in the GS market and its indicators.

The fundamental requirement for primary dealers is to perform the functions of a market maker in the secondary market. This is driven by the need to design an effective mechanism for delivering government securities to end investors and increasing liquidity in the secondary market.

Among other advantages of deploying a primary dealer system, one can highlight:

– enhancing the infrastructure in the GS market by reviving it, increasing liquidity in the market and expanding the base;

– ensuring the development of the underwriting framework and assisting the government authorities in designing the debt management strategy, developing the market through advisory support;

– improving liquidity in the secondary GS market, thus ensuring the market-based pricing, enhancing the GS turnover in the secondary market.

The framework of primary dealers may also carry certain risks associated with the possibility of creation of a primary dealer "cartel". Primary dealers may collude, coordinate their actions, to lower the price at auctions in order to further sell securities in the secondary market at higher prices. In addition, there is a risk of primary dealers setting high commissions for intermediary services, which reduces demand from investors. To manage these risks, appropriate supervision of the activities of primary dealers is necessary; it is possible to prevent such situations with careful analysis of auction results and appropriate control.

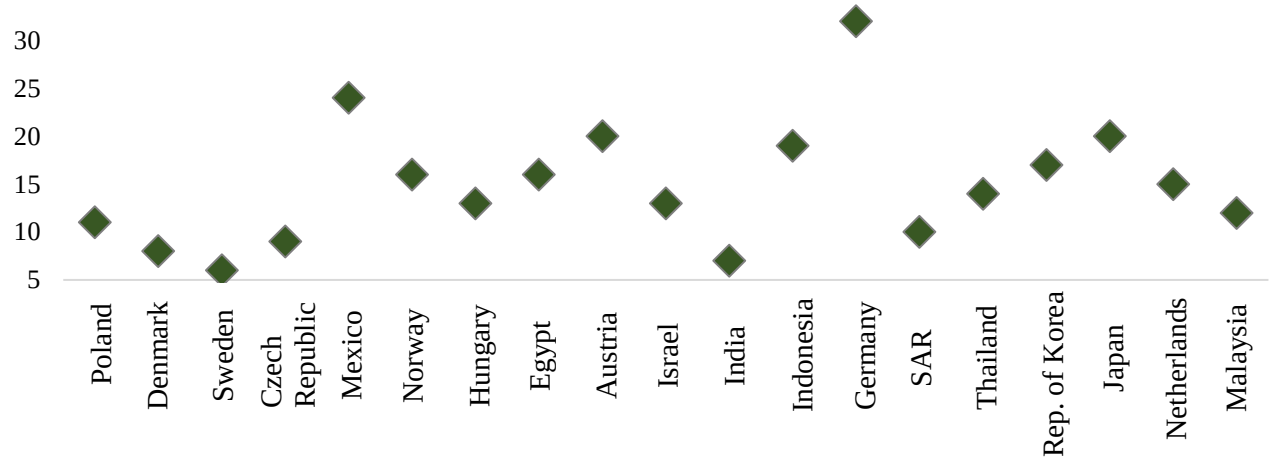
The format of functioning of the framework of primary dealers varies depending on the country; each country adapts the conditions, taking into account the local market situation. In general, the format of functioning is determined by the following factors:

1) the number of primary dealers;
2) selection process and criteria;
3) obligations of primary dealers;
4) privileges of primary dealers.

In practice, the number of primary dealers usually ranges from 5 to 25 participants on average. The largest number of primary dealers is observed in Germany – more than 30, and the smallest in Iceland – 5. It is worth mentioning that almost all of the countries reviewed have non-residents as primary dealers. The most common non-resident primary dealers are J.P. Morgan, Deutsche Bank, Citibank and Goldman Sachs.

Figure 1

The Number of Primary Dealers



Source: compiled by the author based on open source data

In most cases, the competent authorities do not limit the number of primary dealers. All market participants that meet the established criteria have the opportunity to become a primary dealer. At the same time, the criteria for market participants are minimal – often it is necessary to have an appropriate license, a sufficient level of registered capital and consent to fulfill the obligations of primary dealers. The business of primary dealers is assessed on a regular basis (once per quarter or six months), if non-compliance with the requirements is detected, the primary dealer loses its status immediately. However, in Mexico, compliance with the criteria does not guarantee accession to the primary dealer system. The Bank of Mexico determines a pool of suitable candidates based on these criteria, after which the list of primary dealers is determined through a competitive selection.

In the Republic of Korea, the status of primary dealers is granted in several stages. Market participants who meet the criteria are granted the status of "preliminary primary dealer". After 6 months, the activity of "preliminary primary dealers" in both the primary and secondary markets is assessed. In order for a "preliminary primary dealer" to become a primary dealer, it is necessary to score a certain number of points. However, even this does not guarantee inclusion in the short list of primary dealers; the final decision is made by the Ministry of Finance. The existing primary dealers are also subject to assessment: participants who have shown low activity in the government securities market lose their primary dealer status and become "preliminary primary dealers". This decision is also made by the Ministry of Finance, i.e. failure to achieve the required results does not automatically result in exclusion from the list of primary dealers. It is also worth mentioning that in the Republic of Korea, applications for joining the primary dealer system are accepted only twice a year. Hungary, like Korea, initially assigns the status of "candidate for a primary dealer".

The establishment of the framework of primary dealers implies the fulfillment by primary dealers of certain obligations in the primary and secondary markets. In world practice, based on the requirements and status of primary dealers, two common primary dealership regimes are distinguished: homogeneous and specialized. In countries such as Belgium, France, Finland, Japan, Turkiye, and the United States, all primary dealers are subject to homogeneous requirements, which ensures transparency and simplicity of management of the primary dealer system. Some countries (Italy, Canada) consider it effective to separate the obligations of primary dealers, establishing different levels of dealers, each of which has separate requirements and goals. This approach is especially effective in the case of a limited number of institutions with competencies covering all debt instruments. In Brazil, there were organizations specializing only in the secondary market, but in 2010, they moved to applying a single set of obligations to all primary dealers.

The World Bank studies identify several key obligations of primary dealers.

The first is participation in initial offerings. By participating in primary auctions, primary dealers act as a conduit between the issuer and end investors. The obligation to participate in initial offerings usually includes the obligation of the primary dealer to submit a certain minimum number of bids and/or successful bids. The government agency considers this requirement in the context of frequency of participation and the minimum amount of government securities to be purchased by each primary dealer. The minimum amount is usually expressed as a percentage of the total amount announced/placed. The minimum amount varies from country to country: in Hungary and the Czech Republic, primary dealers are required to purchase at least 3% of the total annual volume, in Israel – 4%, in Sweden – 2.5%, in Belgium and France – 2%. In South Africa, the mandatory participation volume at each auction is calculated using the formula:

$$\frac{1}{\text{number of PDs}} + 2\%, \text{rounded to } 1\%.$$

That is, if there are 10 primary dealers, each is required to submit bids at each auction in the amount of at least 12% of the offered volume. A similar system operates in Japan and Mexico, the volume of bids at each auction in percentage terms (rate of bidding responsibility) is equal to 100/number of primary dealers.

In the Republic of Korea, there is no minimum participation volume, but a scoring system is used. Depending on the share of participation in auctions, scores are assigned to primary dealers, with the smallest number of scores given for "short" securities, and the largest – for securities with maturity of 10 and 30 years.

In Poland, the minimum volume is determined by the Ministry of Finance on a regular basis. In this case, the securities are weighted taking into account the terms: government securities with a maturity period of less than 4 years are assigned a weight of 0.5, and government securities with a maturity period of more than 4 years – 1.5.

In Egypt, in addition to the minimum level, a maximum volume is also set – no primary dealer can absorb more than 30% of any auction. The agreement with primary dealers may also include a requirement for regular or mandatory participation in each offering. Many countries require primary dealers to submit bids at acceptable prices (corresponding to secondary market prices) and in a volume no less than a certain predetermined level. This requirement is expressed in determining the frequency of participation (regular or mandatory participation in each offering) and the minimum volume of government securities purchased by each primary dealer.

The second obligation of the primary dealer is to place securities among end investors, which involves facilitating the placement of government securities among the primary agent's client base through research, marketing, and active promotion of products. The third obligation is to maintain liquidity in the secondary market. Most countries require primary dealers to maintain "hard" quotes for a range of securities with different maturities with a set minimum volume over a certain period of time. In Poland, the minimum quote time is set at 5 hours during the trading day. In Latvia, primary dealers are required to offer daily two-way quotes for all securities whose nominal volume exceeds EUR 50 million. Some countries require primary dealers to offer daily quotes only for securities included in the benchmark.

In addition, the primary dealer is often required to set a spread that does not exceed its established maximum spread width, determined by the competent authority by directive or in the form of a specific function. For example, in Norway, a corresponding maximum spread width is set for different terms of government securities: for bonds with maturity of less than a year – 5 bp, more than 9 years – 50 bp. A similar system is in effect in Iceland: there, spreads range from 15 bp for short-term securities to 100 bp for securities with maturity of more than 18 years, but there is a condition, whereunder if a certain volume of transactions during a trading day is exceeded, the requirement for the maximum spread does not apply until the end of that day. There are countries, for example Hungary, that do not limit the maximum spread.

Maintaining liquidity in the secondary market also includes the obligation to maintain a specified level of trading volume in the secondary market over a specified period. The level of such volume may be calculated as a share of the total trading volume or of all participants in the secondary market. For example, in Greece, the minimum trading volume of each primary dealer during the year must be 2% of the total trading volume in all markets. In Belgium, the minimum 2% share for each of the primary dealers is calculated from the total trading volume of all primary dealers. The absence of this requirement in some countries may indicate a greater focus on price certainty than on trading volume, which increases the difficulty of qualitatively assessing the consequences of possible artificial nature of transactions (trading between two market makers).

The fourth obligation of the primary dealer is to conduct advisory activities and maintain partnerships between primary dealers and the authority in charge of government debt management. Most countries do not describe specific requirements for communication with the competent authority, but all mention the need for its presence. Thus, in Poland, primary dealers are required to fill out a weekly questionnaire from the Ministry of Finance, those in Belgium – to provide a market review on regular basis, and in Israel – to participate in meetings with the Ministry of Finance.

The fifth obligation is to report on their activities on a monthly or quarterly basis: reporting by primary dealers helps the authority in charge of government debt management to assess changes in the market and in individual organizations.

As a rule, in exchange for fulfilling their obligations, primary dealers can receive a wide range of privileges. Their provision is aimed, first, at increasing the motivation of primary dealers, and second, at supporting the operations carried out by primary dealers in the primary and secondary markets.

The obvious privileges of primary dealers are the granting of the status of primary dealers, as well as the exclusive right to participate in primary auctions of government securities.

A number of countries, such as Denmark, Sweden, the Netherlands, Iceland and the Czech Republic, provide remuneration for the activities of primary dealers depending on their activity in the government securities market. Iceland has a system of fixed and variable returns, depending on the volumes purchased in the primary market. In addition, the following privileges are typical for most countries:

– obtaining exclusive information from the authority in charge of government debt management regarding its market development strategy, forecasts and plans;

– participating in regular meetings with the authority in charge of government debt management;

– compiling and publishing a ranking of the most active participants in the primary and secondary markets is an effective tool for marketing campaigns of such dealers in order to attract clients and institutional investors;

– non-competitive bids submitted by primary dealers after the auction (Green shoe option);

– exclusive access to securities lending facilities (unsecured securities loans, reverse repo transactions with the central bank);

– privileged access to borrowing from the central bank;

– a right to act as a counterparty in the central bank operations in the secondary market.

The purpose of providing primary dealers with exclusive access to the GS lending facility is to compensate for the risks arising from the very nature of the primary dealer business. In cases where a market maker sets fixed prices and is obliged to sell GS that it does not have in its portfolio, it can borrow GS (Security lending facility). For example, in Norway, primary dealers can borrow securities for up to five days at market prices. The forward price of the reverse transaction is calculated as the policy rate of the Bank of Norway minus 5 bp.

Prospects Regarding the Deployment of the Framework of Primary Dealers in the GS Market of Kazakhstan

In recent years, the National Bank and the Ministry of Finance have intensified joint work to increase attractiveness of the government securities market for foreign investors. In particular, work is underway to include government securities in the J.P. Morgan GBI-EM index. As a result of the measures taken, government securities are currently at the first stage (put on the “radar”) of inclusion in this index. The next stage is the inclusion of government bonds in the “Index Watch” list. Inclusion in the index will increase the recognition and attractiveness of Kazakhstani government securities, attract foreign investors, reduce the cost of borrowing, and diversify the investor base.

At present, the low level of liquidity is still the main restraining factor for inclusion of Kazakhstani government securities in the index. Thus, those who have access to the “stock” platform on the Kazakhstan Stock Exchange participate in the primary auctions of the Ministry of Finance – this is more than 40 participants. Having access to primary auctions for a large number of participants reduces the potential for the development of the secondary market for government securities. In order to increase liquidity in the government bond market, the Ministry of Finance and the National Bank plan to deploy the framework of primary dealers through joint efforts.

In order to implement the project on deploying the framework of primary dealers in the government securities market of Kazakhstan, it is necessary to define the criteria for selecting primary dealers, as well as to develop a concept of obligations and privileges for them. In order to provide equal conditions to all market participants, it was decided to conduct a monitoring period for 6 months to assess the activities of market participants in the government securities market.

For the transparency of the process, the National Bank, in coordination with the Ministry of Finance, developed a scoring model for assessing the activities of participants. The scoring model included the following indicators:

1) primary market indicators:

a) participation share (the volume purchased at primary auctions of the Ministry of Finance was estimated);

b) frequency of participation (the share of auctions in which the participant was taking part of the total number of auctions held);

c) uniformity of participation (allowed assessing the concentration of participation at specified periods and was assessed with HHI (Herfindahl-Hirschman Index));

2) secondary market indicators:

a) participation share (the trading volume of a market participant to the total volume in the secondary market was estimated);

b) the number of quotes (the number of quotes at the on-exchange and OTC platforms was estimated, quotes of at least 500 mln tenge and active during at least 3 hours were estimated);

c) the quantity of unique securities (the quantity of securities for which quotes were offered at the on-exchange and OTC platforms);

d) quoting quality (availability of bilateral quotes at the on-exchange and OTC platforms was assessed);

3) additional indicators:

a) provision of analytical information;

b) communication with the Ministry of Finance;

c) existence of transactions with non-residents.

It is important to note that the scoring model was developed in such a way as to evaluate the activity of participants, not in absolute but in relative terms. Thus, the calculation of scores for the primary and secondary market indicators was made by ranking all market participants based on the relevant indicator.

A participant who took the first place in the ranking for a certain indicator received the maximum number of scores for this indicator as a percentage (100%), subsequent participants received 10% less (for example, for the first place in the ranking, a participant received 100%; for the second place – 90% of scores; for the third – 80%; for the tenth – 10%, and for the eleventh and all subsequent places – 0%). If two or more market participants had the same indicator, they were awarded the same number of scores in accordance with their place in the ranking, and the next participant received 10% less (for example, two participants took the first place and received 100%, the next participant received 90% of the scores, and so on). Therefore, the final score was calculated by multiplying the percentage score by the maximum score for the corresponding indicator.

Calculation for additional criteria is carried out on a yes/no basis. If a participant fulfilled the requirement at least once, it received 5 scores for the criterion, in case of non-fulfillment – 0 scores. This scoring model was explained to all market participants and was also published on the official website of the Kazakhstan Stock Exchange. After the publication of the model, a monitoring period was announced starting from May 2023.

It is noteworthy that the monitoring period had a positive impact on the secondary market of government securities. Thus, the trading volume in the secondary market in the second quarter (after the start of the monitoring period) showed a three-fold increase compared to the first quarter. Moreover, the number of available quotes increased significantly: while before the monitoring period there were practically no quotes on the over-the-counter market (Bloomberg Ebond platform), by the end of the monitoring period, quotes were available on more than 40 securities at the same platform. An important factor is the improvement in the “quality” of quotes. At the beginning of the monitoring period, spreads for most securities ranged from 150 to 200 basis points, while at the moment, spreads generally do not exceed 50 basis points.

Thus, the monitoring period had a positive impact on the state of the government bonds market. In parallel with the launch of the monitoring period, the National Bank, together with the Ministry of Finance, began developing the concept regarding obligations and privileges. The initial version of the concept was discussed with market participants and includes the following provisions on the obligations and privileges of primary dealers.

Obligations in the primary market will include:

1) minimum volume of purchases in the primary market. It is expected to be equal for all participants and will be calculated as the ratio of the share of guaranteed minimum purchase volume for all market participants determined by the Ministry of Finance and the number of primary dealers at the beginning of the year. It is assumed that securities with a longer maturity will have a greater weight;

2) minimum activity in the primary market. Primary dealers will be expected to demonstrate activity (submit bids) of at least a certain percentage of all auctions. At the same time, outlier bids (significantly different from the cutoff price) will not be taken into account.

Obligations in the secondary market will include:

1) daily quotes, based on the maximum spread. Primary dealers will offer daily bilateral quotes on the on-exchange and OTC platforms for securities included in the list of securities mandatory for quotation;

2) minimum volume in the secondary market. Each primary dealer will be required to maintain a certain volume of trades in the secondary market.

As a main privilege, primary dealers will receive exclusive access to the auctions of the Ministry of Finance, which will allow them to resell government securities to other market participants with a set commission. Primary dealers will also have access to the information from the Ministry of Finance regarding the plan for government securities issuance. In addition, primary dealers will be provided with preferential terms on the Kazakhstan Stock Exchange in terms of payment of commissions.

With an aim to ensure more efficient management of the government securities portfolio, the issue of providing primary dealers with the following opportunities is being considered:

1) access to a switch auction. At such auction, primary dealers will be able not only to change the duration of the portfolio by replacing securities with one maturity by another but also to purchase more liquid securities in exchange for less liquid ones;

2) short-term possibility of funding;

3) Securities lending facility. Since primary dealers will have an obligation to quote a number of securities daily, the development of a securities lending mechanism is being considered, which will allow, in the event of a lack of a certain security, to borrow it on market terms;

4) Green shoe option. It is expected that the day after the auction, primary dealers will have the right to purchase a certain additional volume from the amount of bids satisfied at the auction.

Findings and Conclusion

In conclusion, it can be emphasized that the deployment of the framework of primary dealers has the potential to significantly improve the functioning of the market and is becoming a strategic step in the development of the country's stock market. Inefficiency of the existing system of access to the primary auctions of the Ministry of Finance underscores the need to rethink it. Moreover, vulnerability of the existing system to market changes revealed by the experience of 2022 in the context of geopolitical upheavals, underscores the need for robust response mechanisms. The deployment of the framework of primary dealers will create a flexible system that will contribute to more efficient functioning of the government securities market.

During the period of monitoring, it was identified that the presence of incentives for certain market participants can serve as an impetus for the development of the entire government securities market. Thus, the deployment of the framework of primary dealers is not just a tool for solving current problems, but also a strategic initiative that contributes to the long-term strengthening of the government securities market and its adaptation to changes in the market situation.

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