INTERNATIONAL MONETARY FUND

Kazakhstan: Staff Concluding Statement of the 2019 Article IV Mission

November 12, 2019

Growth remains strong, fueled by supportive fiscal policy, oil-and-gas sector investment, and retail lending. Risks to inflation have increased, and the National Bank (NBK) appropriately tightened policy in September. Additional budget outlays have involved resources from the National Fund and revision to the non-oil deficit path. While medium-term fiscal consolidation is envisaged, supported by improved revenue administration, there is a strong case to strengthen the fiscal framework, including fiscal rules and transparency. There is scope for strengthening the effectiveness of monetary and exchange policy as well, including enhancing NBK independence and improving monetary transmission and communications. The asset quality review now underway is an opportunity to address long-standing problems in the banking sector. The formation of a new, independent financial supervisor should be carefully managed to limit risks. Continued implementation of business environment, governance, and public administration reforms is critical for strong, sustained, inclusive growth.

Recent developments, outlook, and risks

1. **Strong growth performance has continued.** GDP grew by 4.3 percent in the first three quarters of 2019, led by the non-oil sector, especially construction and services. Preliminary estimates point to acceleration in the third quarter. A pick-up of consumption and continuing investment activity are key drivers. This reflects fiscal support, strong growth in retail lending, and investment projects in oil and gas. Headline inflation rose to 5.5 percent (yoy) in October, still within the 4-6 percent target band. Lower oil prices and higher imports have weakened the external current account balance this year. Portfolio outflows and debt payments contributed to lower international reserves. There was limited direct foreign exchange (FX) market intervention by the National Bank early in the year. The NBK, as trust manager of the National Fund (NFRK), also periodically performed conversion operations for NFRK transfers to the budget.

2. **Non-oil growth is expected to remain strong going forward, with risks on the down side**. Fiscal support will buoy consumption and investment, although non-oil growth will slow to 4 percent (estimated potential). Inflation will remain elevated next year, including as the effect of utility price cuts in 2018 dissipates. The external current account is expected to worsen with continued strong domestic demand and moderate oil prices. The balance of risks is negative, reflecting commodity prices and trade and geopolitical tensions.

Monetary and exchange rate policy

3. **In light of demand pressures, the tightening of monetary policy by the NBK in September was appropriate.** Rising inflationary pressures prompted an increase of the policy rate by 25 basis points to 9.25 percent. Risks remain due to persistently strong demand, supported by

wage and social spending hikes and consumer lending; further action may be needed. Although the stock of NBK notes has declined, surplus liquidity in the banking sector remains significant. This reflects structural issues in the real sector, notably insufficient credit demand by companies in good financial standing.

4. **Efforts should continue to strengthen the credibility of the monetary and exchange rate framework.** Kazakhstan's experience with inflation targeting (IT) and a flexible exchange rate (ER) has been positive. Implementation of monetary policy is constrained by structural limitations which require measures on the part of the National Bank and the government. Key areas include:

- Enhancing the NBK's independence, including through legal changes and divesting non-core activities and assets to signal a strong commitment to price stability.
- Further strengthening coordination between the government and the NBK to ensure a well-balanced policy mix in support of IT implementation and financial market deepening.
- Improving monetary policy transmission by resolving outstanding issues in the banking sector, further developing capital markets, reducing dollarization, and phasing out subsidized lending.
- Increasing transparency, for example, through the NBK's intended publication of data on FX transactions on behalf of the NFRK, following recent outreach on factors affecting FX developments and changes in reserves.

Financial sector stability

5. **Financial support to banks from the government and NBK has contributed to stabilization of the banking sector, but at a high cost.** Over the past two years, several banks received significant state funds, either through purchase of bad assets by the Problem Loan Fund or subsidized loans from a subsidiary of the NBK. This led to improvement of bank capital and liquidity indicators. Corporate lending has been sluggish, although consumer loans are growing rapidly, which warrants close monitoring. The team supports the planned regulatory tightening through an increase in risk weights on uncollateralized consumer loans and refinements to household debt-burden calculations. In recent years, there have been numerous new credit-support initiatives from the Government and the NBK, targeting sectors, purchases (e.g., vehicles), products (e.g., mortgages), and borrowers (e.g., SMEs). As noted in last year's consultation, extensive state support risks cementing a culture of reliance on subsidies. The growth impetus should move firmly to the private sector. The team again calls on the authorities to abstain from introducing new credit-support initiatives.

6. **The asset-quality review (AQR), now underway, will be instrumental to fully understanding the health of bank operations and balance sheets and identifying needed actions.** The AQR was launched by the NBK in mid-2019, with results expected early next year. Based on the AQR findings, the authorities will formulate follow-up actions, which may include bank recapitalization by existing or new shareholders. State support, if any, should go only to large

and viable banks subject to shareholder contributions and the adoption of comprehensive restructuring plans. In the team's view, state support should not come from the NBK.

7. The planned redesign of the financial supervisory architecture should be carefully managed. The relocation of the NBK to Nur-Sultan and establishment of an independent Agency for Regulation and Development of Financial Markets in Almaty carries risks of reduction of supervisory capacity, which should be addressed. The new architecture should comply with core principles and best practices for effective supervision, particularly for independence, powers, and inter-agency cooperation on macroprudential and contingency issues via the Financial Stability Council. The appointment of strong management, adequate budgetary resources, and adoption of credible restructuring plans, as needed, following the AQR will help the new agency quickly establish a strong track record. Given substantial changes in the monetary and exchange framework, the financial sector, and supervision, the mission encourages the authorities to request a new review under the IMF-World Bank Financial Sector Assessment Program.

Fiscal policy and framework

8. A looser fiscal stance is expected for 2019, due to stepped-up social support and regional development outlays and despite strong non-oil revenues. Non-oil deficit levels in the 2020-22 budget are planned to return to the consolidation path laid out in the 2016 NFRK Concept Note. The team welcomes this return to consolidation and building of buffers at a time of sound economic performance. Initiatives in the revised 2019 budget include wage increases for lower-paid public employees, housing and other financial support to vulnerable households, debt relief for low-income borrowers, and regional and rural infrastructure investments. Improved revenue administration (e.g., e-invoice for VAT, enhanced customs monitoring) is yielding positive results. The authorities expect that continued revenue administration improvements will further boost non-oil revenues in 2020-22. This will support new spending, including the second phase of the "Nurly Zhol" program, and reduce the non-oil deficit from nearly 8½ percent of GDP in 2019 to below 6 percent in 2022. The team welcomes the efforts to enhance revenue administration and build buffers, but sees risks that the ambitious targets may not be fully met. Upgrading the large-taxpayer unit and further actions to enhance risk-based tax compliance will be needed. A three-year suspension of tax audits for SMEs may allow resources to be refocused on high-risk areas, but may also affect compliance. The team sees scope for tax policy changes, including VAT improvements and more aligned tax treatment of individual income from different sources (wages, interest, dividends, capital gains). On spending, the team welcomes efforts to review programs to strengthen efficiency and discontinue ineffective programs to generate space.

9. The authorities intend to upgrade their fiscal policy framework, including the system of fiscal rules. While the framework has served Kazakhstan well by helping maintain strong buffers and providing guidance on policies, there are challenges and shortcomings. For example, definitions and rules, including for NFRK transfers, have been amended several times, and institutional coverage and transparency should be enhanced.

10. The design of the new system should be guided by key principles of simplicity, broad coverage, flexibility, and enforceability. Simplicity means few, clear, and mutually consistent rules. Broad coverage means extension to the full range of fiscal and quasi-fiscal activities and institutions, with further efforts needed in classification and reporting. Flexibility means robust escape clauses (with explanation) and periodic reassessments to make the framework resilient to shocks and changing circumstances. Enforceability means support by strong fiscal transparency, correction mechanisms—for times when the rules are not met—and enhanced communications. The authorities should consider options carefully and comprehensively: changing the rules system and enhancing the fiscal framework is complex and multidimensional and will involve significant preparatory work to bring Kazakhstan in line with best practices.

11. Upgrading the framework should include wide-ranging measures to strengthen fiscal transparency. For example, the NFRK should publish regular, comprehensive reports, including on governance arrangements and rules, operations, finances, investment performance, and risk management, with externally audited financial statements. On transparency of the Republican Budget, the team supports building on the first set of consolidated financial statements submitted to parliament this year. Aggregate performance of public corporations and information on quasi-fiscal activities should be regularly reported, along with comprehensive public debt statistics. The aim to produce a fiscal risk statement is welcome and will require further preparatory work.

12. The authorities' efforts to enhance the fiscal framework and transparency would benefit from a Fiscal Transparency Evaluation (FTE) by the IMF. The FTE will help Kazakhstan benchmark to peers and best practices, providing a comprehensive assessment of transparency across the dimensions of reporting, forecasting and budgeting, risk analysis and management, and resource-revenue management, with prioritized recommendations.

Structural reforms

13. Maintaining structural reform momentum is critical for private sector development and growth. The team welcomes the strong ownership and commitment to ongoing reform programs and supports the authorities' priority areas: promoting competition and investment, enhancing productivity in non-extractive sectors, further improving the business environment, and strengthening governance and public administration efficiency. A significant number of the landmark "100 Concrete Steps" have been completed—58—and the team looks forward to further efforts to implement the remaining steps, including 33 steps under the industrialization and growth pillar. Also, timely conclusion of IPOs for blue-chip SOEs in energy, telecoms, and transport will boost credibility and send a strong signal to investors. Enhancing protection of property rights and bankruptcy procedures will also help.

14. Further efforts are needed to address structural constraints in agriculture and agro-processing. With the second-highest per capita arable land in the world and proximity to large markets in China and Russia, agriculture has significant potential to contribute to diversification and growth. However, deep-seated issues, including infrastructure and irrigation bottlenecks, access to technology and financing, and inefficient use of resources hold back the sector. State programs have made progress in addressing some of the challenges, but should be more effective. Streamlining support mechanisms, shifting the balance of financing from subsidies to investment, and tailoring support to farmers' needs would deliver better results. The restructuring of KazAgro is a step in the right direction. Careful monitoring of execution of state programs, including "Agrobusiness 2020" and "Development of the Agroindustrial Complex 2017-21" is needed to ensure that they achieve their goals of creating a conducive environment for investment and growth.

Governance

15. Sound and robust governance arrangements are key to strong, sustainable, and inclusive growth. Progress is being made, but further gains are needed. Kazakhstan has made several high-level commitments to improve governance and reduce corruption risks, including in the 100 Concrete Steps and the 2015–25 National Anti-Corruption Strategy. Commendable efforts have been undertaken to move to e-governance, including in tax administration and procurement. Recent legal amendments have improved the ability to identify and seize corruption proceeds. Areas for further work to meet international best practices and standards include access to information, whistleblower protection, criminalization of additional corruption offences, revisiting the scope of immunities, and leveraging AML/CFT tools to support anti-corruption efforts. Asset declarations are in place and would benefit from enhanced verification and selective publication, while independence of key agencies should be strengthened. The National Strategy would benefit from measurable actions and benchmarks. Finally, under the 100 Concrete Steps, the authorities have initiated ambitious reforms to improve the effectiveness of the judiciary and contract enforcement, including new dispute resolution mechanisms at the Astana International Financial Center. Implementation of these measures would provide a positive contribution.

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The team thanks the authorities and other stakeholders for hospitality and constructive discussions.

Kazakhstan: Selected Economic Indicators, 2017–21

	2017	2018	2019 (proj.)	2020 (proj.)	2021 (proj.)
Output					
Real GDP growth (%)	4.1	4.1	4.1	3.6	3.8
Real oil	8.7	8.4	-0.3	0.0	1.4
Real non-oil	2.7	2.7	5.6	4.8	4.5
Crude oil and gas condensate production (million tons)	86	90	90	90	91
Employment					
Unemployment (%)	4.9	4.9	4.9	4.9	4.9
Prices					
Inflation (%)	7.3	5.3	5.6	5.5	5.0
General government finances 1/					
Revenue (% GDP)	20.3	22.2	20.9	21.2	21.5
Of which: oil revenue	6.1	7.7	7.1	6.7	6.3
Expenditures (% GDP)	24.7	19.6	20.7	20.8	20.6
Fiscal balance (% GDP)	-4.4	2.6	0.2	0.5	0.9
Non-oil fiscal balance (% GDP)	-10.5	-5.1	-6.9	-6.2	-5.4
Gross public debt (% GDP)	20.3	21.0	21.1	21.1	20.5
Money and credit					
Broad money (% change)	-1.7	7.0	1.0	4.8	5.7
Credit to the private sector (% GDP)	26.5	23.5	22.2	22.3	22.6
NBK policy rate (%, eop)	10.3	9.3	…	…	…
Balance of payments					
Current account (% GDP)	-3.1	-0.2	-2.2	-2.3	-2.8
Net foreign direct investments (% GDP)	-2.3	-2.8	-3.7	-3.9	-3.9
NBK reserves (in months of next year's imports of G&S)	8.0	7.6	7.1	7.0	7.0
NFRK assets (in months of next year's imports of G&S)	15.1	14.3	14.8	15.0	15.1
External debt (% GDP)	102.7	91.8	94.2	90.5	85.7
Exchange rate					
Exchange rate (y-o-y percent change; Tenge per U.S. dollar; eop)	-0.3	15.6	…	…	…

Sources: Kazakhstani authorities and Fund staff estimates and projections.

1/ The fiscal accounts in 2017 include a state support to the banking sector of 4 percent of GDP.