Republic of Kazakhstan — 2014 Article IV Consultation

Concluding Statement of the IMF Mission

April 30, 2014

An IMF mission, led by Hossein Samiei, visited Almaty and Astana during April 21-30 to conduct the 2014 Article IV consultations. The mission met with government and central bank officials, and representatives of the private sector and civil society. Amid uncertain external and domestic environments, keeping monetary conditions under control following the devaluation, strengthening the macroeconomic policy architecture, and accelerating structural and financial reforms are critical to mitigating shocks and achieving medium-term objectives. The mission thanks the authorities and other counterparts for the very helpful and productive discussions.

Outlook and risks

1. Following solid growth performance in 2013, the economy is losing some momentum. In view of the substantial deterioration in the current account balance, concerns about competitiveness (given significant depreciation in the Russian ruble), and the fall in international reserves, the National Bank of Kazakhstan (NBK) devalued the tenge by 18 percent in February. The recently released preliminary figures for 2014Q1 suggest that real GDP growth is decelerating, reflecting the loss of investors' confidence due to regional tensions, weaker demand from emerging market economies, and lower growth in the mining sector. Moreover, price controls announced after the devaluation are expected to adversely affect planned investment of large state-owned enterprises (SOEs). Against this backdrop, our revised preliminary growth projection for 2014 is around 4¾ percent (compared with the earlier projection of 5¾ percent), despite positive contribution from the authorities' planned fiscal measures. Nonetheless, temporary inflationary pressures are likely to emerge from the devaluation, although the authorities are determined to keep inflation within the central bank's objective range of 6-8 percent. Over the medium term, stronger growth prospects are driven by a projected increase in oil output, subject to rising uncertainty associated with the Kashagan oil field.

2. Risks to the near-term growth outlook are predominantly on the downside. The loss of confidence in macroeconomic stability following the devaluation and possible delays in structural reforms pose downside domestic risks to growth. Furthermore, in addition to downside risks from prolonged slowdown in emerging markets, Kazakhstan's economy is vulnerable to additional unfavorable developments in Russia and Ukraine, given the strong trade and financial linkages with Russia (especially in the context of the Customs Union) and potential spillovers to Europe. At the same time, a possible rise in oil prices resulting from an escalation in regional tensions could provide support to growth.

Financial sector

3. The authorities' very recent aggressive efforts to reduce the large stock of nonperforming loans (NPL) are commendable. With system NPLs remaining stubbornly high at above 30 percent of total loans, and already rising as a result of the devaluation, the authorities' commitment to ensuring that banks adhere to the NPL ceilings (15 percent by end – 2014 and 10 percent by end – 2015) is appropriately ambitious. It is critical that credible corrective supervisory actions enforce the NPL ceilings effectively, while ensuring adequate provisions. To facilitate the achievement of these targets, the authorities are buttressing existing policy vehicles and introducing an appropriate mix of incentives and penalties. The recent announcement to substantially increase the financing of the Problem Loan Fund (PLF) is welcome and is expected to be accompanied by expanding the eligibility of loans (especially real estate and construction) that can be purchased by the PLF and by granting special powers to the PLF. Moreover, the authorities are cognizant of the need to expedite the parliamentary approval of their proposed legislative amendments concerning tax incentives for debt write-offs and the removal of legal obstacles to the transfer of NPLs into Special Purpose Vehicles (SPVs) or the PLF. Revising the insolvency law to strengthen protection for legal rights of secured creditors should be considered as well.

4. We welcome the authorities' intention to fully implement the recommendations of the recent Financial Sector Assessment Program (FSAP) mission. Key priority areas (in addition to the single pension fund, insurance and securities market oversight, and financial infrastructure) include:

- *The divestiture of nationalized banks.* Given the systemic implications of the sale of BTA to Kazkommertsbank – with the combined entity accounting for about 25 percent of banking system assets and over 65 percent of all NPLs – the authorities should ensure that an asset quality review (AQR) is carried out, preferably by an independent international entity and prior to the completion of the transaction, and that a time-bound plan for working out those NPLs is submitted as part of the deal. The implementation of this plan should be carefully monitored.

- *Bolstering the financial safety net and moving to risk-based oversight.* Available resolution tools, as foreseen in current legislation, are impractical. Supervisors should have full authority to independently mandate the resolution methods and have a clearly sequenced procedure for graduated intervention. A faster transition from granular compliance supervision towards more risk-based oversight is also needed.

- *The sharp further increase in financial dollarization following the devaluation.* This renders the financial system increasingly prone to foreign-currency risks. It is also likely to put upward pressure on NPLs in the coming months, requiring vigilance to the emergence of related credit risk.

Monetary and exchange rate policy

5. In view of the expected rise in inflation, the NBK should stand ready to tighten monetary policy, if necessary. However, the NBK will need to tread carefully. While ensuring that higher inflationary expectations do not become unhinged, it should also help alleviate a tightening of tenge liquidity conditions in light of slowing growth. Indeed, although overnight and 7-day money market rates have declined significantly recently, banks' longer-term tenge funding is scarce, in part due to the rapid increase in the dollarization of time deposits in recent months. The NBK's expected offering of one-year foreign-currency swap operations with banks could help in this regard, but it should be seen as a temporary measure, and not as an alternative to standard open market operations. Indeed, in view of the importance of anchoring inflation expectations, and with the aim of more effectively signaling a possible tighter stance of monetary policy, the NBK should speed up the planned introduction of a new policy interest rate instrument, supported by active open market operations.

6. Faster progress in introducing a more effective monetary policy framework is imperative. Continued volatility in the money market and rising dollarization further underscore the urgent need to make more rapid progress in adopting effective interest rate instruments. The NBK's tight exchange rate management, and its recent refocusing on the exchange rate both as primary objective and as dominant instrument of monetary policy, complicates the management of system liquidity. As a complement to more effective interest rate policy, and as an intermediary step toward a more flexible exchange rate regime, including the adoption of inflation targeting – a stated NBK medium-term objective – we believe there is scope to widen the exchange rate band. In our view, this would also help manage corrections to the existing currency undervaluation. Moreover, to anchor expectations about policy intentions and operations, the NBK should communicate more openly and clearly the transition plans (including publishing the monetary policy guidelines for 2014), and more generally elaborate on the factors guiding interest rate and exchange rate intervention decisions in NBK's post-meeting communiqués and quarterly inflation reports. The IMF stands ready to provide technical assistance in these areas in support of strengthening the monetary policy framework.

Fiscal policy

7. In light of slowing growth, the authorities' decisions to increase spending in 2014 seem appropriate, but care needs to be taken to ensure that the spending is transparent and of high quality. Recapitalizing the PLF (recommended by the FSAP) and on-lending via commercial banks and Baiterek to support SMEs and priority sectors from the oil fund (amounting to $2.7 billion or 1.2 percent of GDP in 2014) should be based on market principles. These measures together with earlier increases in wages and social benefits following the devaluation will more than offset revenue gains due to higher tax receipts from the oil sector (resulting from the devaluation and a hike in the oil export duty rate). As a result, and reflecting slower projected growth, the nonoil deficit of the consolidated budget (according to IMF methodology) is expected to increase to nearly 9.0 percent of GDP, accounting for the 500 billion tenge stimulus package. Given the downside risks to growth and the much stronger-than-expected performance in 2013 (7.0 percent of GDP), staff can support the revision in the 2014 nonoil deficit. However, it urges the authorities to remain committed to the medium-term target of 6 percent of GDP by 2018 – as envisaged earlier – especially as on-lending out of the oil fund is paid back and the PLF is unwound over time.

8. Against this background, strengthening the fiscal policy framework remains a key priority. Despite important steps outlined in the authorities' fiscal strategy adopted last year, there is ample scope for further progress, especially in extending the coverage of the fiscal framework and improving its integration within the broader macroeconomic policy framework. To better assess the fiscal policy stance, the authorities should consolidate the oil fund into fiscal accounts, in line with international standards, and should reduce off-budget expenditure in the context of enhanced fiscal transparency. Further, it is important that both annual and medium-term fiscal plans are well-integrated into broader macroeconomic policy objectives. This should help reduce the need for frequent revisions and supplementary budgets during the course of the year. Finally, there is room to improve revenue policies, including by reducing dependence on measures like oil export duties and relying more on income, progressive, and resource-rent taxation. The use of administrative price controls as a tool to protect socially vulnerable groups should be replaced with targeted social transfers.

Structural issues and reforms

9. Continued prudent and transparent management of oil wealth is essential. Kazakhstan has compared well to other oil exporters with respect to transparency of operations of the national oil fund. We urge the authorities to continue this practice by channeling the recently announced industrialization and diversification package exclusively through the budget. Furthermore, the lending programs through quasifiscal institutions and commercial banks warrant careful planning and implementation. Liabilities and obligations arising from lending as well as terms and conditions should be market-based and clearly disclosed. More broadly, it will be important to ensure that spending on development and diversification programs is transparent and in line with capacity and high standards of efficiency in order to guard against the resource curse.

10. Bolstering human capital and institutions, and lowering the role of the state in the economy are critical to ensuring sustained and inclusive growth. Successful diversification, which the authorities appropriately consider as a primary long-term goal requires addressing key structural weaknesses, in particular regarding human capital and institutions – areas where the country has lagged behind successful emerging market economies. Robust GDP growth in the previous years has contributed to increasing per capita income and reducing income inequality. However, the relationship between job creation and growth has been weak, particularly since the onset of the global crisis. To promote private-sector led non-oil growth and job creation, the government's long-term development programs (as envisaged in the Kazakhstan-2050 Vision) need to focus on broad-based reforms, notably in the areas of starting business, enforcing contracts, and protecting investors, while avoiding top-down policies of picking winners. In the context of gradually reducing the role of the state in the economy, the authorities' recently announced plan to accelerate the public IPO program of large SOEs is welcome.