Republic of Kazakhstan—2013 Article IV Consultation
Concluding Statement of the IMF Mission

June 4, 2013

An IMF mission, led by Hossein Samiei, visited Almaty and Astana during May 22–June 3 to conduct the 2013 Article IV consultation. The mission met with government and central bank officials, and representatives of the private sector and civil society organizations. The authorities' vision of developing Kazakhstan into a major emerging market economy is commendable but will require concerted efforts to strengthen the policy architecture. The currently stable macroeconomic environment provides a unique opportunity to speed up this process. The mission thanks its counterparts for the helpful and productive discussions.

1. **Growth has decelerated, but medium-term prospects remain solid.** Following rapid output recovery from the crisis, real GDP growth slowed to 5 percent last year, mostly reflecting declines in oil and agricultural output. In 2013, moderate growth is expected to continue, in part due to further weaknesses in the metals sector, with real GDP growth increasing only slightly to around 5¼ percent (compared with the authorities' projection of 6 percent). Over the medium term, growth prospects are stronger, driven by a substantial projected increase in oil output, especially from Kashagan, and diversification plans.

2. **Downside risks to the outlook are primarily external.** Lower commodity prices and weaker external demand, especially from key trading partners such as Russia, China, and Europe would likely hamper growth prospects. The persistently large share of nonperforming loans (NPLs) and possible delays in production in Kashagan are additional risks.

3. **In the financial sector, ongoing efforts to address stability risks should include enhanced supervision and macroprudential surveillance.** We welcome the decision to exit from state ownership in troubled banks. To bolster the stability of the banking system as a whole and to avoid the emergence of new risks, the exit should take place in a fully transparent manner. Meanwhile, private sector credit growth remains relatively weak overall, yet consumer lending is expanding rapidly from a low base at around 40 percent year-on-year. The authorities must ensure that risk management and lending practices are sufficiently robust to avoid exacerbating the NPLs problem. In this regard, further strengthening of supervision and macroprudential tools is crucial, including by bolstering on-site bank supervision, enhancing liquidity and credit risk assessments, stepping up the Early Warning System, and ensuring that banks have viable business plans.

4. **In view of limited progress on the resolution of NPLs, the authorities are adopting a more proactive posture.** Despite the introduction of new measures in 2012, NPLs remain high at around 30 percent. Progress has been limited by banks' unwillingness to sell assets in the expectation of a price recovery, the complexity of the loan-restructuring process, and social constraints in resolving mortgages. In view of this, we welcome the authorities' consideration of a more flexible approach to the design of the Problem Loan Fund, to make it more attractive to banks and to increase its size if necessary. We particularly welcome the introduction of ceilings on NPLs and urge the authorities to enforce these strictly and on a consolidated basis, while ensuring adequate provisions. Extending the tax exemption for banks and buyers of distressed debt beyond 2013 should also help.

5. **The monetary policy stance remains appropriate.** Notwithstanding recent hikes in administered utility prices, inflationary pressures and growth in monetary aggregates have been relatively contained. With projected headline inflation hovering around the midpoint of the objective range (6-8 percent) and core inflation stable, the National Bank of Kazakhstan (NBK) is expected to keep its policy interest rate on hold in the coming months. This stance may need to be reevaluated if excess liquidity in the banking system translates into more rapid private sector credit expansion or if fiscal policy turns out looser than currently expected.

6. **Discussions with the NBK clarified the positive steps that are being taken to enhance the regulation of liquidity in the banking system.** In view of limited instruments for efficiently managing the buildup of excess liquidity in recent years, the NBK has: (i) excluded banks' cash on hand and correspondent accounts in foreign currency from the reserve assets to assess more accurately the size of tenge liquidity; and (ii) been more active in the provision of short-term liquidity to banks through repo operations to smooth seasonal fluctuations in liquidity conditions (e.g. relating to quarterly tax payments). Moreover, the NBK plans to engage in more active open market operations (OMOs) for both the provision and withdrawals of liquidity, through changes to its standing facilitates and introduction of a new repo rate between the two standing facilities' interest rates.

7. **Strengthening monetary policy further will require introducing a policy rate that signals better the stance of policy and enhancing the communication strategy.** The official refinancing rate, the NBK's policy interest rate, has played little role in guiding key market interest rates. The envisaged repo instrument could become the new policy rate (preferably within a narrower interest rate corridor) to guide better key money market rates, hence bolstering the signaling effects of monetary policy. Moreover, to anchor expectations about policy intentions and operations, the NBK should communicate more openly and clearly the transition plans to active OMOs, and more generally elaborate on the factors guiding the interest rate and exchange rate intervention decisions in the NBK's post-meeting communiqué and quarterly inflation reports. Looking ahead, there is scope to allow greater exchange rate flexibility over the medium term to enhance monetary policy transmission.

8. **The unification of Kazakhstan's private pension funds under state ownership and NBK management is progressing, but not without risks.** It is essential to avoid exacerbating fiscal risks and undermining earlier reform efforts, including by making up for eliminating competition in the market for pension services. In particular, we encourage the authorities to fully abide by their intentions to: (i) develop a clear and sound market-based investment strategy for the assets; (ii) secure management independence with arms-length contracts (preferably with reputable international advisors); and (iii) ensure that individual accounts are maintained. Notwithstanding the risks associated with unification, the expected increase in banks' and non-bank financial institutions' participation in the market for government paper, as demand for such paper from pension funds declines, could provide support to the NBK's move to more active OMOs. In this regard, continued close collaboration between the ministry of finance and the NBK will be crucial to secure successful outcomes.

9. **The revised 2013 budget (consolidated to include the National Fund) implies lower fiscal balances than initially planned.** In the first few months of this year revenue performance has been weaker than expected, especially in corporate income tax and VAT

collection, reflecting lower-than-expected nominal GDP. The authorities have responded by cutting planned spending by 0.2 percent of GDP relative to the original budget, implying an overall reduction in spending of 1.5 percent of GDP relative to 2012, using IMF's methodology. Nevertheless, given weaker projected revenues, the overall balance now improves by 0.2 percent of GDP relative to 2012 compared with an improvement by 0.5 percent of GDP implied by the original budget. Since the fall in revenues seems mostly cyclical and the expenditure cuts are already large, the mission does not recommend further cuts this year. However, it urges the authorities to adhere to their announced plans to make up for the shortfall in 2014 and ensure that spending in 2013 remains within the revised budget.

10. **The authorities remain committed to reducing the nonoil deficit to sustainable levels over the medium term, but in our view the assumptions underlying their projections appear unrealistic.** The consolidation plans outlined in the current medium-term framework rely primarily on reducing expenditure in percent of GDP, and hence may be inconsistent with announced (but non-budgeted) large scale public spending plans related to the government's development and diversification programs. Furthermore, growth assumptions underlying the framework may be overly optimistic.

11. **The mission welcomes the authorities' intention to revamp and considerably improve the medium-term fiscal framework by the end of this year.** The revised framework is intended to incorporate the envisaged revenue and expenditure measures systematically and be based on credible macroeconomic assumptions. While the annual spending out of the National Fund may increase through 2018, the target for the minimum balance of the National Fund is planned to be raised from 20 percent to 30 percent of GDP, reaffirming the government's commitment to prudent management of oil revenues. At the same time, the authorities are planning to reduce the budget's reliance on oil revenue over time by introducing new tax measures to ensure medium-term sustainability of the non-oil deficit. However, without further details on these measures and before the new medium-term framework is prepared, we find it difficult to assess the authorities' projections. The recent redistribution of responsibilities for fiscal planning from the Ministry of Finance to the newly reorganized Ministry of Economy and Budget Planning should facilitate the integration of the fiscal plans within the macroeconomic framework.

12. **Diversification of the economy remains a key long-term policy priority.** The authorities' envisaged plans encompass infrastructure development, targeted support to help priority sectors, encouraging innovation, and raising productivity. For successful diversification, it is essential to reduce the role of the state in the economy, while focusing on bolstering human capital and institutions. Furthermore, it will be crucial to ensure that public spending programs are in line with capacity and high standards of efficiency, while refraining from aggressive spending to avoid adverse macroeconomic outcomes. Recent reorganization of the main development institutions under the umbrella of Samruk Kazyna resulted in the creation of a new entity (Baiterek). The authorities should take advantage of this reorganization to further enhance the transparency of quasi-fiscal operations, including through careful cost-benefit analysis (with assistance from international financial institutions) of all government programs implemented through the general government budget, quasi-fiscal institutions, and private public partnerships.