



Report and Recommendation of the President to the Board of Directors

Project Number: 49083-001
July 2015

Proposed Loan Republic of Kazakhstan: Countercyclical Support

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 22 July 2015)

Currency unit	–	tenge (T)
T1.00	=	\$0.0053
\$1.00	=	T187.05

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MDB	–	multilateral development bank
MNE	–	Ministry of National Economy
MOF	–	Ministry of Finance
MSMEs	–	micro, small, and medium-sized enterprises
NBK	–	National Bank of Kazakhstan
NFRK	–	National Fund of the Republic of Kazakhstan
NPL	–	nonperforming loan
OECD	–	Organisation for Economic Co-operation and Development
PFA	–	Partnership Framework Arrangement

NOTE

- (i) In this report, “\$” refers to US dollars.

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CONTENTS

	Page
PROGRAM AT A GLANCE	
I. THE PROPOSAL	1
II. THE PROGRAM	1
A. Rationale	1
B. Impact and Outcome	7
C. Outputs	7
D. Development Financing Needs	7
E. Implementation Arrangements	8
III. DUE DILIGENCE	8
A. Governance	8
B. Poverty and Social	9
C. Safeguards	10
D. Risks and Mitigating Measures	10
IV. ASSURANCES	10
V. RECOMMENDATION	10
APPENDIXES	
1. Design and Monitoring Framework	11
2. List of Linked Documents	13
3. Development Policy Letter	14
4. Assessment of Compliance with the Countercyclical Support Facility Access Criteria	21

PROGRAM AT A GLANCE

1. Basic Data		Project Number: 49083-001	
Project Name	Countercyclical Support	Department /Division	CWRD/CWPF
Country Borrower	Kazakhstan Ministry of Finance	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Decentralization		100.00
	Public administration		300.00
	Public expenditure and fiscal management		500.00
	Social protection initiatives		100.00
	Total		1,000.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded Pillar 3: Extreme deprivation prevented and effects of shocks reduced (Social Protection)	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Public financial governance	Some gender elements (SGE)	✓
Knowledge solutions (KNS)	Knowledge sharing activities		
Private sector development (PSD)	Conducive policy and institutional environment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization:	Complex		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		1,000.00	
Sovereign Countercyclical Support Facility Lending (Loan): Ordinary capital resources		1,000.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		1,000.00	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan for Countercyclical Support to the Republic of Kazakhstan.

2. The proposed loan will help the government mitigate the sudden and significant negative economic impact caused by the steep fall in oil prices and the economic slowdown in the Russian Federation. The government's planned fiscal stimulus expenditure will help Kazakhstan stabilize and continue its economic growth trajectory while targeting fiscal sustainability in the medium term. The proposed loan will contribute to employment creation, social services provision, and low-income household support; expand and modernize physical infrastructure; and promote inclusive private sector development.¹

II. THE PROGRAM

A. Rationale

3. Gross domestic product (GDP) growth slowed from an average of 10.2% during 2000–2007 to 3.3% in 2008 and 1.2% in 2009 during the global financial crisis. Responding to the crisis the government implemented the Anti-Crisis Plan and the Employment Generation Program, which included funding from an Asian Development Bank (ADB) countercyclical support loan of \$500 million.² The government also drew upon the National Fund of the Republic of Kazakhstan (NFRK) to implement the reforms, which cost the government about \$24.4 billion during 2008–2010.³ The countercyclical measures undertaken in response to the global crisis, along with rising oil prices, enabled a return to higher economic growth averaging 6.4% during 2010–2013, but growth did not rebound to pre-crisis growth rates.

1. Serious Impact of Adverse External Factors

4. **In 2014, two significant external factors impaired economic growth, revenue performance, and the government's ability to mitigate these effects.** The first was the Russian Federation's economic slowdown, which triggered a downward adjustment in the tenge exchange rate equivalent to 16.2%, or a 19.4% rise in the tenge–dollar exchange rate.⁴ The Russian Republic provides all pipelines and ports for Kazakh oil and mineral exports, and supplies about 36% of total imports. The economies are further linked through joint membership in the European Economic Union. The second was the steep fall in world oil prices, which fell by

¹ The design and monitoring framework is in Appendix 1. The Asian Development Bank has not provided project preparatory technical assistance for the proposed loan for Countercyclical Support.

² ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Kazakhstan for the Kazakhstan Countercyclical Support Loan*. Manila.

³ The NFRK, established in 2000, ensures stable social and economic development and saving of financial resources for future generations. To ensure transparency, transfers from the NFRK are published, and pass through the republican budget. Transfers include (i) guaranteed transfers to support economic growth, and (ii) targeted transfers for socially important projects that are not self-sustaining and that can be provided by order of the President of Kazakhstan in the absence of alternative financing sources. Direct transfers from the NFRK to state-owned enterprises are not reflected in the republican budget. Collected Acts of the President and the Government of the Republic of Kazakhstan. 2010. *On the Concept of establishment and use of the National Fund of the Republic of Kazakhstan*. Decree of the President of the Republic of Kazakhstan No. 962 dated 2 April 2010. Source for NFRK assets: <http://www.nationalbank.kz>

⁴ Since September 2013, the tenge has been measured against a basket of currencies, which helped reduce the effect of the weakening Russian ruble. The exchange rate band has gradually widened from $T185 \pm T3 = \$1$ in February 2014, from $T155$ the previous day; $T185 + T3$ to $T185 - T15$ in September 2014; and to $T185 + T13$ to $T185 - T15$ in July 2015, widening the band to $T170 - T198 = \$1$.

more than 50% from the end of 2013 to the end of 2014.⁵ Kazakhstan's economy is heavily dependent on oil, which accounts for about 20.0% of GDP, 50.0% of budget revenues, and 76.0% of exports.

5. The downward exchange rate adjustment of the domestic currency in February 2014 undermined confidence in the tenge, increased dollarization, and increased the likelihood of firms' balance sheet and liquidity risks. Firms and households converted tenge deposits into foreign currency, the tenge money supply dropped, and deposit dollarization increased from 37.4% in 2013 to 52.2% by May 2015. Loan dollarization has remained largely the same. Lending has slowed and had by May 2015 contracted 1.9% on a year-on-year basis. Deposits contracted 0.7% on a year-on-year basis. Market indicators suggest a higher perceived credit risk, which is making it harder for Kazakhstan to access international markets for funding without increased cost. In 2015, two of three main global rating agencies downgraded Kazakhstan's sovereign rating, contributing to greater increases in the cost of sovereign borrowing on international capital markets.⁶ Kazakhstan on 14 July 2015 issued a 10-year dollar denominated bond in the amount of \$2.5 billion with a 5.1% coupon and a 30-year dollar denominated bond in the amount of \$1.5 billion with a 6.5% coupon. A Eurobond was issued in October 2014 in 10-year dollar-denominated bonds priced to yield 4.07% and 30-year dollar-denominated bonds priced to yield 5.12%, prices which were 1.03% and 1.38% lower respectively than the 2015 bonds.

6. The adverse external factors have had a significant negative effect on the real economy. GDP growth fell from 6% in 2013 to 4.3% in 2014, and is projected to drop to 1.9% in 2015. The slowdown is due to lower oil industry output, weaker external demand for Kazakhstan's metal exports, and declining domestic demand. The lower commodity prices caused export revenues to fall by 8.6% in 2014, from a 1.1% decline in 2013. Consumption growth—a key economic growth driver—fell from 12.8% in 2013 to 2.5% in 2014, due to the downward adjustment of the tenge and tighter consumer lending. The current account is projected to move to a deficit of 1.0% in 2015. The 12-month inflation rate increased from 5.8% in 2013 to 6.7% in 2014,⁷ but in June 2015 inflation was 3.9% year-on-year.

7. While fiscal policy is sound, the government budget is under pressure to meet critical expenditures. The budget deficit expanded from 2.0% of GDP in 2013 to 2.7% in 2014 (\$6 billion equivalent) and is projected to increase to 3.0% in 2015 (\$6.8 billion equivalent). Transfers from the NFRK to the budget were increased from 26.7% of total revenue in 2013 to 32.6% of total revenue in 2014. The increased NFRK transfers in 2014, together with a 13.3% rise in corporate income tax revenue, caused total budget revenue to increase to 15.1% of GDP in 2014. However, the post-teenge adjustment pay rise and higher pensions and social transfers increased expenditure to 17.9% of GDP in 2014. To meet the budget gap, the government sold \$2.5 billion in Eurobonds in October 2014, pushing public and publicly guaranteed debt up 2.3% to about 15.2% in 2014.

8. The economic decline dampens employment prospects. The historic relationship between job creation and growth has been weak. This reflects the capital-intensive nature of the economy, dominated by the oil subsector with a small, undiversified private sector. The

⁵ Due to measurement methods and economic developments, the report may contain minor data inconsistencies.

⁶ Moody's rates Kazakhstan Baa2 (stable outlook), S&P rates it BBB (negative outlook), and Fitch rates it BBB+ (stable outlook). Kazakhstan retained its investment grade through the 2008–2009 global financial crisis.

⁷ Core inflation increased from 4.3% in 2013 to 6.7% in 2014.

government implemented the first employment road map in 2009 in response to the global financial crisis, undertaking public works to contain sudden rises in unemployment. This countercyclical measure contributed to a reduction in unemployment from 6.6% in 2009 to 5.1% in 2014.⁸ Job creation in services helped keep poverty low, and poverty incidence decreased from 6.6% in 2009 to 2.8% in 2014.⁹ However, 28.0% of the economically active population is self-employed, and is highly vulnerable to the current economic downturn. These workers also are less likely to be covered by social protection and support.¹⁰ Current challenges that the government will address using countercyclical measures include (i) the unproductive farm structure, which reflects limited access to credit and weak integration of food value chains; (ii) the underdeveloped private sector, which does not sufficiently increase employment; (iii) the large public sector, with higher compensation and benefit packages than the private sector; and (iv) the demand for labor, which does not match the available skills mix.

2. Countercyclical Response by the Government

9. **Starting in 2014 the government introduced three main measures to mitigate the significant negative impacts** of Russian Federation's economic slowdown and steep fall in world oil prices, and to deliver the conditions for sustainable, long-term, inclusive economic growth. First, in early 2014 the government launched a long-term development strategy, Kazakhstan 2050, to transform the economy into a diversified, private sector-driven, developed economy. To commence implementation of this strategy, the government developed medium-term action plans to be implemented under Partnership Framework Arrangements (PFA) with multilateral development banks (MDBs).¹¹ Spending priorities include (i) \$1 billion equivalent to increase lending for micro, small, and medium-sized enterprises in manufacturing to increase income-generating opportunities; (ii) \$0.8 billion equivalent to finance infrastructure projects, particularly regional projects in housing and utilities, road construction and repair, and reconstruction of social facilities; (iii) \$1.4 billion equivalent for the Fund for Problem Loans to support banking by purchasing qualified nonperforming loans (NPLs); and (iv) an additional \$2.2 billion equivalent for other projects under the PFA. ADB is expected to support two programs in 2016 under the PFA.¹²

10. The second measure is the Nurlı Zhol program for infrastructure development, approved in April 2015. It includes economic support of \$9 billion equivalent—with annual allocations for 2015, 2016, and 2017—to be financed through the budget by the NFRK and MDB loans. The program will continue reforms to support and stabilize economic growth and employment, including anti-crisis measures for individual sectors of the economy facing export declines. Spending priorities include (i) developing and modernizing infrastructure to support education, tourism, housing, utilities, transport, and logistics; (ii) developing non-oil business sectors, including manufacturing and agribusiness; and (iii) improving the business environment,

⁸ World Bank. World Development Indicators. <http://data.worldbank.org/indicator> (accessed 5 July 2015).

⁹ Poverty is measured by the number of people living below the national poverty line (the proportion of the population with incomes below the subsistence minimum). <http://www.stat.gov.kz> (accessed 5 July 2015).

¹⁰ Government of Kazakhstan. The Official Statistical Information. <http://www.stat.gov.kz> (accessed 5 July 2015).

¹¹ ADB and the Government of Kazakhstan signed the PFA during ADB's 47th Annual Meeting of the Board of Governors in Astana in May 2014. The PFA will deepen cooperation to achieve the goals to support the government's development strategies over the next decade. This is reflected in the government's increased funding share in ADB. (ADB. 2012. *Country Partnership Strategy: Kazakhstan, 2012–2016*. Manila). 2014. *Country Operations Business Plan: Kazakhstan, 2015–2017*. Manila. PFAs also exist with the World Bank, the European Bank for Reconstruction and Development, and the Islamic Development Bank.

¹² The proposed programs are included in ADB. 2014. *Country Operations Business Plan: Kazakhstan, 2015–2017*. Manila.

including increasing availability of finance. Among other results, Nurly Zhol will address problems with the shortage of preschool educational institutions, three-shift education in secondary schools, and poor materials and technical equipment in higher education institutions. To stimulate entrepreneurship, funds will be provided for loans to manufacturing businesses to help create work for more than 4,000 people. In total, the Nurly Zhol expects to generate about 395,000 jobs by 2019 through investment projects.

11. The third measure is the Employment Roadmap 2020, financed with \$200 million equivalent in the revised March 2015 budget, with similar allocations planned for 2016 and 2017. Target population groups include the self-employed, unemployed, part-time, and low-income persons, including youth, women, and the disabled. The road map has three objectives: (i) promote employment of self-employed, unemployed, and target population groups; (ii) develop human resources; and (iii) improve targeted social assistance. It includes increased access to employment opportunities, training, and retraining; and strengthening of the linkage between participation in employment programs (training) and access to social services and aid. By 2020, the target is to keep the total unemployment rate below 5.0%, the unemployment rate of women below 5.5%, and the youth unemployment rate (15–28 years of age) below 4.6%.

12. The government also has taken steps to attract investment to the non-oil economy. The Framework for Attracting Foreign and Domestic Investment into Kazakhstan presented in April 2014 includes a package of incentives for investors: (i) investment subsidies, tax preferences, and procurement incentives; (ii) stable laws and cost predictability for tax, migration and environmental legislation, and predictable tariffs and prices of regulated services; (iii) establishment of a single window for investors; (iv) energy and transport cost subsidies; and (v) attraction of foreign labor. Additional measures include (i) a simplified visa regime, (ii) extended duration of agricultural land leases for foreigners, and (iii) an investment ombudsman. In May 2015, the Plan for the Nation: 100 Concrete Steps for Implementation of Institutional Reforms was approved in response to current global and domestic challenges. A detailed action plan includes policy improvements, outputs, and activities to be completed in 2015. It supports activities in both the Nurly Zhol and the Employment Roadmap 2020.

3. Measures to Ensure Sound Macroeconomic Management, Including a Sound Fiscal Position

13. **The government and the National Bank of Kazakhstan (NBK), the country's central bank, have taken proactive monetary, fiscal, and regulatory measures to address the significant negative external pressures on the economy.** Monetary policy in 2014 aimed to maintain price stability and rehabilitate the banking system, while preventing a post-devaluation downturn. The monetary policy for 2015 and 2016 targets macroeconomic and financial stability, as well as domestic and external competitiveness.¹³ To restore trust in the tenge and stimulate lending, measures have been taken to address the scarcity of long-term tenge funding and the high level of dollarization in the banking system. In a move towards inflation targeting, which will require a shift to a more flexible exchange rate, since the February 2014 devaluation the government has widened the exchange rate band on two occasions (footnote 4).¹⁴ The NBK also plans to moderate exchange rate fluctuation, while limiting market intervention to conserve

¹³ Monetary Policy Guidelines of the Republic of Kazakhstan for 2015, approved by Resolution of the Board of the National Bank of the Republic of Kazakhstan dated 25 February 2015 No. 30; and ADB. 2015. *Asian Development Outlook: Financing Asia's Future Growth*. Manila (March).

¹⁴ Statement by the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan on Main Directions of Economic Policy in 2015. 25 December 2014.

reserves. Measures to reduce dollarization in the economy include a doubling of the ceiling on tenge deposit insurance guarantees to T10 million, while maintaining the T5 million limit on foreign currency deposits.

14. Efforts are under way to strengthen the financial system, rehabilitate weakened banks, and develop capital markets. Requirements for higher bank capitalization will take effect on 1 January 2016. Measures under way to reduce the high number of non-performing loans (NPLs), a legacy from the 2008–2009 global financial crisis, include (i) implementation of maximum percentages of NPLs in bank portfolios (10% starting January 2016); (ii) amendments to three laws to facilitate the writing off of NPLs; (iii) write-offs of bad loans from bank balance sheets; and (iv) provision of funds to buy qualified NPLs from banks for work-outs at later dates. In 2014, the government allocated \$1.4 billion equivalent from the NFRK to capitalize the Fund for Problem Loans to purchase NPLs from banks. These steps enabled NPL reduction from 33.7% of total bank portfolios in April 2014 to 23.1% (\$17.6 billion equivalent) in April 2015.

15. Government fiscal policy is to balance the budget and manage drawdowns from the NFRK by (i) developing a consistent medium-term macro-fiscal framework; (ii) increasing the sustainability of the non-oil deficit over the medium-term; and (iii) reducing the non-oil deficit from 7.7% of GDP in 2014 to 2.8% by 2020. However, for the next two years the budget and related NFRK transfers will be under significant pressure. In March 2015, the budget was revised, at which time revenues were reduced by 14% and expenditures by 10%. Government salary increases were delayed, but social support and services allocations were increased to 39.1% of the budget. Slower growth, lower oil revenues, reduced export duties, and constrained imports are expected to continue to limit revenues, while expenditure must be sustained to meet economic growth needs. Thus the revised budget projects a deficit of 3.0% of GDP in 2015 or \$6.8 billion equivalent, and the provisional 2016 budget projects a deficit of 2.4% of GDP or about \$5.8 billion equivalent.¹⁵ To support the 2015 budget, the government allocated guaranteed and targeted transfers from the NFRK of \$13.4 billion equivalent or 41.5% of total revenue. Total NFRK allocations for 2016 are projected at about \$11.2 billion. The transfers in both years will be insufficient to fill the budget deficit, and the government will need to go to the market and MDBs to meet the shortfall.¹⁶ The projections suggest that public and publicly guaranteed debt will need to increase to 17.6% of GDP in 2015 and to 19.0% in 2016.¹⁷

16. To ensure sustainable use of NFRK resources, a presidential decree established rules of operation which provide for maximum guaranteed transfers to support the economy, a minimum total asset size to perform the mandated savings functions of the NFRK, a limit for government debt service tied to investment income, and a debt service link to revenues including NFRK transfers (footnote 3). The maximum amount for guaranteed transfers has now been reached. The increased use of NFRK resources to support the economy, together with lower income from oil, have resulted in a contraction of asset growth, Total assets of the NFRK of \$69 billion in May

¹⁵ The revised budget revenues are based on oil price forecasts of \$50.00 a barrel. This is not sufficient to meet the fiscal break-even oil price of \$80.00/barrel for 2015. The external break-even point, the price of oil when the current account balance is zero, is about \$105.30 for 2015. The fiscal break-even point is the price of oil at which the fiscal balance is zero.

¹⁶ Transfers from the NFRK in 2015 are \$9.2 billion equivalent in guaranteed transfers, and \$4.2 billion equivalent in targeted transfers. Equivalent amounts in 2016 are projected at about \$9.2 billion in guaranteed transfers and \$2.0 billion in targeted transfers.

¹⁷ Monetary Policy Guidelines of the Republic of Kazakhstan for 2015, approved by the Resolution of the Board of the National Bank of the Republic of Kazakhstan dated 25 February, 2015 No. 30; International Monetary Fund. 2014. *Regional Economic Outlook: Middle East and Central Asia*. Washington, DC (October). Source: <http://www.fxempire.com/commodities/brent-oil/> (accessed 15 March 2015).

2015 is nearing the 2015 minimum savings function of \$67 billion, leaving limited headroom for further support to the economy. The threshold for annual government debt service is expected to be \$3.3 billion in 2015, given the impact of the exchange rate adjustment. The 2014 debt service ratio is expected to increase to 10.2% in 2015.¹⁸ These debt ratios are within the limits.

17. Based on government macroeconomic and fiscal assumptions, the public debt–GDP ratio is expected to increase to 17.6% in 2015 and 19.0% in 2016. It is projected to fall to 15.0% by 2018 and 13.9% by 2020, as economic growth rebounds and fiscal deficits shrink. A low debt ratio suggests that public debt is sustainable, if government assumptions are realized. Assets of the NFRK support ADB's conclusion that the medium term outlook is generally benign. The impact of the proposed loan for countercyclical support on public debt sustainability was assessed under a scenario that reflects ADB disbursing a \$1 billion loan in two equal tranches of \$500 million in 2015, jointly with expected World Bank loans of \$1 billion in 2015 and \$1 billion in 2016. The joint effect initially raises the public debt ratio to 20.2% by 2016, compared with the baseline of 19.0%, and then converges to the baseline due to swift amortization and the predominantly benign debt dynamics incorporated in the projections.¹⁹

4. Proposed Loan for Countercyclical Support

18. **The proposed loan results from extensive ADB policy dialogue with the government and development partners on economic developments, policy reform, anti-crisis measures, management and monitoring of reform efforts, and other related areas.**²⁰

The government is committed to mitigating the impacts of the adverse economic developments, implementing countercyclical expenditures and related policies to address the significant negative effects of the oil price decline and the Russian Federation's economic slowdown, and maintaining sound macroeconomic management.²¹ The proposed loan will support budgeted countercyclical programs and help the government achieve a sound macro-fiscal position. Payments of the proposed loan are divided into two tranches of \$500 million each, with disbursement conditions for the second tranche based on key policy reforms (para 24). The government has met the access criteria for countercyclical support: (i) significant adverse impact of the crisis; (ii) planned countercyclical development expenditures to address the challenges and protect low-income households; and (iii) sound macroeconomic management, including a solid fiscal position.

19. **Reforms will be carried out in cooperation with ADB and other MDBs that will provide financial and technical support.** ADB's proposed loan will complement the World Bank's development policy financing; the PFA designed to support the government's development strategies; and ADB's ongoing support to micro, small, and medium-sized enterprise development.²² It is in line with ADB support to upper middle-income countries, and with the International Monetary Fund and the World Bank in their support to countries affected by falling export receipts and tax revenue.²³ Lessons from previous loans for countercyclical

¹⁸ The Law on Republican Budget, with amendments, as of 11 March 2015.

¹⁹ ADB staff debt sustainability assessment.

²⁰ The proposed loan for countercyclical support has also considered the IMF Article IV report, August 2014; and the statement from the IMF staff visit, December 2014.

²¹ The development policy letter in Appendix 3 confirms the government's commitments.

²² ADB. 2013. *Report and Recommendation of the President to the Board. Multitranchise Financing Facility to the Republic of Kazakhstan for the Small and Medium Enterprise Investment Program*. Manila.

²³ ADB. 2015. *Clients–Contributors–Collaborators: A New Partnership with Upper Middle/Income Countries*. Manila (February); and Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries. Washington, DC. 18 April 2015.

support implemented by ADB are reflected in this proposed loan through (i) strengthened review and analysis of macroeconomic and finance sector development, and (ii) better internal coordination and collaboration among ADB departments. Another key lesson is the need for greater ADB institutional readiness and flexibility in responding to crises to ensure relevance of ADB support, especially for expenditures for social and pro-poor schemes supported by government policies.

B. Impact and Outcome

20. The impact will be sustained pro-poor economic growth. The outcome will be improved fiscal sustainability.

C. Outputs

21. The proposed loan will have three outputs: (i) measures to promote non-oil and private sector development implemented, (ii) measures to increase employment implemented, and (iii) priority expenditures to sustain jobs and social expenditure maintained.

D. Development Financing Needs

22. To meet the budget gap in 2015, the government transferred \$13.4 billion equivalent from the NFRK to the budget. Despite this transfer, the budget deficit is projected at \$6.8 billion equivalent. The government will finance \$4.8 billion equivalent of the budget deficit through the issuance of bonds, including from internal sources. The World Bank is expected to provide \$1.0 billion in 2015 and \$1.0 billion in 2016 through its development policy financing.

23. The government has requested ADB to provide a \$1 billion loan in 2015 from ADB's ordinary capital resources under the Countercyclical Support Facility to support critical countercyclical expenditures.²⁴ One of the features of the Countercyclical Support Facility, as mainstreamed under the 2011 Review of ADB's Policy-Based Lending, is the ceiling of \$500 million for lending to each country.²⁵ To support the government's request, it is recommended that the ceiling be waived for this proposed loan. The lending terms are considered appropriate with regards to the government debt repayment capacity and with ADB's risk-bearing capacity. ADB's risk-bearing capacity and the proposed \$1 billion loan are considered to be in line with ADB's long-term capital adequacy framework.²⁶

24. ADB will release the proposed loan in two equal tranches of \$500 million. The first tranche will be released upon loan effectiveness. ADB management will authorize release of the second tranche once the government has met the following disbursement conditions: (i) the establishment of a single database for tax and customs administration is approved through an order of the Ministry of Finance (MOF), (ii) the establishment of an information system for e-declaration of customs clearance is approved through an order of the MOF, (iii) a draft law is submitted to the Parliament to increase attractiveness of investment in the electricity generation subsector. The tariff policy will introduce a feed-in tariff structure based on a fixed component to cover capital expenditures and a variable component to cover generation costs; and (iv) a draft law is submitted to the Parliament to introduce optimized social aid with a targeted approach.²⁷

²⁴ Compliance status with the access criteria for Countercyclical Support Facility is in Appendix 4.

²⁵ ADB. 2009. *Enhancing ADB's Response to the Global Economic Crisis—Establishing the Countercyclical Support Facility*. Manila (para. 14 [iv]); and ADB. 2011. *Review of ADB's Policy-Based Lending*. Manila (para. 35 [ii] [b]).

²⁶ ADB. 2008. *The Asian Development Bank's Long-Term Capital Adequacy Framework*. Manila.

²⁷ See Loan Agreement (accessible from the list of linked documents in Appendix 2).

25. The loan amount is considered appropriate. Borrowing from MDBs reflects a rational debt strategy that minimizes the cost of debt to the budget, subject to the timeliness of cash flow to meet budget needs. A further drawdown on the NFRK to stabilize the economy will require the government to amend the rules of operation of the NFRK, which exist to stabilize medium-term expenditure plans and ensure long-term savings when oil resources are depleted. Repeated amendments risk weakening Kazakhstan's international investment position, as NFRK size and management is a key factor in assessing sovereign creditworthiness. Lack of MDB support would force the government to access international financial markets when the cost of borrowing is expected to increase, given the higher perceived risk suggested by available market indicators. Lack of MDB support in 2015 will also have negative implications for the debt management strategy, and affect the government's ability to maintain priority social expenditures during this fragile economic period. The proposed loan will have a 5-year term, including a grace period of 3 years; straight line repayment option with a 10% discount factor; an annual interest rate will be determined in accordance with ADB's London interbank-offered rate (LIBOR)-based lending facility plus 200 basis points; a commitment charge of 75 basis points on the undisbursed loan balance; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement.²⁸

E. Implementation Arrangements

26. The MOF will be the executing agency for the proposed loan. The implementing agencies will be the Ministry of National Economy, the Ministry of Healthcare and Social Development, the Ministry of Energy and the NBK (Table 1). Macroeconomic and financial sector conditions will be monitored to determine the impact of countercyclical measures. The government will provide annual reports to ADB on (i) macroeconomic and financial sector conditions; (ii) expenditures made from the republican budget to support the countercyclical measures, as well as the budget execution; and (iii) implementation of countercyclical measures, including progress in the implementation of the Nurly Zhol development program, and the Employment Roadmap 2020.

Table 1: Implementation Arrangements

Aspects	Arrangements
Implementation period	September 2015–December 2016
Estimated closing date	31 December 2016
Management	
(i) Executing agency	Ministry of Finance
(ii) Key implementing agencies	Ministry of National Economy, Ministry of Healthcare and Social Development Ministry of Energy, National Bank of Kazakhstan
Disbursement	The proposed \$1 billion loan for countercyclical support will be disbursed in two tranches: \$500 million upon effectiveness and \$500 million on completion of disbursement conditions in accordance with the Asian Development Bank's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time).

Source: Asian Development Bank.

III. DUE DILIGENCE

A. Governance

27. A system of budget preparation and reporting is in place, and monthly budget execution reports are available on the MOF website. To enhance budget efficiency and improve fiscal sustainability, government agencies have migrated to accrual-based accounting and financial

²⁸ Based on these terms, the average loan maturity is 4.25 years and there is no maturity premium payable to ADB.

reporting in line with the International Public Sector Accounting Standards. In 2013, the government adopted public audits and prepared a draft law on public audit and financial control, but it has not been passed.²⁹ The budget does not cover all fiscal activities. Budget execution and accounting procedures are not regularly applied to development programs, especially if they are financed through transfers from the NFRK.³⁰ Revenue collection is consolidated within one authority to create a favorable climate for businesses and reduce administrative barriers. Procurement is decentralized to national and regional bodies, and is executed through the electronic government procurement web portal established in 2008. The Public Procurement Law was updated. Elements of e-procurement were introduced, and public procurement requirements amended to reflect Eurasian Economic Union requirements. To further align the law with these requirements, a new amendment for the Public Procurement Law has been submitted to Parliament, including new procurement mechanisms, such as online contract signing. It is expected to become effective on 1 January 2016.

28. A legal and institutional framework for combating corruption is in place. The anti-corruption law, adopted in 1998, defines the core principles underlying the anticorruption effort, types of corruption crimes, and responsible anticorruption agencies. It supports and protects whistle-blowing. The criminal code criminalizes active and passive bribery, attempted corruption, extortion, money laundering, abuse of office, and bribe facilitation by third parties. On 6 August 2014, the Agency of the Republic of Kazakhstan on Fighting Economic and Corruption was dissolved, and the function for fighting corruption was transferred to the newly established Agency for Civil Service Affairs and Fight against Corruption.³¹ In December 2014, the Anticorruption Strategy 2015–2025 was adopted.³² Kazakhstan joined the ADB–Organisation for Economic Co-operation and Development Anticorruption Initiative for Asia–Pacific in May 2002, and the Istanbul Anti-corruption Action Plan in 2003.³³ It acceded to the United Nations Convention against Corruption in June 2008. ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOF. In October 2013, the international board of the Extractive Industries Transparency Initiative assigned Kazakhstan the status of “compliant country” in observing the international standard of revenue transparency. Kazakhstan provides annual reports disclosing revenues from natural resource extraction. Companies disclose what they have paid, and the government discloses what it has received.³⁴

B. Poverty and Social

29. The proposed loan will help the government (i) meet expenditures for social support and services, (ii) maintain the confidence of international markets, (iii) invest in education improvements and other social infrastructure; and (iv) improve employment and social protection for low income families. This will enable more inclusive growth and economic diversification, with increasing business growth and employment. The gender mainstreaming category is some gender elements, with women’s employment and social welfare incorporated.

²⁹ Organisation for Economic Co-operation and Development. 2014 *Anti-Corruption Reforms in Kazakhstan*. Paris.

³⁰ International Monetary Fund. 2014. Article 4 press statement.

³¹ Decree of the President of the Republic of Kazakhstan No. 883 in 2014 of “On further measures to improve the governance system in the Republic of Kazakhstan.”

³² Transparency International. <http://www.transparency.org/country/#KAZ>

³³ Organisation for Economic Co-operation and Development. *Istanbul Anti-corruption Action Plan*. <http://www.oecd.org/corruption/acn/istanbulactionplan/>

³⁴ Extractive Industries Transparency Initiative. <https://eiti.org/news/kazakhstan-accepted-eiti-compliant>

C. Safeguards

30. The proposed loan is categorized C for environment, involuntary resettlement, and indigenous peoples and does not envisage any category A or B activities. Investment activities prohibited under ADB's Safeguard Policy Statement (2009) will be excluded.

D. Risks and Mitigating Measures

31. Risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.³⁵ The benefits and impacts of the proposed loan are expected to outweigh the costs. The program pre-mitigating risk is medium.

Table 2: Summary of High Risks and Mitigating Measures

Risks	Mitigating Measures
Further weakening of economic growth and oil price widens revenue shortfalls	The Asian Development Bank's loan for countercyclical support and the World Bank's development policy financing will help the government (i) mitigate spillover effects from the Russian Federation's weak economy, and the sharp fall in oil prices; and (ii) achieve a sound fiscal position while maintaining priority expenditures, including those for social expenditures.
External environment deteriorates, and delays reforms to improve fiscal consolidation	Coordinated development partner support will ensure consistency in implementation of countercyclical measures through regular policy dialogue and monitoring.

Source: Asian Development Bank.

IV. ASSURANCES

32. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, and disbursement, as described in detail in the loan agreement.

V. RECOMMENDATION

33. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the waiver of the ceiling for total lending to each country under the Countercyclical Support Facility as discussed in para. 23 above; and
- (ii) the loan of \$1,000,000,000 to the Republic of Kazakhstan for the Countercyclical Support from ADB's ordinary capital resources, with interest rate to be determined in accordance with ADB's London interbank-offered rate (LIBOR)-based lending facility plus 200 basis points; for a term of 5 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

31 July 2015

³⁵ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impacts of the countercyclical support facility			
Sustained pro-poor economic growth (State Program of Infrastructure Development Nurly Zhol for 2015–2019, Employment Roadmap 2020) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Improved fiscal sustainability	By 2016 a. Budget deficit is reduced to 2.4% of GDP in 2016 (2014 baseline: 2.7%) b. Non-oil deficit is reduced to 7.0% of GDP in 2016 (2014 baseline: 7.8%)	a. Ministry of National Economy annual budget b. Ministry of National Economy annual budget	Low and volatile oil and commodity prices lead to volatile growth and revenue performance. External environment deteriorates and delays reforms to improve fiscal consolidation.
Outputs 1. Measures to promote non-oil and private sector development implemented	1a. Contribution of MSME sector to GDP increased to 21.0% of GDP in 2016 (2014 baseline: 20.0%) 1b. Labor productivity in agriculture increased to at least T700,000 by 2016 (2014 baseline: T572,800) 1c. Volume of nonresource exports by enterprises that have received support under the program increased to at least T25 billion in 2016 (2015 estimated baseline: T21.7 billion)	1a. Ministry of National Economy Committee on Statistics quarterly statistical report 1b. Ministry of National Economy annual monitoring reports 1c. Ministry of National Economy annual monitoring reports	Budget management challenges reduce the effectiveness of implementation of the government's countercyclical measures.
2. Measures to increase employment implemented	2a. Employment by MSMEs increased to at least 3.1 million people in 2016 (2014 baseline: 2.9 million) 2b. Percentage of self-employed population in the economically active population decreased to at least 27.1% in 2016 (2014 baseline: 28.0%) ^b	2a. Ministry of National Economy annual monitoring reports 2b. Ministry of National Economy, Committee on Statistics quarterly statistical report	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	2c. Unemployment for women decreased to at least 5.5% by 2016 (2013 baseline: 5.9%) 2d. Number of jobs created under Nurly Zhol increased to least 100,000 by 2016 (2014 baseline: 10,400)	2c. Ministry of Healthcare and Social Development annual monitoring report 2d. Ministry of Healthcare and Social Development annual monitoring report	
3. Priority expenditures to sustain jobs and social expenditure maintained	3a. Budget expenditure for social expenditures in percent of total expenditure is maintained or increased in 2016 (2014 baseline: 37.5% of total expenditure) ^c	3a. Ministry of Finance annual monitoring reports	
Activities with Milestones 1. Measures to promote non-oil and private sector development implemented 1.1 Government establishes a single database for tax and customs administration (October 2015) 1.2 Government establishes e-declaration system for customs clearance (October 2015) 1.3 Government introduces a new tariff policy in the electricity generation subsector (October 2015) 1.4 Government provides support to current and potential domestic exporting enterprises in non-resource sector of the economy (December 2016) 1.5 Government provides financial support to agribusiness (December 2016) 2. Measures to increase employment implemented 2.1 Government implements action plan for Employment Roadmap 2020 (December 2015) 2.2 Government raises public awareness of employment-related activities (December 2016) 3. Priority expenditures to sustain jobs and social expenditure maintained 3.1 Government introduces optimized social aid based on a targeted approach (October 2015) 3.2 Government ensures countercyclical measures for social expenditure and job creation are included in the budget, implemented, monitored, and reported (December 2016)			
Inputs Asian Development Bank: \$1 billion in 2015 (ordinary capital resources) World Bank: \$1 billion in 2015, \$1 billion in 2016 (planned parallel financing) Government: \$4.8 billion			
Assumptions for Partner Financing Not applicable			

GDP = gross domestic product; MSME = micro, small and medium-sized enterprises.

^a Decree of the President of the Republic of Kazakhstan. 2015. State Program of Infrastructure Development Nurly Zhol for 2015–2019. Astana. Resolution of the Government of the Republic of Kazakhstan. 2015. Employment Roadmap 2010. Resolution No.162. Astana.

^b Self-employed workers are unregistered self-employed workers, persons engaged in the production of goods for own consumption in private household plots, and unpaid family enterprise workers, a significant portion of whom are not covered by social protection and support.

^c Social expenditures: education; health care; social assistance and provision for social security and social aid; and culture, sport, tourism, and information.

Sources: Asian Development Bank, Ministry of National Economy, Ministry of Healthcare and Social Development, Ministry of Energy.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=49083-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Debt Sustainability Assessment
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

Supplementary Document

11. Economic Developments

DEVELOPMENT POLICY LETTER

ҚАЗАҚСТАН РЕСПУБЛИКАСЫ
ҰЛТТЫҚ ЭКОНОМИКА
МИНИСТЕРЛІГІ



MINISTRY
OF NATIONAL ECONOMY OF THE
REPUBLIC OF KAZAKHISTAN

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№ 24-1/8945

cm 24.04.15

Mr. Takehiko Nakao
President Asian Development Bank

Dear Mr. Nakao!

The Ministry of National Economy expresses its gratitude to you and Asian Development Bank Board of Directors for the establishment of the Countercyclical Support Facility Lending (CSF) for ADB member countries and your timely consideration of our request for emergency assistance via provision of a loan to support the Government of the Republic of Kazakhstan.

This letter supports the government's request to ADB for a \$1 billion loan under your CSF. We believe that the government has responded effectively to mitigate the impact of the fallout from the difficult external environment.

1. Economic Developments

Following the global financial crisis in 2008-2009, GDP slowed from high growth averaging about 10.2% per annum during 2000-2007 to 3.3% in 2008 and 1.2% in 2009. Growth rebounded following the government's swift response to rapidly increasing unemployment by planning and implementing anti-crisis programs. Using its savings from oil revenues, the government drew upon the National Fund of the Republic of Kazakhstan (NFRK) and borrowed under ADB's CSF in 2009 to implement countercyclical reforms. On the back of economic reforms and rising oil prices, economic growth averaged 6.4% growth from 2010-2013. GDP growth slowed from 6.0% in 2013 to 4.3% in 2014 and is expected to slow further in 2015.

Slow global growth has reduced demand for Kazakhstan's main export commodities. Two external factors in 2014 have added significant pressure to our economy and to our long-term development agenda. The first factor was the

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spillover effects from the economic slowdown in the Russian Federation. The second factor was the steep fall in oil prices, which dropped over 50.0% from end-2013 to end-2014. Kazakhstan's economy is highly dependent on the oil-gas sector, which accounts for about 20.0% of GDP, 76.0% of exports, and 50.0% of revenues.

Many firms and households convert tenge deposits in foreign currency as a result of devaluation expectations related to the economic situation in the Russian Federation and the exchange rate of the ruble against the US dollar. This reduced the tenge money supply and raised deposit dollarization from about 37.4% in 2013 to about 54.5% in April 2015. The increase in dollarization carries risks for financial stability, through rising balance sheet risks for the private sector and consequent credit risks for banks. At the same time consumption growth dropped from 12.8% in 2013 to 2.5% in 2014 and bank lending has slowed from an expansion of 13.4% in 2014 to a contraction of 0.5% in April 2015.

Although the exchange rate adjustment initially boosted exports, declining commodity prices offset the gains and caused export revenue to fall by 8.6% versus a 1.1% decline in 2013. Imports also fell, by 15.6% following a 4.1% increase in 2013, as imports of food, chemicals, metal products, and machinery all declined. Declining oil prices are expected to reduce exports further. The strengthening position of the tenge against the ruble, together with the economic slowdown is also weighing on the competitiveness of Kazakhstan's non-oil and non-metal export. While the current account surplus widened from 0.5% in 2013 to 2.2% of GDP in 2014, it is projected to move to a deficit of 1.0% of GDP in 2015. Inflation increased from 4.3% in 2013 to 6.7% in 2014.

Gross reserves rose to \$28.9 billion in 2014 from \$24.7 billion at the end of 2013. NFRK assets reached \$73.2 billion at the end of 2014, though heavier use of NFRK funds for budgetary support and lower windfall from oil revenues reduced growth in NFRK assets to 3.9% from 22.2% in 2013. In May 2015 NFRK assets stood at \$69.0 billion, a 9.0% contraction on asset growth on a year on year basis. External debt, including intercompany loans, reached an estimated 74.2% of GDP in 2014 as per current data from 64.8% in 2013, while public and publicly guaranteed external debt rose to 3.9% of GDP from 2.4% a year earlier, according to current data. External debt is expected to increase in coming years, as foreign borrowing drives public and publicly guaranteed external debt.

The current situation also poses challenges for the labor market. Since we implemented the first employment roadmap in 2009 we have been successful in reducing unemployment from 6.6% to 5.1% in 2014 and in reducing the incidence of poverty from 6.6% in 2009 to 2.8% in 2014. However, the economic situation has dampened employment prospects. Challenges include the need to develop the

private sector, increase productivity in the farm sector, limit growth of the public sector, and enhance skills of labor to better meet the demand for labor. Another challenge is the large number of self-employed who comprise 28.0%, or 2.5 million people. A significant part of the self-employed are not covered by social protection and support. The labor market mismatch contributes to high government spending on social support for the poor.

Due to the significant decrease of oil and gas prices during the second half of 2014 the republican budget deficit increased to 2.7% of GDP, as per tentative data, or \$6 billion, from 2.0% in 2013. To meet a shortfall in revenue, transfers from the NFRK to the republican budget were increased from the equivalent of 4.0% of GDP in 2013 to 4.9% of GDP in 2014. These transfers together with a 13.3% rise in corporate income tax revenue contributed to increase the total budget revenue from 14.7% in 2013 to 15.3% of GDP in 2014. However, the post-tenge adjustment pay rise and higher pensions and social transfers increased expenditure from 17.0% in 2013 to 17.9% of GDP in 2014. In October 2014 Kazakhstan sold \$2.5 billion in eurobonds, pushing public and publicly guaranteed debt to an estimated 15.2% of GDP from 12.9% in 2013. State enterprise debt, however, declined to equal 13.4% of GDP at the end of September from 14.3% at the end of 2013.

2. Countercyclical Support Measures

To mitigate the effects the external factors have had on Kazakhstan's economy, we will through budgeted countercyclical measures continue our efforts to further diversify Kazakhstan's economy and implement structural reforms in the industry which originated as a result of the implementation of the first five-year industrialization plan. It is necessary to foresee a comprehensive and modern industrial policy to restore and maintain competitiveness of industry, services, and agriculture, and to deliver conditions for sustainable long-term inclusive economic growth.

Economic diversification will depend on stronger promotion of private sector development and an industrial policy conducive to industries that promise to drive future growth. Structural reform will need to address concerns about the business climate, property rights and the rule of law, bankruptcy procedures, governance issues, and price controls, and access to finance for small and medium-sized enterprises. In a move to address some of these problems, we are implementing both long- and medium-term measures to stabilize the economy and continue our path towards the realization of Kazakhstan's Strategy 2050. Priorities are to generate growth in the non-oil sector, stimulate aggregate demand and avoid a downward spiral of low demand and increasing unemployment.

Implementation of the new government program, Nurly Zhol, will support economic growth and employment through continuing structural reforms of the economy. Priorities will be creation of effective transport and logistics infrastructure, development of industrial and tourism infrastructure, reinforcement of energy infrastructure, modernization (reconstruction and construction) of housing and utilities infrastructure, increased access to housing by people, development of infrastructure in education area, as well as countercyclical measures in light of existing economic situation to support some sectors of manufacturing industry, agricultural sector, exporters, and private sector development. These directions will be financed in the total amount of \$9 billion—with annual allocations of about \$4.3 in 2015 billion, \$2.0 billion in 2016, and \$2.7 billion in 2017—as well as with financing to be provided by multilateral development banks in the amount of about \$8.1 billion and own resources of national companies and development institutions amounting \$1.3 billion. It expects to create around 395 thousand temporary and permanent jobs 2015-2019.

The Employment Roadmap 2020, a continuation of employment programs implemented 2009-2010 and 2013-2014, will increase employment of the population, promote social welfare and reduce unemployment, including improvement of targeted social assistance. For 2015 about \$200 million has been allocated in the Republican budget for the program. Amounts of funding from republican and local budgets will be adjusted in subsequent years in developing corresponding budgets for the planning period. Targets in the Employment Roadmap will also benefit from large construction projects under the Nurly Zhol. It targets unemployed, part-time, low-income, self-employed population as well as women in rural areas and youths.

Through the Partnership Framework Arrangement we have together with ADB and other international financial institutions developed medium-term action plans which will help accelerate the diversification our economy and increase its competitive ability to achieve sustainable and inclusive growth. It will also deepen our cooperation to achieve the goals set in the Country Partnership Strategy launched in 2012–2016.

Funds will be drawn from the NFRK to directly support the budget. This is in line with the objectives of the NFRK, which was established in 2000 to safeguard the country's petroleum earnings, use them to maintain macroeconomic stability, and ensure their availability for future generations. In 2014 the government allocated about \$11 billion from the NFRK. In 2015 and 2016 the allocations will be about \$13 and about \$11 billion respectively. A minimum balance in the amount of 30.0% of predicted GDP value at the end of the relevant financial year is required to perform saving functions of the NFRK. In 2014 this was about \$66.2 billion.

We have taken proactive and swift monetary, fiscal and regulatory measures to mitigate the fallout from the difficult external environment. Monetary policy in 2014 aimed to mitigate inflation growth. To restore trust in the tenge and stimulate lending, measures were taken to stabilize the exchange rate, increase tenge liquidity, and address scarcity of long-term tenge funding and high dollarization in the banking system. Monetary policy for 2015 will aim to ensure price stability and balance between the internal and external competitiveness of Kazakhstan's economy. Monetary policy will lay the groundwork for moving to inflation targeting and a shift to a floating currency in the medium-term. Inflation targeting will make it possible to increase real returns on tenge-denominated savings and lower inflationary expectations. Modernizing the monetary policy framework also includes the introduction of a new policy interest rate and setting-up of a monetary policy committee.

We have taken measures to reduce the high level of NPLs, a legacy from the 2008-2009 global financial crisis. These include: (i) implementation of thresholds for reducing NPLs, in the form of maximum percentages of portfolios which are NPLs. The benchmark was set at 15% by end 2014, and 10% starting January 1, 2016; (ii) amendments to three laws which facilitated writing off NPLs; (iii) write-offs of bad loans from the banks' balance sheets. In 2014 about \$1.4 billion were also allocated from the NFRK as a targeted transfer to capitalize the Fund for Problem Loans (FPL) for purchasing NPLs from banks. As a result of these measures, NPLs were reduced from 33.7% (about \$26 billion) in April 2014 to 23.1% (\$17.6 billion) of the banking sector total loan portfolio by the end of 2014. About 70% of these NPLs are held by two banks, Kazkommertsbank (KKB) and BTA Bank (BTA). KKB in 2014 acquired 46.5% of BTA. The banking license of BTA bank has subsequently been revoked with plans of establishing BTA as an asset management company to resolve distressed assets.

In the current year, the government budget was revised for 2015 following the President's instruction to the government to reduce budget expenditures but increase financing for agriculture, fund job preservation in industry, and enlarge a government reserve fund. A revised 2015 Republican Budget projects the deficit expanding to 3.0% of GDP. The provisional 2016 budget projects a smaller deficit of 2.4% of GDP. Slower growth, lower oil revenues, cuts in export duties, and constrained imports are expected to limit revenue to 14.2% of GDP in 2015 and 13.6 in 2016. Expenditure is forecast at 17.5% of GDP in 2015 and 16.2% in 2016. Planned wage increases for 2015 have been postponed, and state-owned enterprises are reining in operating costs. In terms of GDP, transfers from the NFRK will thus increase from 4.9% in 2014, to 6.0% in 2015 and make up 4.6% in 2016. The projected deficit suggests that public and publicly guaranteed debt may increase to 17.6% of GDP in 2015 and 19% of GDP in 2016. Policies to balance the budget

and the NFRK will be aimed at developing a sustainable macro/fiscal framework and a well-defined non-oil deficit target which should not exceed 2.8% of GDP by 2020. To ensure fiscal sustainability we will reduce transfers from the NFRK in coming years and reduce overall expenditures. However, we will maintain priority expenditures to sustain jobs and social expenditures.

3. Monitoring and Reporting System

We have in recent years implemented a number of measures to enhance budget efficiency and improve fiscal sustainability. Government agencies have migrated to accrual-based accounting and financial reporting to follow International Public Sector Accounting Standards (IPSAS). A draft law "On State audit and financial control", is under consideration in the Majilis of the Parliament. This draft draws on international best practice and international professional audit standards and guidelines for the Lima Declaration, and includes financial audit, performance audit and compliance audit. The government has also consolidated the responsibility for revenue collection within one authority to create a favorable climate for businesses and reduce administrative barriers.

The government is monitoring the implementation of the countercyclical measures at various levels. First, we are closely tracking macroeconomic and financial sector conditions to monitor the impact of the countercyclical measures on key macro and financial indicators. Second, the government, through the Ministry of Finance and other state bodies, is monitoring the budget execution and flow of funds of countercyclical measures. The NBK monitors NFRK flows under the countercyclical policy and is responsible for NFRK asset management. Overall coordination of the NFRK is by the Management Council. The government is committed to provide ADB on an annual basis the following reports: (a) the Ministry of National economy will provide a macroeconomic situation report and a report on the implementation of countercyclical measures, including progress made in implementing the Nurly Zhol and in meeting the established targets; (b) the National Bank of Kazakhstan will provide a report on the state of the financial sector; (c) the Ministry of Health and Social Development will provide a report on progress made in implementing the Employment Roadmap 2020 and in meeting the established targets; (d) the Ministry of finance will provide a report on expenditures of the Republican budget to support the countercyclical measures and budget executions.

4. Near-term Prospects and Use of Countercyclical Loan Proceeds

The current difficult external environment has adversely affected Kazakhstan though impacts triggered by contagion from weak economic developments in the Russian Federation and by the sharp fall in the price of oil

and. As a result of declined revenues and cash flows to NFRK, the budget will face a significant deficit in 2015. The proceeds from the \$1 billion countercyclical support loan from ADB will help us defray part of the costs for implementing countercyclical support measures and to maintain key social expenditures.

5. Conclusion

The next two years are likely to bring challenges to Kazakhstan. Nevertheless, the Government of the Republic of Kazakhstan remains committed to implement its longer term reform and development agenda. We therefore appreciate your positive response to our request for support and look forward to working with you in the context of the proposed Countercyclical Support Loan.

Yours sincerely,

**Acting as
Minister of National Economy
of the Republic of Kazakhstan**



Timur Zhaxylykov

ASSESSMENT OF COMPLIANCE WITH THE COUNTERCYCLICAL SUPPORT FACILITY ACCESS CRITERIA

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
1. Adverse impact of the crisis	<p>In 2014, Kazakhstan experienced two external factors that impacted economic growth, revenue performance, and the government's ability to mitigate the effects through countercyclical expenditures. The first was the spillover effects from the economic slowdown and uncertain situation of the Russian Federation, which triggered a downward adjustment in the tenge exchange rate equivalent to 16.2%, or a 19.4% rise in tenge-dollar exchange rate. The second was the steep fall in global oil prices, which dropped over 50% from the end of 2013 to the end of 2014.</p>
(i) Kazakhstan experienced a significant reduction in growth, trade, and consumption; an increase in dollarization; and a contraction in bank lending.	<p>These developments have left Kazakhstan in difficult economic circumstances. GDP in Kazakhstan fell from 6.0% in 2013 to 4.3% in 2014, and is expected to decrease to 1.9% in 2015 according to the <i>Asian Development Outlook</i> (1.5% according to the Ministry of Finance of Kazakhstan). The year-on-year decline in growth is projected to be 56% in 2015. On a 3-year average GDP growth rate, the projected decline from 2011–2013 to 2014–2016 is 46%. Following the global financial crisis, GDP growth has not reached pre-crisis growth rates, which averaged 9.8% during 2005–2007. Kazakhstan can be classified as a severely affected country.</p> <p>Oil prices dropped 51% from January 2013 to June 2015. As of 10 July 2015, the Brent spot price was \$58.73. Oil revenue accounts for about 20% of GDP, 50% of total revenues, and 76% of exports. The fiscal break-even oil price is \$80.00 for 2015 (as of May 2015). This is the oil price at which the fiscal balance is zero. The fiscal deficit of 2.7% in 2014 is projected at 3.0% for 2015. The external break-even oil price is \$105.30 for 2015 (as of October 2014). This is the oil price at which the current account balance is zero. The current account balance in percent of GDP is projected at -1.0% in 2015 according to the <i>Asian Development Outlook</i> (the IMF projects a current account balance in percent of GDP at -4.4% in 2015.) Futures prices indicate a sustained period of low oil prices: \$68.30/barrel in 2015 and \$77.20/barrel in 2022, below the fiscal and external break-even points.</p> <p>Following the announcement by the Central Bank of the Russian Federation of a transition to a floating exchange rate in 2013, the tenge has appreciated 32.1% against the Russian ruble from January 2013 to June 2015. Since September 2013, the tenge has been measured against a basket of currencies. While this helped decrease the effect of the weakening Russian ruble, the depreciation of the ruble triggered a downward adjustment of the tenge-dollar exchange rate in February 2014. At this time, NBK reset its exchange rate band for the tenge at T185 ±T3 = \$1, from T155 the previous day; equivalent to a 16.2% downward adjustment of the exchange rate, or a 19.4% rise in the tenge-dollar rate. It has since been reset twice: in September 2014 at an asymmetric band T185 +T3 to T185 -T15 = \$1, widening the band to T170–T188; and in July 2015 to T185 +T13 to T185 -T15, widening the band to T170–T198 = \$1. The tenge has depreciated 20.2% against the dollar, depreciated 17.3% against the yuan, and appreciated 26.2% against the ruble from February 2014 to July 2015. Deposit dollarization</p>

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
	<p>has increased from 37.4% in 2013 to 52.2% in May 2015. Loan dollarization has remained largely the same at 29.7% as of May 2015. Dollarization can limit the effectiveness of monetary policy, and increase the likelihood of balance sheet and liquidity risks.</p> <p>In the long run, the depreciation of the ruble against the tenge is weighing heavily on the competitiveness of Kazakhstan's non-oil and nonmetal exports, with cheaper imports from the Russian Federation outcompeting domestic products. In total, exports declined 7.6% in 2014 and are projected to drop by 32.0% in 2015, and be unchanged in 2016. In 2014, exports to the People's Republic of China decreased by 31.7%, to the Netherlands by 11.8%, and to the Russian Federation by 11.9%. Imports decreased by 14.5% in 2014, and are projected to contract by 10% in 2015 on lower volume and declining prices for goods from the Russian Federation. In 2013, imports from the Russian Federation decreased by 23.6%, from the People's Republic of China by 11.9%, and from the United States by 6.4%.</p> <p>In addition, (i) inflation increased from 5.8% in 2013 to 6.7% in 2014. In June 2015, year-on-year inflation had fallen to 3.9%, below the authorities' objective target range of 6%–8%; (ii) bank lending has slowed from a credit expansion of 13.4% in 2013 to a credit contraction of 1.9% in May; (iii) consumption growth declined from 12.8% in 2013 to 2.5% in 2014 (consumption is a key growth driver); and (iv) the budget deficit expanded from 2.0% of GDP in 2013 to 2.7% in 2014, and is projected at 3.0% of GDP in 2015.</p>
(ii) Kazakhstan is facing significant fiscal constraints because of the effects of external developments.	<p>The fiscal deficit is expected to expand in 2015 to 3.0% of GDP or \$6.8 billion equivalent, and to 2.4% or \$5.8 billion equivalent in 2016. This deficit estimate was calculated after revisions to the budget in March 2015, when revenues were reduced by 12.9% and expenditures by 4.8%. Slower growth, lower oil revenues, cuts in export duties, and constrained imports are expected to limit revenue growth to 14.5% of GDP in 2015 and 13.8% in 2016. Tax income is expected to decrease to 7.4% in 2015 and increase again in 2016 to 10.1%. Expenditure is forecast at 17.5% of GDP in 2015 and 16.2% in 2016. Planned wage increases for 2015 have been postponed. The government increased funding for social support and services, which comprise 39.1% of budget expenditures, 6.9% of GDP, or \$15.3 billion equivalent. Expenditures were also increased to support for example financing for agriculture and industry. In 2013 and 2014, social support and services comprised 38.5% and 37.5% of total expenditures respectively.</p> <p>The projected deficit suggests that public and publicly guaranteed debt will increase to 17.6% of GDP in 2015 and to 19.0% in 2016. The revised budget is based on oil price forecasts of \$50.00/barrel. This is not sufficient to meet the fiscal break-even oil price—the price of oil at which the fiscal balance is zero—of \$80/barrel for 2015 (as of May 2015). Government policies to balance the budget and the NFRK will be aimed at developing a consistent medium-term macro-fiscal framework; increasing the sustainability</p>

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
	<p>of the non-oil deficit over the medium term; and reducing the non-oil deficit from 7.7% of GDP in 2014 to 2.8% by 2020. The non-oil deficit is expected to increase in 2015, and then fall to a sustainable medium-term rate. Measured on IMF methodology, the non-oil deficit is projected to fall to 8.7% of GDP by 2020, which compares to an estimated medium-term sustainable non-oil deficit 5.5% on GDP. (The external break-even point is about \$105.30 for 2015. The external break-even oil price is when the current account balance is zero.)</p> <p>To meet budget expenditures in 2015, the government transferred \$13.4 billion equivalent from the NFRK to the budget. Despite this transfer, the budget deficit is projected at \$6.8 billion equivalent. The government will finance \$4.8 billion equivalent of the budget deficit through issuance of bonds and from internal sources, including issuance of government bonds for internal borrowing from the Unified Pension Fund and other investors. The government has requested ADB to finance \$1 billion in 2015 through the proposed loan from ADB's ordinary capital resources. The World Bank is expected to provide \$1.0 billion in 2015 and \$1.0 billion in 2016 through development policy financing.</p>
(iii) Available market indicators (credit default swap spreads and market-implied ratings) suggest a higher perceived credit risk, which is likely to increase the future cost of borrowing.	<p>Based on available information, market indicators suggest a higher perceived credit risk, which is likely to increase the cost of borrowing. Increased borrowing on the international debt market might also have negative implications for the debt management strategy.</p> <p>In 2015, both S&P and Moody's downgraded Kazakhstan's sovereign rating, although it is still investment grade. Sovereign downgrades can lead to greater increases in the cost of financing, and the government will have to pay higher interest on its debt. Increased costs to service national debt—the interest paid on what is owed—affect the entire economy. Increased borrowing on the international debt market is likely to have negative implications in terms of the debt management strategy.</p> <p>Kazakhstan on 14 July 2015 issued a 10-year dollar denominated bond in the amount of \$2.5 billion with a 5.1% coupon and a 30-year dollar denominated bond in the amount of \$1.5 billion with a 6.5% coupon. By contrast, a Eurobond was issued in October 2014 in 10-year dollar-denominated bonds priced to yield 4.07% and 30-year dollar-denominated bonds priced to yield 5.12%, prices which were 1.03% and 1.38% lower respectively than the 2015 bonds.</p>
2. Planned countercyclical development expenditures for poverty reduction	<p>The government has introduced countercyclical policy measures to mitigate the fallout from the difficult external environment and to deliver conditions for sustainable long-term inclusive economic growth. These are aimed at improving the investment climate, expanding and diversifying the non-oil subsector, and generating employment.</p> <p>Early in 2014, the government launched a long-term development strategy, Kazakhstan 2050, to</p>

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
	transform the economy into a diversified, private sector-driven, developed economy by 2050. The government has also taken steps to attract investment in the non-oil economy. The Framework for Attracting Foreign and Domestic Investment into Kazakhstan presented in April 2014 includes a package of incentives for investors. In May 2015, the Plan for the Nation: 100 Concrete Steps for Implementation of Institutional Reforms was approved in response to current global and domestic challenges. A detailed action plan includes policy improvements, outputs, and activities to be completed in 2015. It supports activities in both the Nurly Zhol and the Employment Roadmap 2020.
(i) The government has specific countercyclical development expenditure programs to be supported by the proposed loan, and is committed to their implementation.	<p>In March 2015, the Employment Roadmap 2020 was approved. For 2015, \$200 million equivalent has been allocated to implement the Employment Roadmap with similar budget allocations for 2016 and 2017.</p> <p>In April 2015, the Nurly Zhol development program was approved. It includes a program of \$9 billion equivalent with annual allocations of about \$4.3 billion equivalent in 2015, \$2.0 billion equivalent in 2016, and \$2.7 billion equivalent in 2017.</p> <p>In the revised budget of March 2015, the government increased funding for social support and services, which comprise 39.1% of budget expenditures, 6.9% of GDP, or \$15.3 billion equivalent. Expenditures were also increased to support, for example, financing for agriculture and industry.</p> <p>The IMF notes the multi-year fiscal stimulus package is justified on countercyclical grounds and infrastructure needs, and given large buffers.</p>
(ii) The countercyclical development expenditure program includes investment in public infrastructure.	Under the Nurly Zhol development program, the government will implement measures to support economic growth and employment through continuing reforms. Spending priorities include (i) development and modernization of infrastructure to support education, tourism, housing, utilities, transport, and logistics; (ii) development of non-oil business sectors, including manufacturing and agribusiness; and (iii) improvement of the business environment, including increased availability of finance. The Nurly Zhol includes allocations to address problems with (i) the shortage of preschool educational institutions, (iii) three-shift education in secondary schools, and (iv) poor materials and technical equipment in higher education institutions.
(iii) The countercyclical development expenditure program includes social assistance targeting the poor.	The Employment Roadmap 2020 includes active measures to (i) promote employment of self-employed and unemployed; (ii) develop human resources; and (iii) improve targeted social assistance. Target population groups include unemployed, part-time, low-income, and the self-employed, including youth, women, and disabled.

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
3. Sound macroeconomic management and sound fiscal position	The government and NBK have taken proactive monetary, fiscal, and regulatory measures to mitigate the economic effects from external developments. The IMF assessment notes the stimulus to be appropriately front-loaded and aimed at modernizing critical infrastructure and promoting private sector development and recognize important steps taken to overhaul the monetary policy framework in support of inflation targeting.
(i) Monetary policy addresses price stability as one of its core objectives. Inflation is controlled.	Monetary policy in 2014 aimed to maintain price stability and rehabilitate the banking system, while preventing a post-devaluation downturn. Monetary policy for 2015 and 2016 aims to maintain macroeconomic and financial stability, and to build Kazakhstan's domestic and external competitiveness. ^a To restore trust in the tenge and stimulate lending, measures have been taken to address both the scarcity of long-term tenge funding and high dollarization in the banking system. Preliminary measures to prepare for inflation targeting will be introduced. ^b Inflation targeting will require a shift to a more flexible exchange rate. It would help insulate the economy and public finances from external shocks, and curb inflation. NBK plans to moderate exchange rate fluctuations, while limiting intervention in the foreign exchange market to conserve reserves. NBK and the government have started to implement measures to reduce dollarization in the economy. In early 2015, the authorities doubled the ceiling on tenge deposit insurance guarantees to T10 million, while maintaining the T5 million limit on foreign currency deposits.
(ii) Public finances are sound, including a sustainable public debt position.	<p>The budget was revised in March 2015, and revenues were reduced by 14.0% and expenditures by 10.0%. The government increased funding for social support and services, which comprise 39.1% of budget expenditures, 6.9% of GDP, or \$15.3 billion equivalent. (In 2013 and 2014 social support and services comprised 38.5% and 37.5% of total expenditures respectively.) Budget expenditures for 2015 were also increased to support financing for agriculture and industry.</p> <p>In 2014, the government allocated about \$10.9 billion equivalent from the NFRK. In 2015 total allocations will be about \$13.4 billion equivalent, and in 2016 about \$11.2 billion equivalent. In terms of GDP, transfers from the NFRK will increase to 6.0% in 2015 and decline to 4.6% in 2016. The projected deficit of 3.0% of GDP in 2015 and 2.4% in 2016 suggests that public and publicly guaranteed debt will increase to 17.6% of GDP in 2015 and to 19.0% in 2016.</p> <p>Government policies to balance the budget and the NFRK will be aimed at developing a consistent medium-term macro-fiscal framework; increasing the sustainability of the non-oil deficit over the medium term; and reducing the non-oil deficit from 7.7% of GDP in 2014 to 2.8% by 2020. The non-oil deficit is expected to increase in 2015, and then fall to a sustainable medium-term rate. Measured on IMF methodology, the non-oil deficit is projected to fall to 8.7% of GDP by 2020, which compares to an estimated medium-term sustainable non-oil deficit 5.5% on GDP.</p>

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
	<p>Kazakhstan has established a sound system of budget preparation and reporting. Monthly budget execution reports are available on the website of the Ministry of Finance. To enhance budget efficiency and improve fiscal sustainability, government agencies have migrated to accrual-based accounting and financial reporting in line with the International Public Sector Accounting Standards. In 2013, the government adopted public audits in Kazakhstan and prepared a draft law on public audit and financial control. However, the pending adoption of the law delays the implementation of relevant audit standards and the setup of internal audit units. The budget does not cover all fiscal activity. Budget execution and accounting procedures are not regularly applied to development programs, especially if they are financed through transfers from the NFRK. The government has consolidated revenue collection within one authority to create a favorable climate for businesses and reduce administrative barriers.</p>
<p>(iii) International reserves are determined to be adequate, taking into account the import coverage ratio and the short-term external debt-financing requirement. Debt sustainability of the borrower is confirmed.</p>	<p>Gross official reserves increased from \$24.7 billion in 2013 to \$28.9 billion in 2014. In terms of months of merchandise imports, reserves increased from 4.7 months in 2013 to 6.2 months in 2014. Kazakhstan's key strengths include its relatively large economy, low public debt, and correspondingly high debt affordability. Kazakhstan's budget is supported by the NFRK, the resource savings that provide a significant buffer against external shocks. Total assets in the NFRK were \$73.2 billion equivalent at the end of 2014 and \$69.0 billion equivalent at the end of May 2015.</p> <p>Based on government macroeconomic and fiscal assumptions, the public debt–GDP ratio is expected to increase to 17.6% in 2015 and to 19.0% in 2016. It is projected to fall to 15.0% by 2018 and to 13.9% by 2020, driven by rebounding economic growth and shrinking fiscal deficits. A low debt ratio suggests that public debt is sustainable if government assumptions are realized. Assets of the NFRK support the conclusion that the outlook is generally benign. The impact of the proposed loan on public debt sustainability is assessed by a scenario that reflects disbursement of an ADB \$1 billion loan in 2015, jointly with expected World Bank loans of \$1 billion in 2015 and \$1 billion in 2016.^c The joint effect initially raises the public debt ratio to 20.2% by 2016, compared with the baseline of 19.0%, then converges to the baseline due to swift amortization and the predominantly benign debt dynamics incorporated in the projections. The IMF assessment letter notes the multi-year fiscal stimulus package is justified on countercyclical grounds and infrastructure needs, and given large buffers.</p>

ADB = Asian Development Bank, GDP = gross domestic product, IMF = International Monetary Fund, NBK = National Bank of Kazakhstan, NFRK = National Fund of the Republic of Kazakhstan.

^a Monetary Policy Guidelines of the Republic of Kazakhstan for 2015, approved by Resolution of the Board of the National Bank of the Republic of Kazakhstan dated 25 February, 2015 No. 30; and ADB. 2015. *Asian Development Outlook: Financing Asia's Future Growth*. Manila (March).

^b Statement by the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan on Main Directions of Economic Policy in 2015. 25 December 2014.

^c ADB staff debt sustainability assessment.

Source: Asian Development Bank.