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REPUBLIC OF KAZAKHSTAN—ASSESSMENT LETTER TO THE ASIAN DEVELOPMENT BANK

June 12, 2015

The letter reflects our latest assessment of Kazakhstan's economic conditions and policies, based on the concluding statement of the 2015 Article IV consultation mission issued on May 26, 2015. It updates the findings of the 2014 Article IV staff report, which was discussed on July 21, 2014 by the IMF Executive Board and published in August 2014.

Recent Developments, Outlook, and Risks

Against the backdrop of mostly external shocks, economic growth has decelerated, financial conditions have tightened, and external imbalances are emerging. Real GDP growth slowed to 2.2 percent year-on-year in the first quarter of this year, down from 4.3 percent in 2014, driven by spillovers from the slowdown in key trading partners, lower oil prices and output, and weaker domestic demand. Bank lending growth has also decelerated sharply and latest figures point to a nominal contraction in private sector credit of about 1 percent year-on-year. As a result, inflation has been falling, reaching 4.6 percent year-on-year in April—well below the authorities' objective range of 6–8 percent. Despite weaker domestic demand, staff projects a current account deficit of around 4 percent of GDP by end-2015, primarily due to lower revenues from oil exports.

The outlook for growth has also weakened, with risks predominantly on the downside. GDP growth is projected to decelerate to 2 percent this year, despite the fiscal stimulus (see below). In view of the likely long-lasting terms-of-trade shock, the medium-term growth outlook is also less favorable than seen earlier as lower oil prices and the secular slowdown in Russia are expected to weigh down on non-oil potential growth in Kazakhstan. Staff now estimates potential growth at around 4¾ percent (vs. previous estimates of 5½–6 percent). Downside risks to the outlook are mainly external, and mostly related to oil prices and regional uncertainty, while prolonged tightness in credit is a source of domestic risk.

Macroeconomic and Financial Policies

The multi-year fiscal stimulus package is justified on countercyclical grounds and infrastructure needs, and given large buffers. The package is expected to total around

$20 billion or 7.3 percent of GDP over the next 3–5 years. The stimulus is appropriately frontloaded, and aimed at modernizing critical infrastructure and promoting private sector development through onlending to small- and medium-sized enterprises (SMEs). Large fiscal buffers, including the sizable oil fund (35 percent of GDP) and low public debt (15 percent of GDP), can accommodate the countercyclical policy response.

However, to ensure fiscal sustainability, the stimulus needs to be accompanied by medium-term fiscal consolidation. Based on announced policies, and assuming a small decline in expenditure as a share of GDP over the medium-term, staff projects the nonoil deficit (measured on IMF methodology) to fall gradually to 8.7 percent of GDP by 2020. This compares with an estimated medium-term sustainable nonoil deficit of 5.5 percent of GDP. To close this projected gap, the authorities have suggested improvements in tax administration (including the recent integration of the tax and customs administrations) and unspecified cuts in expenditure. Potential measures could include (i) reducing tax exemptions, including those associated with the Special Economic Zones; (ii) strengthening tax collection; and (iii) making income taxes more progressive. In the period ahead, we expect the authorities to specify more clearly their plans to close the gap over the medium term. In the period ahead, we expect the authorities to specify more clearly their plans to close the gap over the medium term.

Enhancing the fiscal policy framework is critical to ensuring transparency and medium-term sustainability. The authorities' fiscal policy framework is partial and does not adequately portray the full range of fiscal activities. Key priorities include integrating fiscal policy into a broader macroeconomic policy framework, and expanding the budget coverage to all fiscal activity, including by aligning the methodologies for reporting overall fiscal and non-oil fiscal balances. Moreover, budget transparency could be strengthened by fully incorporating the oil fund into fiscal accounts and using the implied consolidated non-oil deficit for the general government to anchor fiscal policy.

Important steps are being taken to overhaul the monetary policy framework in support of inflation targeting. In particular, the recently published monetary policy guidelines for 2015 and 2020 stress the planned introduction of a new policy interest rate, supported by open market operations. The National Bank (NBK) has also recognized the need to strengthen its governance structure, including setting up a monetary policy committee and greater central bank independence in policy decision making.

Greater exchange rate flexibility in tandem with the introduction of new monetary policy instruments would help to enhance the policy architecture and alleviate imbalances. While buffers allow the NBK to continue to manage the exchange rate tightly for a reasonable period of time, increasing flexibility will help the economy absorb current and future external shocks, support competitiveness and diversification, and allow a more independent monetary policy. Greater flexibility could be introduced by widening the exchange rate band initially, with the aim of removing the band altogether when conditions allow. To ensure financial stability, it is critical for the NBK to communicate its plans consistently and credibly.

In view of rising vulnerabilities, further actions are needed to bolster financial sector resilience. Efforts to reduce the large stock of nonperforming loans (NPLs) are paying off and the ratio to total loans has fallen from around 34 percent a year ago to 23.5 percent. System-wide capital adequacy ratio (CAR) is above the regulatory minimum but has recently declined, mainly due to NPL write-offs. At the same time, tight liquidity is weakening bank profitability and exerting downward pressure on capital adequacy. Moreover, dollarization and tenge shortages are increasing balance-sheet vulnerabilities, with potential widening of currency and maturity mismatches. Consequently, the authorities are taking steps to shore up macroprudential policy by strengthening capital adequacy requirements through increasing risk weights on FX loans. The authorities are also making progress toward implementing the IMF's Financial Sector Assessment Program (FSAP) recommendations. Given the possibility that weakening activity could give rise to new NPLs, the authorities should follow up with the FSAP recommendation to undertake an independent asset quality review, starting with the merged KKB-BTA entity, which accounts for 70 percent of total NPLs.

Relations with the Fund

Kazakhstan is on the standard 12-month Article IV consultation cycle. The last Article IV consultation mission was held during May 13–25, 2015. The IMF Executive Board is tentatively scheduled to discuss the 2015 Article IV consultations on July 31, 2015.

Republic of Kazakhstan: Selected Economic Indicators, 2012–2020

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections			
			(Annual percent change, unless otherwise indicated)						
National accounts and prices									
Real GDP 1/	5.0	6.0	4.3	2.0	3.2	4.8	4.6	4.4	5.0
Real oil	-2.2	3.2	-1.3	-0.4	0.4	6.4	4.6	3.3	5.5
Real non-oil	8.0	7.0	6.3	2.8	4.1	4.3	4.6	4.7	4.8
Real consumption	9.9	9.8	1.5	1.7	6.3	5.3	5.2	4.4	4.2
Real investment	10.8	5.4	1.7	8.7	-1.5	2.0	2.8	4.8	2.3
Real exports	3.4	-0.9	1.8	1.6	2.4	5.9	4.7	4.1	8.0
Real imports	19.4	5.0	-6.7	7.8	4.2	4.4	4.3	4.5	4.2
Output gap (in percent of potental GDP)	0.1	1.0	0.7	-1.6	-2.6	-1.9	-1.2	-0.6	0.7
Crude oil and gas condensate production (million tons)	79	82	81	81	81	86	90	93	98
Consumer price index (p.a.)	5.1	5.8	6.7	5.2	5.5	5.4	5.7	5.7	5.7
Core consumer price index (p.a.)	5.6	4.3	6.7	4.2	5.0	5.4	5.7	5.7	5.7
GDP deflator	4.8	9.7	7.4	-2.5	6.9	6.0	6.1	5.8	5.3
Exchange rate (tenge per U.S. dollar; eop)	1.5	2.2	18.7	3.1	0.0	0.0	0.0	0.0	0.0
			(In percent of GDP, unless otherwise indicated)						
General government fiscal accounts									
Revenues and grants	26.0	23.8	23.8	19.9	20.8	20.8	20.5	20.1	19.7
Of which: Oil revenues	13.4	11.8	11.3	8.1	9.2	9.5	9.4	9.2	8.9
Expenditures and net lending	22.4	20.3	22.1	22.8	22.2	21.8	21.3	21.1	20.6
Overall fiscal balance	4.5	5.0	1.7	-3.1	-1.5	-1.0	-0.8	-1.0	-1.0
Financing	-4.1	-3.3	1.9	3.1	1.5	1.0	0.8	1.0	1.0
Domestic financing	2.7	2.1	1.5	2.6	2.4	3.4	3.9	4.5	5.0
Foreign financing	0.2	0.2	1.6	0.9	1.7	1.2	1.1	0.6	0.2
NFRK	-7.0	-5.5	-1.3	-0.3	-2.6	-3.4	-4.1	-4.1	-4.2
Gross public debt (percent of GDP)	12.4	12.9	14.5	18.0	20.4	22.8	25.4	28.1	30.6
Non-oil fiscal balance (percent of GDP)	-8.9	-6.8	-9.6	-11.3	-10.3	-9.7	-9.2	-9.0	-8.7
Non-oil fiscal balance (percent of non-oil GDP)	-13.0	-9.4	-13.4	-13.8	-12.6	-11.9	-11.2	-10.8	-10.3
			(Annual percent change, eop, unless otherwise indicated)						
Monetary accounts									
Reserve money	1.9	-2.2	20.8	7.0	7.4	8.3	8.3	8.3	8.3
Broad money	7.9	10.2	2.4	14.6	10.3	11.1	11.1	11.1	11.1
Broad money velocity (annual average)	2.9	3.0	3.3	2.9	2.9	2.9	2.9	2.9	2.8
Credit to the private sector 2/	11.6	12.7	5.7	3.8	12.8	12.9	12.3	11.8	11.9
Credit to the private sector (percent of GDP) 2/	41.5	40.2	37.9	39.6	40.4	41.1	41.6	42.1	42.6
NBK refinance rate (eop; percent)	5.5	5.5	5.5	...	...	...	...	...	...
			(In billions of U.S. dollars, unless otherwise indicated)						
External accounts									
Current account balance (percent of GDP)	0.5	0.4	2.1	-4.4	-3.7	-2.6	-1.9	-1.7	-0.8
Exports of goods and services	91.8	90.7	85.4	59.6	64.2	70.2	75.6	79.6	86.4
Oil and gas condensate	56.4	57.2	53.6	32.7	35.8	39.7	43.1	44.9	48.1
Imports of goods and services	61.5	63.0	56.2	53.2	55.9	58.8	61.7	64.7	67.6
Foreign direct investments (net, percent of GDP)	-5.8	-3.4	-2.7	-2.5	-2.3	-2.1	-2.0	-1.8	-1.7
NBK gross reserves (eop) 3/	28.3	24.7	28.9	28.9	29.9	30.9	31.9	32.9	33.9
In months of next year's imports of goods and services	5.4	5.3	6.5	6.2	6.1	6.0	5.9	6.1	6.0
NFRK assets (eop)	57.9	70.8	73.6	74.2	80.2	89.0	100.6	113.6	128.3
Total external debt 4/	136.9	149.9	157.1	171.3	184.4	197.0	208.6	220.2	229.2
In percent of GDP	67.3	64.7	71.2	80.9	79.9	76.8	73.3	70.1	66.0
Excluding intracompany debt (percent of GDP)	34.1	33.1	35.3	42.4	43.6	43.3	42.3	41.2	39.2
Memorandum items:									
Nominal GDP (in billions of tenge)	30,347	35,275	39,530	39,334	43,387	48,221	53,536	59,091	65,279
Nominal GDP (in billions of U.S. dollars)	203.5	231.9	220.6	211.7	230.8	256.5	284.8	314.3	347.2
Saving-Investment balance (percent of GDP)	0.5	0.4	2.1	-4.5	-3.4	-2.1	-1.5	-1.3	-0.7
Crude oil, gas cnds. production (millions of barrels/day) 5/	1.65	1.70	1.68	1.68	1.68	1.79	1.87	1.94	2.04
Oil price (in U.S. dollars per barrel)	105.0	104.1	97.0	73.4	76.7	79.2	82.4	83.1	83.5

Sources: Kazakhstani authorities and Fund staff estimates and projections.

1/ The base year for real GDP calculations has been changed from 1994 in previous Fund documents to 2007.

2/ Private sector includes nonbank financial institutions, public and private nonfinancial institutions, nonprofit institutions, and households.

3/ Does not include NFRK.

4/ Gross debt, including arrears and other short-term debt.

5/ Based on a conversion factor of 7.6 barrels of oil per ton.