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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF US$ 1 BILLION TO

THE REPUBLIC OF KAZAKHSTAN

FOR THE

FIRST MACROECONOMIC MANAGEMENT AND COMPETITIVENESS

PROGRAMMATIC DEVELOPMENT POLICY LOAN

October 9, 2015

Macroeconomic and Fiscal Management Global Practice

Central Asia Country Management Unit

Europe and Central Asia Region

REPUBLIC OF KAZAKHSTAN

GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of September 30, 2015)

Currency Unit	=	Kazakhstan Tenge (KZT)
US$1.00	=	272.0 KZT

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

BEEPS	Business Environment and Enterprise Performance Survey
CC	Competition Committee
CPS/CPF	Country Partnership Strategy/Country Partnership Framework
DPF	Development Policy Financing
EaEU	Eurasian Economic Union
FDI	Foreign direct investment
FX	Foreign exchange
GFS	Government Financial Statistics of the International Monetary Fund
GoK	Government of Kazakhstan
MCI	Monthly calculation index
MNE	Ministry of National Economy
MoF	Ministry of Finance
NBK	National Bank of Kazakhstan
NFRK	National Fund of the Republic of Kazakhstan
NPL	Non-performing loan
OECD	Organization for Economic Co-operation and Development
PFA	Partnership Framework Arrangement
PLF	Problem Loans Fund
PPP	Public-private partnership
RAS	Reimbursable advisory services
RIA	Regulatory impact assessment
SMEs	Small- and medium-sized enterprises
SOEs	State-owned enterprises
SPIID	State Program for Industrial and Innovative Development
SRC	State Revenue Committee
TSA	Targeted social assistance
VAT	Value-added tax
WTO	World Trade Organization

Regional Vice President:	Cyril E. Muller
Country Director:	Saroj Kumar Jha
Global Practice Vice President:	Jan Walliser
Senior Practice Director:	Marcelo Giugale
Practice Manager:	Miria Pigato
Co-Task Team Leaders:	Christos Kostopoulos
	Sona Varma

REPUBLIC OF KAZAKHSTAN

FIRST MACROECONOMIC MANAGEMENT AND COMPETITIVENESS

PROGRAMMATIC DEVELOPMENT POLICY LOAN

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The First Macroeconomic Management and Competitiveness DPL for Kazakhstan was prepared by a team consisting of Christos Kostopoulos and Sona Varma (Task Team Leaders), Dorsati Madani, Ilyas Sarsenov, Juan Pradelli, Javier Suarez, Martha Martinez Licetti, Graciela Miralles Murciego, Asset Bizhan, Joao Pedro de Azevedo, Judy Yang, Saida Ismailakhunova, Keiko Inoue, Dingyong Hou, Katerina Petrina, Robert Chase, Thomas Farole, Mohamed Ihsan Ajwad, Aliya Bizhanova, Marcelo Bortman, Baktybek Zhumadil, Melissa Rekas, Harald Jedlicka, Peter Ladegaard, Jieun Choi, Jyoti Bisbey, Christopher David Miller, Jacques Bure, Alexander Pankov, Colleen Mascenik, Qahir Dhanani, Yeraly Beksultan, Tatyana Chursova, Amitabha Mukherjee, Alma Nurshaikhova, Rajul Awasthi, Jay-Hyung Kim, Ekaterina Romanova, Lisa Lui, Nagaraju Duthaluri, Nurbek Kurmanaliev, Arman Vatyan, Aliya Kim, Eric Ranjeva, Andrei Busuioc, Peter Goodman, Talimjan Urazov, Rakhymzhan Assangaziyev, Irina Galimova, Shynar Zakir, Gulmira Akshatyrova, and Valeriya Marufi.

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SUMMARY OF PROPOSED LOAN AND PROGRAM
REPUBLIC OF KAZAKHSTAN
FIRST MACROECONOMIC MANAGEMENT AND COMPETITIVENESS PROGRAMMATIC DEVELOPMENT POLICY LOAN

Borrower	Republic of Kazakhstan
Implementing Agencies	Ministry of Finance, Ministry of National Economy, and National Bank of Kazakhstan
Financing Data	IBRD Loan, Terms: Variable Spread Loan, 20 years including 2.5 years of grace period; Front-end fee: To be paid from the Borrowers' own resources; Amount: US$ 1 billion equivalent.
Operation Type	Programmatic (1st of 2), single-tranche
Pillars of the Operation and Program Development Objective(s)	The objective of the proposed DPL is to support the Government of Kazakhstan to implement reforms that: (i) strengthen the sustainability of the macroeconomic framework while protecting the vulnerable; and (ii) help improve competitiveness of the non-oil economy.
Results Indicators	Pillar 1: Strengthening sustainability of the macroeconomic framework while protecting the vulnerable: • The consolidated non-oil deficit as a share of GDP reduced from 10.5 percent of GDP in 2014 to less than 9 percent of GDP in 2017. • Increased non-oil non-mineral revenues of the state budget from 4,649.4 billion tenge in 2014 by 24 percent in 2017. • Coverage of eligible employable recipients of the targeted social support by the active forms of employment support increased from 34 percent in 2015 to more than 50 percent in 2017 (gender disaggregated). • Volatility of market interest rate at the money market reduced by 10 percent (methodology to be developed). Pillar 2: Improving the competitiveness of the non-oil economy: • Number of corporate rehabilitation cases initiated in calendar year, and the percentage of total annual corporate bankruptcies, which they represent, as measured by the MOF increase from 43 to 200. • The weighted average tier 1 capital to risk weighted assets ratio for commercial banks increased from 13.2 percent in end-2014 to 15 percent in 2017. • Cluster Development Actions conducted increases from 0 in 2015 to 2 in 2017. • Citizen engagement rule making indicator increases from 3.0 in 2015 to 3.5 in 2017. • Number of recommendations of the Competition Commission implemented by the Government following the subsidiarity methodology to guarantee that SOEs limit their role to the provision of goods and services that could not otherwise be provided by the private sector increases from 0 in 2014 to 4 in 2017.
Overall risk rating	Moderate
Climate and Disaster Risks	Are there short- and long-term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating?) No.
Operation ID	P154702

**IBRD PROGRAM DOCUMENT FOR
THE FIRST MACROECONOMIC MANAGEMENT AND COMPETITIVENESS
PROGRAMMATIC DEVELOPMENT POLICY LOAN
TO THE REPUBLIC OF KAZAKHSTAN**

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document presents a proposed Development Policy Loan (DPL) series of two loans to support the Republic of Kazakhstan to adjust to an external shock that is expected to persist.** A large oil exporter in Central Asia, Kazakhstan is facing a difficult external environment owing to a significant decline in the international oil price--which markets expect to be persistent--and the economic difficulties in Russia (one of its largest trading partners) as well as lower growth in China. The objective of the proposed DPF is to support the Government of Kazakhstan (GoK) to implement reforms that: (i) strengthen the sustainability of the macroeconomic framework while protecting the vulnerable; and (ii) help improve competitiveness of the non-oil economy. This operation, in the amount of US$ 1 billion, is the first of two operations in a programmatic series. The proposed series is aligned with the GoK's reform program and is supported by analytical and Reimbursable Advisory Services (RAS) under the Country Partnership Strategy (CPS) for Kazakhstan (FY12-FY17).

2. **Oil revenues have strongly supported Kazakhstan's progress towards the twin goals of ending extreme poverty and boosting shared prosperity**. Kazakhstan's poverty rate (the ECA regional moderate poverty line of $5/day 2005 PPP) has dropped from 54 percent in 2006 to 13.5 percent in 2014 and the size of the middle class has increased from 8 percent to 28 percent of the population, though a large share of the middle class resides in the urban areas of Almaty and Astana.[1] Growth in the income of the bottom 40 has been systematically higher than average GDP growth during this period, reflected in a decline in the Gini coefficient from 0.31 in 2006 to 0.28 in 2014. Most of the poverty reduction in this period has been driven by growth, through labor markets, particularly via higher earnings (Figure 1). Despite the progress in reducing overall poverty levels, spatial disparities have persisted. The poorest regions in Kazakhstan, which are almost exclusively in the rural areas, have experienced smaller reductions in poverty.

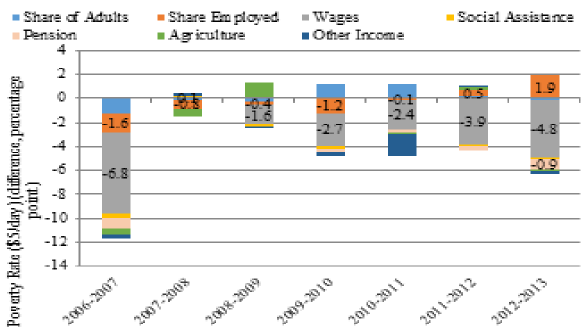
3. **Poverty reduction and shared prosperity have resulted from economic growth in multiple sectors, which have led to job creation and earnings growth**. Economic growth has come from most sectors of the economy (Figure 2), while the services sector has been the driver of job creation. Labor force participation and employment rates have been traditionally high in Kazakhstan. In 2014, among those 15 years and older, 77 percent of men and 65 percent of women were economically active. Official figures indicate that unemployment halved between 2001 and 2014, decreasing from 10.4 to 5.0 percent, with long-term unemployment declining to just 2.5 percent. Youth unemployment fell even more sharply, from around 19 percent in 2001 to 4 percent in 2014. Moreover, real wages doubled between 2003 and 2013, and wage income was the largest contributor to poverty reduction over the past decade.

4. **Earnings growth has contributed to political stability**. President Nazarbayev has served since independence and was re-elected in 2015 with a large majority. His new term will end in 2020. The President has stated that his priority is to transform Kazakhstan into an OECD country by 2030. Many of the next generation of reforms are at the institutional level (improving public administration, enforcing the

[1] The ECA regional poverty line is $2.5/day PPP, and was determined based on the same methodology used for the Global $1.25/day PPP poverty line, but including only ECA countries into the computations. The $5/day PPP line is the ECA regional moderate poverty line used in countries such as Turkey, Kazakhstan, and Russia.

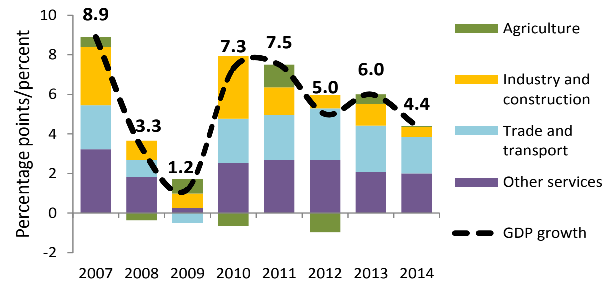
rule of law, increasing transparency and accountability of the state, and uniting the nation), and are intended to increase the size of the middle class.

Figure 1. Income Decomposition, Contribution to Changes in Poverty



Source: World Bank estimates.

Figure 2. GDP Growth: Aggregate and Contribution by Sectors



Source: Statistical Office of Kazakhstan.

5. **However, the external shock threatens economic sustainability when coupled with Kazakhstan's large fiscal imbalances.** A number of macroeconomic and structural challenges create risks to economic growth and threaten Kazakhstan's progress on the twin goals**.** First, over the past decade, the economy increased its reliance on the state and especially on oil revenues. Since 2010 the non-oil deficit has averaged 9.1 percent of GDP compared to just 3.4 percent in 2000-2007, in good part as a result of lower taxation of the non-oil economy. The higher non-oil deficit has supported an appreciated real exchange rate, which has hampered diversification objectives set by the GoK. Public spending has also helped bolster Kazakhstan's state-owned enterprises (SOEs)--structured around the Samuk-Kazyna holding, the KazAgro holding, and other smaller groups of SOEs— which account for a significant share of GDP and employment (SOEs' assets represent about a half of Kazakhstan's annual GDP and the SOE sector employs more than 30 percent of labor force).[2] Second, while the economy has created many new jobs, Kazakhstan's labor market continues to be characterized by relatively low employment elasticity to growth (0.23 percent) and a large share of jobs are concentrated in the public sector.

6. **Because the external shock is expected to be long term, the GoK has chosen to act quickly and (a) initiate a macroeconomic adjustment and (b) strengthen the competitiveness of the non-oil economy.** Both of these actions are expected to help Kazakhstan to adjust quickly to the new reality of lower income but with good jobs relying on an overall more competitive economy**.** Kazakhstan's oil revenues have halved since the beginning of 2014; this requires significant adjustment in the macroeconomic framework –fiscal and monetary, and exchange rate policies- to ensure that the fiscal and external balances are sustainable. The GoK will need to reduce its reliance on oil, and allow prices relative to the rest the world to adjust. Given the fiscal adjustment, Kazakhstan will need to ensure it establishes an environment that facilitates job creation in the private sector. Given GoK's priority to develop a well-functioning non-oil economy and create good jobs, the present decline in oil prices is an opportunity not to be missed. To this end, the GoK has initiated a consolidation of public spending to reduce the non-oil

[2] Relative to peers, however, Kazakhstan does not appear to have an extraordinarily large public sector. Public sector employment as share of total employment is lower than most of Kazakhstan's peers and its share of wage employment, although considerably higher, remains below that of Canada, Australia, Chile, and South Africa. Of course, a considerable share of private sector employment in Kazakhstan is accounted for by state-owned firms, so the public sector presence in the labor force remains considerable. Source: Kazakhstan: Development of a Jobs Strategy. Draft Policy Note June 2015.

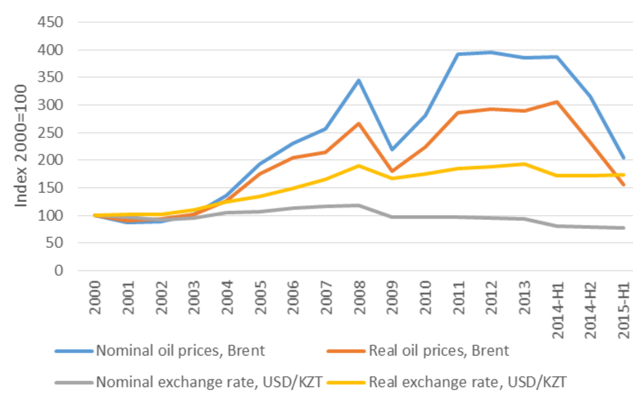
deficit, floated the currency, and begun the implementation of a wide range of structural reforms to support the development of a more diversified and competitive non-extractive economy.

7. **The proposed DPL series responds to the Government's request for financing, underpinned by a strong set of policy measures that are expected to support the World Bank's twin goals of ending extreme poverty and boosting shared prosperity.** The series aims to strengthen the sustainability of the macroeconomic framework while protecting the vulnerable, which would support the goal of poverty reduction. Policies to enhance the competitiveness of the non-oil economy would support job creation, thus boosting shared prosperity and growth of the middle class. To that effect, the series supports reform measures related to fiscal consolidation (including expenditure efficiency and non-oil revenue increases), exchange rate liberalization (including moving to inflation targeting), private sector development, and financial sector efficiency (Annex 1). The World Bank Group has worked closely with the GoK on a wide-ranging knowledge and investment agenda, which has resulted in relevant analytical work that has informed the programmatic operation.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

Figure 3. Oil Price and the Exchange Rate



Source: National Bank of Kazakhstan and World Bank.

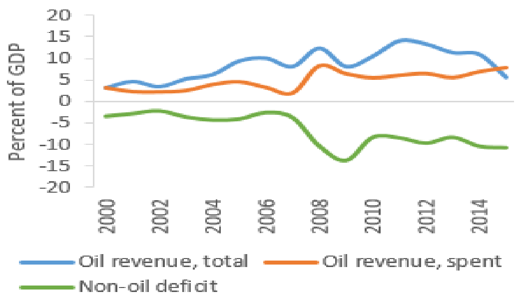
8. **The growth of Kazakhstan's economy slowed in 2014-15 due to weaker domestic and external demand.** After the global financial crisis, Kazakhstan's real GDP growth averaged 6.5 percent between 2010 and 2013, but slowed to 4.4 percent in 2014 and is expected to reach 1 percent in 2015. A tightening of lending conditions for consumer loans in late 2013, and the delayed impact of the slower growth on real wages contributed to the weakening of domestic demand and slowing of the economy in 2014. In addition, the slowdown of the Russian economy in early 2014 and the subsequent depreciation of the Ruble and the adjustment of the Chinese economy to a lower growth rate, all created headwinds for Kazakhstan's economy. In a bid to address emerging imbalances, the authorities devalued the tenge by 19 percent in February 2014 (from 156 KZT/USD to 185 KZT/USD). In the first half of 2014, private consumption was affected by the negative wealth and price effects of the February 2014 devaluation. Starting in July 2014, oil prices started to fall, negatively affecting exports and fiscal revenues, as well as private consumption and business confidence and by extension economic growth.

9. **In 2014, amidst signs of a weakening domestic economy and an initial assessment that the external shocks were short term, the Government initiated a counter-cyclical fiscal policy by launching two economic support programs to stimulate domestic demand.** In early 2014, the economy faced declining prospects for growth, the negative impact of the February devaluation, and the oil price fall. Two economic support programs were launched in February and November 2014 respectively, with a focus on settling the long-standing non-performing loan (NPL) issue, funding infrastructure and social investments and providing credit to small and medium enterprises (see Box 1 for details). The government's efforts to stimulate the economy resulted in a higher level of public spending, with capital expenditures and

net lending, including transfers and lending to SOEs, increasing from 5.4 percent of GDP in 2013 to 6.6 percent of GDP in 2014. On the revenue side, global metal prices softened, leading to lower non-oil revenues for Kazakhstan. Consequently, the non-oil deficit widened from 8.4 percent of GDP in 2013 to 10.5 percent in 2014. Figure 4 shows the widening of the non-oil deficit from 2008 onwards relative to 2000-2007 and the wider non-oil deficit in 2014 relative to 2013. Figure 5 shows the deterioration in non-oil revenue since 2008. Lower oil prices and oil revenue inflows resulted in a narrowing of the overall fiscal surplus (according to World Bank calculations) from 3.4 percent of GDP in 2013 to 0.9 percent of GDP in 2014 (Table 1).

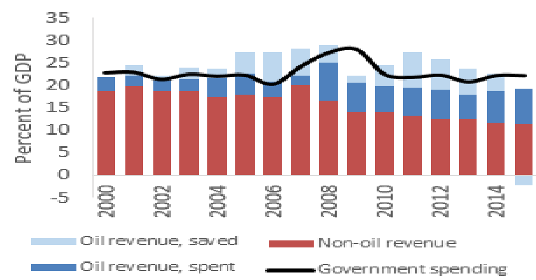
10. **A critical feature of the economic support programs was to address the financial sector issues -- the overhang of non-performing loans (NPLs) that emerged in the 2007-08 banking crisis was still on the books of commercial banks and served as a deterrent to expanding private sector credit**. The banking sector also benefited from the economic support program. In 2014, economic support was also targeted to the banking sector to relieve credit problems by addressing a long-standing issue with NPLs and providing subsidized loans to small- and medium-sized enterprises (SMEs). The economic support program recapitalized the Problem Loans Fund (PLF) by 250 billion tenge, equivalent to US$ 1.4 billion, in 2014 in order to reduce NPLs, which constituted about 23.5 percent of total bank loans in December 2014. Following the de-licensing of BTA Bank and the purchase-and-assumption of BTA by Kazkommertsbank in June 2015, the PLF placed its entire value as a deposit at Kazkommertsbank to provide liquidity on condition of the reduction of the bank's NPLs to 10 percent by end-2015. The authorities also extended tax exemptions for NPL write-offs and strengthened prudential regulation by introduction of new requirements for calculation of capital adequacy in accordance with Basel III, in effect from January 2015, which is expected to improve banks' risk management and soundness.

Figure 4. Fiscal Oil Revenue and Non-oil Deficit



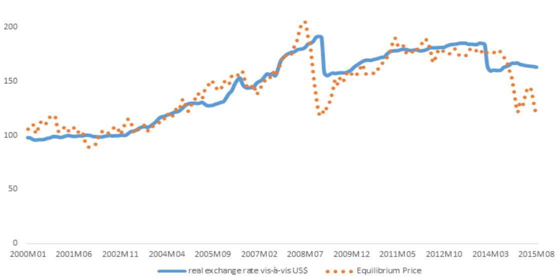
Source: WB staff calculations and estimates based on data provided by the Government of Kazakhstan.

Figure 5. Consolidated Fiscal Accounts



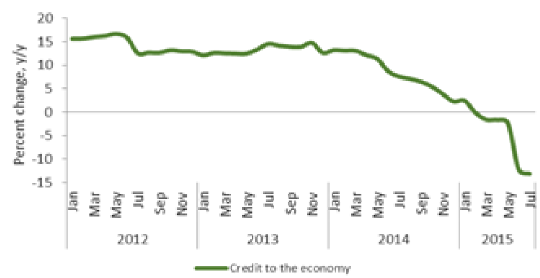
Source: WB staff calculations and estimates based on data provided by the Government of Kazakhstan.

Figure 6. Real Exchange Rate vis a vis the USD and Equilibrium Exchange Rate, 2000-Aug 2015



Note: Equilibrium exchange rate as predicted by regression of oil price changes.
Source: WB staff calculations.

Figure 7. Credit to the Non-Financial Private Sector



Source: National Bank of Kazakhstan.

11. **However, in early 2015, market analysts began to agree that the external shock was likely to persist for the longer term, suggesting that GoK's short term counter-cyclical fiscal policy was not the appropriate policy response because it could lead to larger deficits along with external imbalances and a further deterioration of NFRK assets in the long term**. The GoK acted with urgency to implement corrective action on the fiscal front. The GoK chose to quickly halt the expansionary fiscal stance and curtail new commitments on the oil fund. In light of lower revenues in 2015, it acted to curtail the widening of the Republican budget deficit. Fiscal policy was adjusted in March 2015, following the appreciation by policy makers that low oil prices are not a temporary phenomenon. The government took three actions. First, it revised the 2015 GDP growth estimate based on a baseline of $50 per barrel, down from the $80 per barrel, which was the oil price in the approved 2015 (original) budget. Second, it postponed some salary increases in 2015 for social purposes in light of maintaining sustainability of public sector wage bill. Third, it reduced capital expenditures from the budget, offsetting spending allocated for the economic support packages (details of expenditure cuts are in paragraph 22 and Table 6). In light of the 1 percent of GDP drop in the revenues of the Republican budget, these three actions are expected to reduce Republican budget

Box 1. Government Economic Support Programs 2014-2015

The authorities launched two economic support programs to mitigate the impact of the downturn, refocusing expenditures on transport infrastructure. The first program was launched immediately after the tenge devaluation in February 2014, amid early indications of an economic slowdown. It comprised an economic support program for 2014-15 of one trillion tenge, equivalent to $5.5 billion, used mainly to direct credit to SMEs and relieve problems in the banking sector. With oil prices falling and external uncertainties heightening, the government launched a second program, Nurly Zhol, spanning 5 years, intended to support the development of transport and utility infrastructure and building social housing and schools. Assuming relatively stable external conditions, the economic support program is expected to have a positive impact on employment in the near term and on growth from 2016 onward.

Kazakhstan: Economic Support Packages, 2014-17

	Original allocation	**2014-15 package**		**2015-17 package (Nurly Zhol)**			**Total**	**Total**
	2014	2014	2015	2015	2016	2017	2014-17	2014-17
		(In billion tenge)						(In US$ bill.)
Oil Fund use for economic support*	**150**	**600**	**400**	**686**	**394**	**205**	**2,435**	**13.2**
Targeted transfers	150	325	360	423	342	205	1,805	9.8
NPL resolution		250					250	
SEZ infrastructure		50	81				131	
EXPO-2017	46	25	29				100	
Transport infrastructure	60			198	150	107	514	
Utilities network modernization				60	90		150	
Subsidized housing				52	28		80	
Social infrastructure				33	33	34	100	
Co-financing projects with IFIs				39	41	64	145	
Other infrastructure				41			41	
Industrial support	45						45	
Contingency fund			250				250	
Direct lending to SOEs		275	40	263	53		630	3.4
SME support		200		170	15		385	
Subsidized housing				88	13		100	
Industrial support		75		5	10		90	
EXPO-2017			40		15		55	
Oil Fund lending to Samruk-Kazyna								**2.7**
Investment loans committed by IFIs								**7.0**

Source: WB staff calculations based on data provided by the Government of Kazakhstan.

Table 1. Kazakhstan: Key Macroeconomic Indicators, 2011-17

	2011	2012	2013	2014e	2015p	2016p	2017p
National Accounts and Prices	*(Annual percentage change, unless otherwise indicated)*						
Nominal GDP (billion tenge)	27,572	30,347	35,275	39,041	39,205	45,471	49,560
Real GDP	7.5	5.0	6.0	4.4	1.0	1.7	3.3
Oil sector, broad definition, *of which:*	5.5	0.0	-4.8	-1.0	-1.0	-1.9	4.7
Oil extraction	0.7	-0.2	3.2	-0.9	-0.5	-4.3	6.8
Non-oil sector	7.9	6.0	7.9	5.3	1.3	2.3	3.1
Contributions (percentage points):							
Consumption	5.6	6.2	6.1	0.1	-0.8	0.5	0.9
Investment	0.9	2.2	1.2	0.1	-0.4	0.7	0.8
Net exports	-0.6	-3.4	-1.5	3.1	0.7	0.3	1.6
Statistical discrepancy	1.6	0.1	0.2	1.1	1.5	0.2	0.0
Imports of goods and services	2.8	20.9	5.2	-15.7	-5.0	-5.0	2.3
Exports of goods and services	0.4	4.7	-0.2	-4.6	-1.7	-2.9	6.7
GDP per capita (US$, nominal)	11,358	12,120	13,612	12,602	10,509	9,380	9,808
GNI per capita (US$, Atlas method)	8,190	9,780	11,560	11,830	11,410	9,990	9,300
Unemployment rate, ILO (percent)	5.4	5.3	5.2	5.0	5.1	5.1	5.1
GDP deflator	17.6	4.8	9.7	6.0	-0.6	14.0	5.5
Consumer price inflation, year-end	7.4	6.0	4.8	7.4	8.1	7.0	4.8
Consolidated Fiscal Accounts	*(Percent of GDP, unless otherwise indicated)*						
Revenues	27.7	26.4	24.2	23.1	19.2	20.4	21.0
Oil revenue	14.4	13.8	11.8	11.4	7.6	8.5	9.0
Non-oil revenue	13.3	12.6	12.4	11.7	11.6	11.9	12.0
Expenditures	21.8	22.3	20.8	22.2	23.5	19.6	18.8
Current expenditures	14.9	16.1	15.5	15.7	16.4	16.1	15.2
Capital expenditures and net lending	5.0	4.7	4.0	4.4	4.0	3.2	3.6
Transfers and lending to SOEs	1.9	1.6	1.3	2.2	3.1	0.3	0.0
Overall fiscal balance	5.9	4.0	3.4	0.9	-4.3	0.8	2.2
Non-oil deficit	-8.5	-9.8	-8.4	-10.5	-11.9	-7.7	-6.8
Non-oil deficit (percent of non-oil GDP)	-11.5	-13.3	-10.7	-13.2	-13.7	-9.0	-8.0
Public and publicly-guaranteed debt	10.4	12.3	12.8	14.7	15.9	13.4	11.1
Selected Monetary Accounts	*(Annual percentage change, unless otherwise indicated)*						
Base money	27.8	3.4	-1.6	18.9	10.7	12.6	2.4
Credit to the private sector	14.3	11.6	13.1	5.7	-5.0	8.1	6.9
NBK refinance rate, year-end (percent)	7.5	5.5	5.5	5.5	..	..	..
External Accounts	*(Percent of GDP, unless otherwise indicated)*						
Current account balance	5.4	0.5	0.4	2.1	-0.6	-0.4	0.6
Imports of goods and services	27.3	30.5	26.7	25.9	22.9	24.7	24.0
Exports of goods and services	47.6	45.1	38.2	39.1	30.1	32.6	33.8
Foreign direct investment	4.6	5.8	3.4	2.7	4.2	3.9	4.0
Total official FX reserves	38.8	42.4	41.2	47.0	56.2	58.6	56.3
FX reserves in the Oil Fund	23.2	28.5	30.5	33.8	39.7	44.7	43.4
Gross reserves at the Central Bank	15.6	13.9	10.7	13.3	16.5	13.9	12.9
In months of next year's imports	5.7	5.4	5.3	8.2	8.9	6.5	6.2
As % of short-term external debt	372.8	311.1	260.2	291.6	295.7	223.2	214.3
External debt, total	66.6	67.3	64.7	72.1	88.6	98.5	95.2
External debt, excl. intra-company loans	33.4	34.1	32.8	35.7	44.1	48.1	46.4
Terms of trade (percentage change)	14.05	-2.07	-2.11	1.65	-20.82	-1.25	4.02

Source: WB staff calculations and estimates based on data published by the Statistical Office of Kazakhstan, the Ministry of Finance of Kazakhstan, and the National Bank of Kazakhstan. Note: e=estimate, p=projection.

spending by 0.4 percent of GDP, and contain the Republican budget deficit to 3.1 percent of GDP. However, to put this in perspective relative to the 2014 consolidated budget, the three actions would have resulted in the decline of the consolidated budget non-oil deficit from 13.2 percent of non-oil GDP in 2014 to 11.5 percent in 2015. Yet, in June 2015, the GoK allocated $2.7 billion from the Oil Fund to support the external debt service of Kazmunaygaz, which holds the Kazakh government's interests in the energy industry, and, additionally, in July 2015 the NBK announced that it would arrange a $4 billion debt swap with Samruk-Kazyna for a 10 percent stake in Kazmunaygaz. Kazmunaygaz faced a series of debt repayments that were hard to meet given low oil prices. Proper accounting (according to IMF GFS standards), requires that this transaction is reflected in the consolidated fiscal balances; as a consequence, the non-oil balance of the consolidated budget increased in 2015 to 13.7 percent of non-oil GDP.

12. **The year 2015 also saw renewed pressure on the exchange rate, stemming largely from the fall in oil prices that started in July 2014.** As oil prices fell and external demand from China and Russia weakened (for metal and metal products, in particular), export revenues dropped substantially, leading to a narrower trade surplus in H2-2014 and H1-2015.[3] Total export revenues almost halved from $42.3 billion in H1-2014 to $36.7 billion in H2-2014 and to an estimated $26.2 billion in H1-2015 creating pressure on the external account. However, some of that pressure was alleviated as import values fell during H1-2015, owing to weakened domestic demand lower import prices.[4] As a result, the trade surplus narrowed substantially, affecting negatively the current account, which turned from a surplus of $6.9 billion in H1-2014 to deficits of $2.2 billion in H2-2014 and estimated $0.7 billion in H1-2015. The capital and financial account also deteriorated as the oil price shock led to an increase in deposit dollarization and capital flight.[5] Meanwhile, net inflow of direct and portfolio investments (excluding investments of the Oil Fund) have declined since mid-2014. Foreign direct investment (FDI) inflows remain high as investment in the oil and gas pipeline infrastructure continues (e.g. currently, oil pipelines at Kashagan are being replaced by the operator and China continues to expand its oil and gas pipeline network in Central Asia). These inflows and external borrowing by residents helped to partially offset short-term capital outflows in H1-2015. Nevertheless, the overall balance of payments deficit (excluding investments of the Oil Fund) increased from $1.4 billion in H2-2014 to estimated $2 billion in H1-2015, putting pressure on the exchange rate.

13. **During 2015, the conduct of monetary policy to maintain the exchange rate within a preset corridor, and the deterioration of the current account increased devaluation expectations**. As a result, the demand for foreign currency increased and this led to a rise of dollarized deposits in the banking system by end-2014. This pressure was accentuated by the large depreciation of the Russian ruble between July and December 2014, which led the bilateral real exchange rate to appreciate 43 percent and a spike in Russian exports to Kazakhstan during the first half of 2015. Kazakhstani exports were also affected by China's economic slowdown. China is one of the three major trade partners for Kazakhstan: during the first five months of 2015, Kazakhstan bought about 17 percent of its imports from China (a wide range of capital, intermediate and consumer goods and sold about 11 percent of its products to China (mostly oil and some industrial products). The authorities' defense of the pegged exchange rate resulted in a large fall in

[3] Crude oil and metals represent about 90 percent of total merchandise exports of Kazakhstan. The rest of Kazakhstan's exports constitutes of grain (dominated by wheat) and other forms of primary intermediaries.

[4] The real tenge appreciated vis-à-vis the Russian ruble by 43 percent y/y in H1-2015, leading to an increase in cheaper imports from Russia.

[5] As was reported by the authorities, defending stability of the exchange rate cost them about $28 billion during 2014-15, of which about $12 billion remained in the economy in the form of foreign exchange/currency (FX) deposits in the banking system and other types of FX savings (FX deposits in the banking system, in particular, increased from about $25 billion at the end of 2013 to almost $33 billion in July 2015), and about $16 billion was in the form of net short-term capital outflows (mainly to Russia). At the same time, borrowers have shifted away from FX loans, such that FX lending as at August 1, 2015 represented 23 percent of total bank lending (16 percent of which to physical persons and 84 percent of which to legal entities).

foreign exchange reserves (about $28 billion in 2014-15) and a sharp overvaluation of the real effective exchange rate by June 2015 (120 compared to 99.5 in June 2014 (index, 2000=100)).

14. **Monetary policy, aiming to maintain the exchange rate within the preset corridor, increased devaluation expectations, and low domestic demand led to contraction of credit to the economy.** Credit continues to be tight, and overall credit was about 12 percent below June 2014 volumes, as funding cost for banks increased and the deposit base was increasingly converted into US dollar and Euro-denominated deposits (Figure 7). Currently, two-thirds of individual deposits are held in US dollars. Both corporate and individual borrowers were affected by the credit contraction. To address the issue, the authorities extended subsidized credit programs (with the interest rate capped at nominal 6 percent per annum) for SMEs and launched two new subsidy programs for mortgage refinance and purchase of cars assembled domestically. The government intervention helped a partial recovery of credit growth in these selected industries, but this was partly negated by high borrowing costs (at over 20 percent) for other industrial sectors.

Table 2. Kazakhstan: Balance of Payments, 2011-17

	2011	2012	2013	2014e	2015p	2016p	2017p
	(In US$ billion, unless otherwise indicated)						
Current account	**10.2**	**1.1**	**0.9**	**4.6**	**-1.1**	**-0.7**	**1.0**
Merchandise trade	44.8	38.1	34.8	35.6	19.1	18.9	22.8
Services	-6.6	-7.9	-7.1	-6.4	-5.8	-5.7	-5.6
Income	-27.7	-28.1	-25.1	-22.9	-12.8	-13.0	-15.3
Current transfers	-0.3	-1.0	-1.6	-1.7	-1.6	-0.8	-0.9
Capital and financial account	**2.7**	**8.9**	**9.6**	**2.0**	**6.9**	**6.7**	**5.1**
Direct investment	8.6	11.9	7.9	5.9	7.8	6.5	7.0
Portfolio investment	-0.2	-3.1	2.8	2.0	4.5	0.0	0.0
Medium- and long-term loans	0.0	4.1	5.1	2.2	0.6	3.2	1.1
Other short-term investment	-5.6	-3.9	-6.4	-8.1	-6.0	-3.0	-3.0
Overall balance/Change in reserves	**12.9**	**10.0**	**10.5**	**6.7**	**5.7**	**6.0**	**6.1**
Changes in FX reserves at NBK	0.3	-4.3	-2.4	3.9	6.3	4.7	4.1
Change in FX reserves of NFRK	12.6	14.3	12.9	2.8	-0.6	1.3	2.0
Use of IMF credit	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: WB staff calculations and estimates based on data published by the National Bank of Kazakhstan.
Note: e=estimate, p=projection.

15. **The first half of 2015 saw lower inflation.** Headline inflation fell from 7.5 percent y/y in the beginning of 2015 to 3.9 percent in June, affected by weaker domestic demand and cheaper import prices, including for fuel. Food price inflation more than halved from 8.7 percent y/y in January 2015 to 3.7 percent in June. Prices for transport services and gasoline, in particular, declined by 2 percent y/y in June 2015, contributing to lower food prices. Non-food inflation was also down from 7.4 percent y/y in January 2015 to 3.6 percent in June, mainly due to slower increase in utility tariffs.

16. **In August 2015, the monetary authorities responded to external developments and floated tenge, enabling macroeconomic adjustment to take place.** Over the past two years, NBK's exchange rate policy hampered the adjustment process, as adherence to a pegged exchange rate in the wake of the oil price fall had created a large exchange rate misalignment (Figure 6). The February 2014 devaluation was not effective in addressing this misalignment because it was a one-time adjustment to a continuously deteriorating external environment. By July 2014 the oil price started to fall, and by October 2014 the

Russian Ruble was floated. By late 2014 the tenge real effective exchange rate had re-valued to pre-February 2014 devaluation. In August 2015, policymakers went further as Kazakhstan moved to a free floating of the exchange rate, which triggered a sharp depreciation of the tenge to the U.S. dollar. Kazakhstan abandoned the crawling peg and the currency band and moved to anchor its monetary policy to inflation targeting. The tenge lost a quarter of its value when it plunged from 188.38 KZT/USD to 255.26 KZT/USD on August 20, 2015 –and since that time has usually remained in the 260 KZT/USD – 280 KZT/USD range. The impact of the tenge depreciation on the financial sector is likely to cause deterioration of banks' assets that are more exposed to unhedged FX borrowers, although overall FX lending has declined, and physical persons' FX loans represents less than 4 percent of total bank lending as at August 1, 2015.

17. **While the depreciated tenge will impact the financial sector by causing a deterioration of some banks' assets, the impact is not expected to be nearly as large as it was in the 2009 crisis. Still, financial sector risk is to be watched closely**. In January 2008, the FX portion of total bank lending was 43 percent, and it rose to 53 percent in the third quarter of 2009 before the crisis unfolded. But FX lending has steadily declined over past few years (from 42.3 percent in 2011, to 35.3 percent in 2012, 29 percent during 2013-January 2015, to 23.3 percent in August 2015); as a consequence the impact of the depreciation on the banks' assets should be mitigated. Foreign currency lending to physical persons has declined during the same period from 10.1 percent to 3.7 percent of total lending. Banks' balance sheets do not yet reflect asset deterioration—in fact, system wide NPLs declined from 23.5 percent in January to 9.4 percent in August following the June Kazkommertsbank/BTA purchase-and-assumption. Nevertheless, the financial sector risk needs to be monitored closely by the GoK and the NBK. Already, in September Moody's downgraded the four top banks with sizeable FX exposures, based on the FX exposures and/or limited capital buffers. These actions should be viewed as trade-offs against expected medium-term benefits in terms of improved tenge liquidity and access to hedging instruments to mitigate asset-liability mismatches. It is expected that further resolution of NPLs in the BTA SPV and across the banking sector will free up banks' resources for further financing of economic activities. Strengthening the corporate insolvency framework and creating the basis for a personal insolvency framework are also key measures to enable sustainable credit growth to the economy.

18. **The depreciated tenge is expected to affect aggregate demand through the wealth effect, though this impact may be relatively small**. The wealth effect comes from the loss in value of tenge denominated holdings, which in turn may lead to households to reduce consumption and businesses to curb planned investments and activities businesses had switched their banking deposits to dollar denominated deposits. In June 2015 two-thirds of the individual bank deposits were held in dollar denominated accounts. Also, the government announced a program to compensate holders of tenge denominated deposits valued up to one million tenge (about $3,800) and launched income support programs for select groups. As only 3.7 percent of the bank lending is FX loans to individuals, it is expected that a small number of households will face a bigger loan repayment burden. This may be partially mitigated by the Government's new mortgage refinance program.

19. **The depreciated tenge can affect aggregate demand through the price channel.** Import prices are expected to rise in the wake of the significant depreciation, affecting domestic consumers. This is expected to further affect negatively the weak private demand as households are expected to lose purchasing power and businesses will have to pay higher prices for imported intermediate and capital products. While, the authorities have announced price controls of 33 basic food products to mitigate the pass-through effects of the depreciation on domestic consumer prices, in the medium term, support mechanisms for the vulnerable might be better integrated with the broader package of more targeted transfers.

20. **Overall, in terms of macroeconomic policies, the GoK responded to the large external shock of the plunge in the oil price by putting in place building blocks for macroeconomic adjustment over**

the medium term: fiscal adjustment is planned extremely quickly, monetary policy adjustment came with some delay. The decline in the price of oil forced Kazakhstan to adjust to a new external environment at a lower level of income. The spending cuts in 2015, and the floating of the tenge as well as the move to inflation targeting are building blocks to allow the economy to adjust to lower oil prices, and to a different set of relative prices between tradables and non-tradables that will encourage non-oil exports. This adjustment is expected to reduce internal and external imbalances.

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

21. **Kazakhstan's GDP growth is expected to recover gradually over the next three years.** Based on an oil price assumption of $53 per barrel in 2015[6] and continued weakness in the economy, Kazakhstan’s GDP growth is expected to slow considerably from 4.4 percent in 2014 to about 1 percent in 2015 (Table 1). Lower oil export revenues are expected to lead to deficits in both the current account and the overall fiscal balance in 2015. In the medium term, provided oil prices start to recover gradually, domestic demand is expected to resume and contribute to higher GDP growth, projected at 1.7 percent in 2016 and 3.3 percent in 2017. This scenario assumes that oil production will remain almost flat until 2017 when the off-shore oil field Kashagan is expected to come on line and boost oil production.[7] There is also a downside risk that oil prices will fall below the assumed $53 per barrel in 2015 and /or will not recover in the medium term, which will lead to a lower and slower GDP growth recovery.

22. **Fiscal adjustment is based largely on expenditure contraction.** The government plans to reduce government spending from 23.5 percent of GDP in 2015 to 19-20 percent of GDP in 2016-17. As a result of this and a small increase in non-oil revenue, the non-oil fiscal deficit is projected to decline from 10.5 percent of GDP in 2014 to 6.8 percent in 2017 (or from 13.2 to 8.0 percent of non-oil GDP, respectively). Much of the expenditure contraction will come from delaying public sector salary increases by six months (until January 1, 2016), restructuring some programs (e.g. the Employment Road Map 2020 and the State Program for Industrial and Innovative Development (SPIID) for 2015-19), and cutting some inefficient capital expenditures for 2016-17 to the packages announced in 2014, while keeping the Nurly Zhol program largely intact. The Nurly Zhol program includes a set of social, utilities, infrastructure, as well as private sector support projects (detailed in Box 1) that are of highest priority.[8] Although it is expected that downsizing the capital budget may have a negative impact on growth, this adjustment is inevitable as the

[6] World Bank projection as of September 2015.

[7] The Government of Kazakhstan has taken a more conservative medium-term outlook for the purpose of adjusting its budget, based on oil prices at $40 per barrel for 2016-17. While expectations about when Kashagan will be come on line are according to official sources, that field has already experienced several years of delays thus far.

[8] An OECD Study on Energy Subsidies and Climate Change in Kazakhstan (2013) identified that direct budgetary energy subsidies are not significant, while indirect ones are widely used. The Study reported that, according to the IEA methodology, in Kazakhstan consumer subsidies for energy amounted to $5.85 billion in 2011, equivalent to 3.3 percent of GDP. The major part of these subsidies were for consumption of oil (55 percent), electricity (30 percent), and coal (10 percent). Direct budgetary support for electricity and heat consumers has largely been eliminated. However, support has been provided indirectly by regulating electricity and heat tariffs and keeping them below the full cost of provision of the service. Cross-subsidies, whereby tariffs for residential consumers are effectively supported by higher tariffs for other consumers, were also widely used. The review of budgetary spending at the national level indicated that the scale of direct producer subsidies was also not significant. The main producer subsidy program identified was the indirect subsidy to diesel for farmers in the form of price controls and seasonal diesel export bans. In 2010-2012, these export bans resulted in approximately a 10 percent discount for agricultural producers compared with the average market price of diesel fuel. Today, Kazakhstan is reevaluating its subsidies: on September 4, 2015, the GoK announced that it would stop regulating the most commonly used gasoline prices for cars.

whole economy is adjusting to the new reality of low oil prices and thus potential growth is lower than it used to be until recently.

23. **Total government debt is expected to remain low, while accumulation of oil revenue reserves in the oil fund is expected to continue**. External debt of the government debt and state guarantees, is expected to increase from 3.9 percent of GDP in 2014 to about 6-7 percent in 2015-17 as the government issued Eurobonds of $4 billion in 2015 (in addition to $2.5 billion issued in 2014) and will borrow about $7 billion from multilaterals in the context of the implementation of the Partnership Framework Arrangement (PFA) for 2015-17 to support the Kazakhstan 2050 development strategy (Table 3).[9] Meanwhile, government's domestic indebtedness is expected to decrease as the Republican Budget deficit is planned to be lowered from 3 percent of GDP in 2014 to 1 percent by 2018. Domestic debt of the government is estimated to drop from about 11 percent of GDP in 2014 to about 4-6 percent in 2016-17, bringing total government debt down to about 11-13 percent of GDP in 2016-17. The net financial asset position of the government will remain strong as the NFRK foreign exchange (FX) reserves continue to increase and exceed total government debt by a significant margin. The ratio of government's external debt to GDP and the debt service ratio are anticipated to remain stable and sustainable for the medium term. Total external debt is also expected to remain stable (in U.S. dollars), but remains vulnerable to further depreciation shocks (Figure 9).[10] In nominal terms, external debt of the private sector, excluding intra-company loans, declined from $70 billion in 2013-14 to $66 billion in Q1-2015. Although private sector external debt is high (73 percent of GDP at end-March 2015), much of it comprises intra-company loans (40 percent of GDP) between foreign firms and the Kazakhstan based affiliates. These do not represent a major risk to external debt sustainability as the loans can be restructured bilaterally if needed.

Table 3. Kazakhstan: Public Debt Sustainability, 2013-20

	2013	**2014e**	**2015p**	**2016p**	**2017p**	**2018p**	**2019p**	**2020p**
	(In percent of GDP, unless otherwise indicated)							
Government net financial assets	**17.7**	**19.1**	**23.7**	**31.3**	**32.4**	**34.4**	**33.3**	**33.0**
NFRK FX assets, stock	30.5	33.8	39.7	44.7	43.4	43.0	42.8	42.8
Government debt, stock	12.8	14.7	15.9	13.4	11.1	8.6	9.5	9.8
External debt and guarantees	2.4	3.9	6.0	7.0	6.8	6.9	7.0	6.5
Domestic debt and securities	10.4	10.8	10.0	6.4	4.2	1.7	2.5	3.3
Public debt service (percent of total revenue)	5.9	6.6	8.3	8.7	4.8	3.4	1.9	2.2

Source: World Bank staff calculation and estimates.
Note: e=estimate, p=projection.

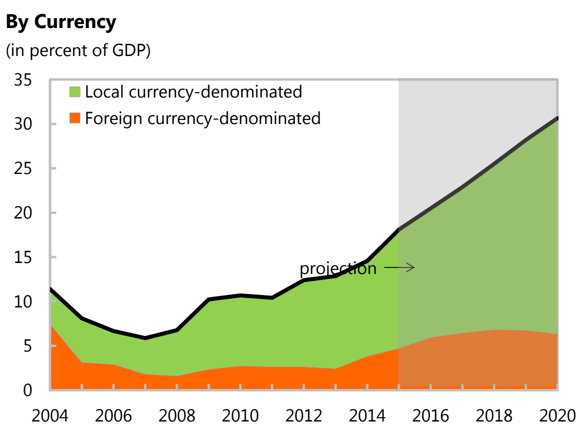
24. **The move towards inflation targeting is expected to support price stability.** The 2015 Annual Statement on Economic Policy—issued jointly in late 2014 by the government and the National Bank—affirmed the objectives of maintaining macroeconomic and financial sector stability in the short run and supporting sustainable economic growth in the medium term. According to the Statement, macroeconomic stability would be maintained by implementing coordinated monetary and fiscal policy and maintaining inflation in the planned 6–8 per cent band. The money supply will be managed in line with inflation. The new free-floating exchange rate policy will support price adjustment especially vis-à-vis the large neighboring economy of Russia. At the same time, the monetary policy will lay the groundwork for moving

[9] Partnership Framework Arrangement (PFA) is a new instrument, guided by the CPS and aimed to support the Government's efforts to ensure more sustainable development and inclusive growth that is widely shared and benefits the lower-income groups of the population.
[10] This analysis is part of the IMF's 2015 Article IV Consultation (May 2015).

to inflation targeting. While the pass-through of the tenge depreciation to domestic prices is expected to be limited due to administratively-controlled prices of basic goods and services, the higher cost of imports may put pressure on prices of other goods. CPI inflation is expected to increase by end-2015 (Table 1).

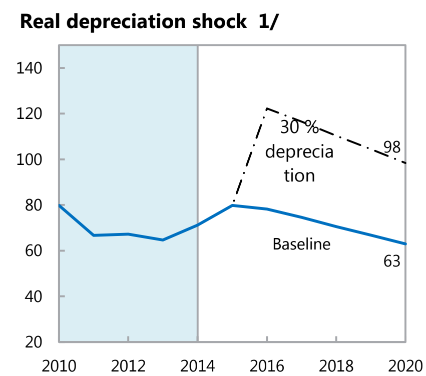
25. **The economic outlook for Kazakhstan is subject to downside risks.** Risks to the short-term outlook may emerge from a greater slowdown in China. Kazakhstan's economy will also be affected further by a more severe economic contraction in Russia that affects metal production and metal processing industries in Kazakhstan. Investor sentiment may worsen and risk aversion could increase if the Russia-Ukraine crisis persists and the Western sanctions against Russia get prolonged. Slower than expected recovery in the EU, Kazakhstan's main market, is an additional risk, as is the prospects of a U.S. Fed interest rate hike, which could lead to capital outflow from emerging economies – including Kazakhstan – and make attracting FDI and borrowing abroad more expensive. Moreover, if the global oil glut continues, oil prices may remain at their current low for several years and may further undermine Kazakhstani consumer and business sentiments and lead to lower GDP growth outcomes.

Figure 8. Public Debt Sustainability Analysis



Source: IMF staff estimates based on May 2015 Article IV Consultation.

Figure 9. External Debt Sustainability Analysis



1/ One-time real depreciation of 30 percent occurs in 2016.
Source: IMF staff estimates based on May 2015 Article IV Consultation.

Table 4. Kazakhstan: External Debt Composition, 2014

	US$ (Bn)	% of total	% of GDP
Monetary authority	1.0	0.6	0.4
General government	8.3	5.3	3.9
Banks	10.1	6.4	4.6
Other sectors, *of which:*	137.7	87.7	63.2
Intra-company lending	79.2	50.4	36.4
Total external debt	157.1	100.0	72.1
Long-term	147.1	93.7	67.5
Short-term	9.9	6.3	4.6

Sources: National Bank of Kazakhstan; Ministry of Finance of Kazakhstan

26. **The GoK will need to watch the course of the economy in 2015 and 2016 and respond should downside risks materialize.** The GoK has sought a quick and aggressive fiscal policy to help the economy adjust to a new economic reality of lower oil prices which is expected to persist into the longer term. The strategy is based on the premise that (a) a quick adjustment is more efficient than a protracted one, (b) social support infrastructure is in place to address immediate social needs, and (c) limited recourse to the oil fund

is desirable, as it is important to maintain the asset value of the NFRK. However, should downside risks materialize, or should the downward the impact on the fiscal adjustment prove overwhelming, the premise a quick and aggressive fiscal adjustment and preservation of NFRK assets will need to be reviewed.

27. **Despite the risks, Kazakhstan's macroeconomic framework for 2015–17 is adequate for a development policy loan.** This assessment is based broadly on: (a) the revision of the planned 2015 Republican Budget, the prudent fiscal stance in 2015, and the new *Forecast of Socio-economic Development of the Republic of Kazakhstan for the Years 2016-2020*, adopted by the GoK in August 2015, presents its fiscal consolidation framework and identifies fulfillment of its social engagements as its first priority; (b) the recent move to a floating exchange rate coupled with steps to implement inflation targeting to ensure a balance between the internal and external balances; and (c) a strong commitment to undertake institutional reforms in the medium term. The government has sizable fiscal buffers to cope with external shocks and is maintaining close cooperation with the IMF and the Bank team in developing policy responses. While continued external uncertainty may affect the economy in 2015 and beyond, Kazakhstan has established a track record in recent years of quick action when confronted with economic adversity.

C. IMF Relations

28. **The IMF completed its Article IV report for Kazakhstan in July 2015**. The consultation focused on policy measures to mitigate shocks and achieve the authorities' short- and medium-term objectives, in particular: (i) ensuring fiscal sustainability, with fiscal stimulus to be accompanied by credible medium-term fiscal consolidation, especially on the revenue side, and a more transparent fiscal policy framework; (ii) enhancing the monetary policy architecture and addressing imbalances by introducing greater exchange rate flexibility in tandem with the introduction of a new monetary policy instrument; (iii) bolstering financial sector resilience by reducing the level of non-performing loans to sustainable levels; and (iv) implementing ambitious structural reforms in collaboration with multilateral development banks, including in priority areas of strengthening human capital, building institutions, bolstering the rule of law, enhancing financial intermediation, improving the business climate, and reducing the state footprint in the economy to ensure successful implementation of the broader private-sector-led growth strategy and diversification away from the oil sector (Annex 3). An IMF Article IV Mission in May 2015 also highlighted the need for sustained commitment to fiscal sustainability and macroeconomic stability. Kazakhstan does not currently have a program with the IMF.[11]

29. **IMF and World Bank are collaborating closely on the proposed DPL series**. The Bank and the IMF teams have collaborated very closely in the preparation of the DPL series, most particularly in the areas of monetary/exchanged rate and fiscal policies. The Bank has strong on the ground presence, which contributes to the assessment of the macroeconomic policy environment and to fiscal policy analysis. The Fund, has its traditional strength in fiscal policy, and has maintained a program of technical assistance in monetary policy, which has played a supportive role to policymakers.

III. THE GOVERNMENT'S REFORM PROGRAM

30. **The GoK's reform program is anchored on the objectives of a new development strategy, Kazakhstan 2050**. In December 2012, the government unveiled a major long-term development goal with the objective of Kazakhstan joining the "top thirty advanced countries" by 2050. The over-arching objective

[11] The IMF's Staff Report includes data from their mission in May 2015, before the GoK released its new fiscal framework.

of the strategy is to accelerate the transformation of Kazakhstan into a modern society with a knowledge-based, diversified and private-sector driven economy.[12] To implement the over-arching objective of Kazakhstan 2050, a four-pillar approach has been adopted. It incorporates measures to improve: (i) infrastructure: (ii) human capital and skill building: (iii) diversification and (iv) institutional development and governance. The fourth component - the institutional and governance agenda – "one hundred concrete steps, a modern state for all" program, launched in May 2015, is structured around five components: (i) professionalizing the public administration, (ii) enforcing the rule of law, (iii) increasing transparency and accountability of the state, (iv) fostering economic diversification and growth, and (v) uniting the nation (Box 2). This "100 Steps Program" has become the key focus for policymakers who have prioritized its implementation within the next few months and are working intensively to ensure that they meet the President's deadline of completing actions under this Program by end-2015.

Box 2. Highlights of the 100 Steps Program

- **Professionalizing the Public Administration** (introducing a meritocratic model and a result-based pay system)

- **Enforcing the Rule of Law** (reforming enforcement institutions; streamlining regulations; protecting property rights)

- **Increasing Transparency and Accountability of the State** (implementing People's IPO and a Yellow Pages Rule for SOEs)

- **Fostering Economic Development** (enabling environment for agriculture, energy sector, manufacturing, transport, and tourism)

- **Uniting the Nation** (supporting multiculturalism, tri-lingualism, and social mobility)

Source: The Government of Kazakhstan.

IV. THE PROPOSED OPERATION

A. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

31. **The objective of the proposed DPL is to support the GoK to implement reforms that: (i) strengthen the sustainability of the macroeconomic framework while protecting the vulnerable; and (ii) help improve competitiveness of the non-oil economy.** The design of the program reflects the Government's priorities, as reflected in the Kazakhstan 2050 strategy, the "100 Steps" program, as well as recent initiatives to stimulate private sector investment and reform public administration.

(i) The first pillar of the DPF series supports measures to improve the sustainability of the macroeconomic framework through fiscal adjustment while protecting the most vulnerable, exchange rate flexibility and steps towards inflation targeting, revenue mobilization measures, and the rollout of an enhanced social protection strategy. While these measures assist Kazakhstan to adjust to a new external environment of lower oil prices, they initiate the move to new policy anchors (the non-oil deficit for fiscal policy and the base interest rate for monetary policy) for macroeconomic management.

(ii) The second pillar supports measures to enhance competitiveness of the non-oil economy, which will be key to foster private sector-led growth and boost shared prosperity, including financial

[12] President Nazarbayev outlined the government's seven strategic priorities in his 2014 Address to the Nation to meet this objective: (i) innovative industrialization; (ii) an efficient agri-industrial sector; (iii) improved potential for science; (iv) urban and infrastructure development; (v) development of small- and medium-sized enterprises (SMEs); (vi) an active, educated, and healthy population; and (vii) efficient public institutions.

sector reforms, measures to improve the investment and regulatory policy regimes, the introduction of market-based approaches to industrial policy programs, measures to strengthen corporate governance of SOEs, and improvements to the competition policy framework.

32. **The design of the proposed series** builds on the rich knowledge base resulting from a series of RAS activities under the Joint Economic Research Program (JERP), a knowledge building activity implemented by the World Bank for the GoK (Table 7). The policy content of the DPL series has been coordinated with the Asian Development Bank which has provided budget support to Kazakhstan in 2015. The identification of prior actions was informed by existing analytical work.

B. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening sustainability of the macroeconomic framework while protecting the vulnerable.

33. **In the face of lower oil prices, the GoK is adjusting its macroeconomic policies to help bring about the required adjustment in income and relative prices in a sustainable way.** This DPL series supports a number of policy changes underway in Kazakhstan to adjust to an adverse external environment. These include: (i) reduction in the non-oil deficit and more accurate information on the non-oil deficit for policymakers to base fiscal policy decisions; (ii) enhancement of the social assistance program to protect the vulnerable; and (iii) exchange rate flexibility and progress towards an inflation targeting regime.

Ensure fiscal sustainability by reducing the non-oil fiscal deficit while maintaining social spending commitments

34. **Fiscal policy in Kazakhstan has been prudent by many counts.** A clear set of rules governing the level of transfers from the oil fund, the National Fund of the Republic of Kazakhstan (NFRK), has been in place since 2001 and enabled Kazakhstan to manage its oil revenues well. Kazakhstan has saved just under 50 percent of its oil revenues since 2008, having accumulated about $68 billion in the NFRK. The rest has been deployed largely through the budget in support of the country's development objectives. While the oil fund has been used for stabilization purposes in the past, and Kazakhstan could finance its budgetary needs by further drawing it down, the GoK has chosen to proceed with fiscal adjustment --as oil prices are expected to remain low and are no longer considered to be a temporary phenomenon—and to draw partially on the oil fund as well as to borrow to meet its financing needs. Fiscal adjustment and preservation of oil wealth rather than oil revenue financing is the prudent way to go forward (Annex 4 presents further details on the oil fund).

35. **In response to the changed environment, the GoK has reduced its budget by cutting and prioritizing investment expenditures.** While commitments to the economic support programs (Box 1), as well as their funding from the oil fund, have been maintained, the GoK has responded to lower oil prices by cutting back planned increases in the 2015 central government budget (the Republican budget) and retaining total spending at the 2014 level (in nominal terms). The GoK did maintain most of the planned 2015 increases in recurrent spending, including critical social expenditures (which were maintained at 41 percent of total expenditures), but cut back or postponed lower priority/inefficient investment spending from the central government budget, or investments that are still at an early stage of development. On the investment side, for 2016 and 2017 the GoK has committed not to draw down additional funds from the NFRK for new programs but to remain within planned NFRK transfers and existing commitments to the Nurly Zhol program. Given the important interplay between the central government budget and the NFRK, appropriate way to determine the pro/counter cyclical policy stance of the government is by looking at the consolidated budget, which is presented in tables 1 and 6. Box 3 contains details on fiscal consolidation plans for 2015 and 2016.

Box 3. Fiscal Consolidation 2015-2016

The GoK is pursuing fiscal consolidation in line with the medium-term objective of reaching sustainable non-oil deficit levels. The Republican budget is composed of about 45 percent current spending and 55 percent investment budget. The focus of fiscal consolidation is not only on budget cuts but also on improving efficiency of expenditures – especially investment expenditures - within the Republican budget. The budget cuts include both capital and current expenditures, but target more heavily projected capital expenditures. The table below provides important of revisions. Principal areas of consolidation and reprioritization are as follows. First, the budgets of the Ministry of National Economy (MNE) and Ministry of Investment and Development (MID) are being cut substantially. The cuts will come from a variety of sources: suspension of projects that are not close to completion, new projects delayed or transferred to SOEs to implement, some current expenditure cuts, and in the case MID streamlining of some of the industrial support and subsidy program. Second, other major revisions in current expenditures are mostly from delaying promised salary increases to civil servants and the launch of the piloting the per-capita financing in education. Third, the GoK has also taken the opportunity to right-size the Employment Road-Map 2020. This reform comes in the aftermath of a review of the recent performance of the Road-Map and seeks to increase its efficiency within a smaller budget envelop. Fourth, the security apparatus (Ministry of Interior, Ministry of Defense, and National Security Committee) will experience substantial reductions in their capital expenditures in 2015 and 2016 revised budgets. Fifth, other line agencies are also subject to budget cuts but of lower magnitude.

Republic budget for 2015-2016	2015 Initial plan	2015 plan vs. revised	2016 Initial plan	2016 plan vs. revised
(In billion tenge unless noted otherwise)				
Total, of which:	7,855	-8%	8,042	-9%
Cuts in MNE and MID				
MID budget	695	-10%	689	-18%
MNE budget	909	-14%	863	-32%
Other cuts in current expenditures:				
Delaying salary increases	119	-100%	298	2%
Delaying piloting per-capita financing in education	13	-91%	15	-87%
Healthcare services	615	-4%	639	-1%
Reforming Employment Road-Map 2020	90	-59%	101	-63%
Other cuts in capital expenditures:				
Ministry of Interior	67	-69%	59	-73%
Ministry of defense				-19%
National Security Committee		-8%		-20%

Source: World Bank staff calculations, based on data provided by the Government of Kazakhstan.

36. **The GoK plans to strengthen its non-oil revenues in the medium term.** In 2009, the GoK reduced the corporate tax rate from 30 to 20 percent as an anti-crisis measure. This policy change initiated the gradual reduction of non-oil revenues illustrated in figure 5, though some of the revenue reduction is owed to declining revenues from metals and minerals, which were subject to declining commodity prices. The higher oil prices of 2009-2015 rendered the higher non-oil deficit affordable (Figure 4). The GoK is now keen to raise its non-oil revenues but is mindful of overburdening the private sector at a time when the economy is weakened (in 2016 the private sector will need to increase social security contributions and support the introduction of social health insurance). As a first phase in increasing non-oil revenues, for 2016, the GoK will lower the VAT threshold (which is a prior action for this operation) but also undertake a host of other administrative measures, which aim to simplify processes, lower administrative costs, and increase revenues. These include, on the customs side, introduction of electronic shipping invoices and reduction of the list of required documents for imports, and obtaining information from departmental information systems. Additionally, the GoK will also launch a program to distribute electronic terminals to vendors and introduce incentives for the use of payments using electronic cards in place of cash. For 2017, the GoK will introduce a policy and legal framework with supporting IT systems to provide for an

Automatic Exchange of Information on tax matters with other countries (which is a trigger for this operation).

37. **GoK's fiscal framework will need to maintain a strong development focus and a balanced approach to expenditure reduction and revenue increases; it will also need to adjust as economic developments unfold**. The GoK has set an aggressive deficit reduction plan relying mostly on expenditure cuts but also on non-oil revenue increases. In the short term, the adjustment is coming from cuts in investment spending while support to high priority investment projects is maintained. Going forward, the GoK is working to reprioritizing its central government budget by evaluating the performance of its many government programs, including support programs to enterprises. The GoK will need to remain flexible in the implementation of its deficit reduction target, monitoring the performance of the economy. Already, in the fall of 2015 the GoK has scheduled a review of its non-oil revenue polices which will assess the need for additional non-oil revenue measures (these can include reduction on exemptions and additional measures to strengthen revenue administration). The development focus of the budget will need to balance meeting investment needs to ensure that the country's infrastructure base continues to be developed, the efficient use of recurrent expenditures (especially on the social sector side), and reduction of the non-oil deficit. Deficit reduction will likely have an impact on SOEs. Since SOEs have benefitted from budgetary spending and direct transfers from the oil fund (Box 1) commitments to reduce the non-oil deficit and limit oil fund use will reduce resources available to SOEs (and the generation of new jobs). In order to achieve its development focus efficiently, the GoK will needs to strengthen is comprehensive view of the consolidated budget (which is a prior action for this operation).

38. **All the above-mentioned fiscal consolidation measures aim to the bring non-oil deficit to a sustainable level**. Our latest estimates suggest that at $40/bbl real oil price Kazakhstan's non-oil deficit may be maintained in the range of 3.6 percent of GDP in a low-case to 6.6 percent in a high-case. These scenarios differ in the assumption of recoverable oil reserves in the ground (Table 5). At $60/bbl price, the non-oil deficit level may be maintained higher, ranging from 5.4 percent of GDP in the low-case to 9.9 percent in the high-case. Based on the above sustainability analysis, the government's fiscal consolidation efforts should be acknowledged, though with some caution regarding the pace of adjustment and the composition of fiscal consolidation measures envisaged. Currently, the government plans to cut the non-oil deficit from 10.5 percent of GDP in 2015 to below 7 percent by 2018.

Table 5. Kazakhstan: Sustainable Non-oil Deficit under Alternative Scenarios

	Oil Reserves	**Oil Price**	**Non-oil deficit financing at RR**		**Non-oil deficit**
			1.00%	**3.00%**	**% of GDP**
Low Case	4.0 bn. tons	$40	$2,960	$7,789	3.6
	(30 bn. bbl)	$60	$4,450	$11,691	5.4
Base Case	5.3 bn. tons	$40	$4,298	$10,986	5.1
	(40 bn. bbl)	$60	$6,457	$16,487	7.6
High Case	6.7 bn. tons	$40	$5,639	$14,185	6.6
	(50 bn. Bbl)	$60	$8,468	$21,285	9.9

Table 6. Kazakhstan: Consolidated Budget and Republican Budget, 2011-16

	2011	2012	2013	2014	2015 plan	2015 revised	2016 plan
	(In percent of GDP, unless otherwise indicated)						
Consolidated Budget*							
Revenue and grants	27.7	26.4	24.2	23.1	..	19.2	20.4
Oil revenue, total	14.4	13.8	11.8	11.4	..	7.6	8.5
Oil revenue, saved	8.2	7.3	6.2	4.4	..	-0.4	0.7
Oil revenue, spent, *of which:*	6.1	6.6	5.6	7.0	..	8.0	6.3
KZT 1 trillion package				0.8	0.8	0.9	
Nurly Zhol program					0.8	1.1	0.8
Non-oil revenue	13.3	12.6	12.4	11.7	..	11.6	11.9
Expenditure and net lending	21.8	22.3	20.8	22.2	..	23.5	19.6
General government expenditures	21.5	22.1	20.1	21.5	..	20.9	19.5
Current expenditure	14.9	16.1	15.5	15.7	..	16.4	16.1
Capital expenditure and NL	5.0	4.7	4.0	4.4	..	4.0	3.2
Transfers to SOEs	1.7	1.3	0.6	1.5	..	0.5	0.2
NFRK lending to SOEs, *of which:*	0.3	0.2	0.7	0.7	0.1	2.6	0.1
KZT 1 trillion package				0.7	0.1	0.1	
Nurly Zhol program						0.7	0.1
S-K KMG debt repmt (partial)						1.4	
Overall fiscal deficit	5.9	4.0	3.4	0.9	..	-4.3	0.8
Non-oil deficit	-8.5	-9.8	-8.4	-10.5	..	-11.9	-7.7
Non-oil deficit (% of non-oil GDP)	-11.5	-13.3	-10.7	-13.2	..	-13.7	-9.0
Financing	-5.9	-4.0	-3.4	-0.9	..	4.3	-0.8
Domestic financing	1.7	2.7	1.8	1.6	..	-0.7	-0.3
Foreign financing, *of which:*	0.3	0.3	0.2	1.2	..	2.0	1.9
Eurobonds				1.2	..	1.9	
DPFs (ADB and IBRD)					..		1.1
Other borrowing from IFIs	0.3	0.3	0.2	0.0	..	0.1	0.8
NFRK ('-'= saving)	-8.0	-7.0	-5.4	-3.7	..	3.0	-0.6
Republican Budget							
Revenue and grants	16.1	15.7	14.7	15.1	15.4	14.4	14.7
Tax revenue	10.9	9.8	10.0	9.4	9.2	7.5	7.6
Non-tax revenue	0.4	0.8	0.3	0.3	0.3	0.4	0.3
Income from capital transactions	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Transfer receipts	4.8	5.0	4.4	5.4	5.9	6.5	6.8
Expenditure and net lending	18.2	18.7	16.7	17.9	17.7	17.5	16.4
Total expenditure	16.7	17.3	16.2	16.6	16.5	16.9	15.8
Current expenditure	12.9	14.1	13.3	13.8	14.1	15.0	..
Capital expenditure	3.8	3.3	2.8	2.8	2.4	1.9	..
Net lending	0.3	0.2	0.1	0.1	0.2	0.2	0.3
Targeted transfers to SOEs	1.2	1.2	0.5	1.2	1.0	0.5	0.2
Republican Budget deficit	-2.1	-3.0	-2.0	-2.8	-2.3	-3.1	-1.6
Republican Budget non-oil deficit	-8.5	-9.8	-8.3	-10.5	-9.7	-10.4	-9.1

Source: Government of Kazakhstan

Note: * The Consolidated Budget consists of the central government budget (Republican Budget, which is overwhelmingly the largest part), regional budgets, and the NFRK (the Oil Fund).

39. **The DPL series supports the enhancement of GoK's fiscal framework to incorporate the majority of public spending in medium-term budget policy documents as a mean to increase fiscal sustainability and budgetary transparency.** While the government continues to act responsibly by keeping its debt accumulation to manageable levels, it increased direct lending from the NFRK to SOEs (as part of the economic support program) to stimulate domestic demand. Not capturing NFRK direct lending in the budget underestimates GoK's fiscal policy stance as measured by the non-oil deficit, which is expected to remain high at 10.1 percent of GDP compared to 10.5 percent in 2014. Moreover, currently, Kazakhstan's Budget Code classifies customs duties on oil exports as non-oil revenue and thus distorts calculation of the non-oil deficit.[13] As part of the DPL series, the GOK agreed to start showing two non-oil deficit lines, a lower one as prescribed by the Budget Code, and a higher much closer to the GFS methodology. The GoK's use of the central government budget and the oil fund to conduct fiscal policy, at a minimum, necessitates that a consolidated picture of the non-oil deficit is available to policymakers and stakeholders. The DPF supports changes in the Government's key fiscal policy documents that help capture consolidated expenditure and oil revenues more accurately. These changes are expected to allow the GoK to use the non-oil deficit as a fiscal anchor.

40. **The following prior actions and indicative triggers are proposed:**

- ***Prior Action 1**: The GoK made the following fiscal adjustments:*
    - *a) revised the 2015 Republican Budget expenditures and gross lending downwards by almost 8 percent from 7,855.1 to 7,244.5 billion tenge, as evidenced by Law No. 290-V, dated March 11, 2015, to avoid an excessive widening of the non-oil deficit;[14] and*
    - *b) amended the Order of the Minister of National Economy No. 9, dated January 8, 2015, and titled "On Approval of Rules and Timing for the Preparation of Socio-Economic Development Forecast" (also referred as the Guidelines for the Preparation of the Medium-Term Macroeconomic and Fiscal Framework), as evidenced by the Order of the Minister of National Economy No. 557, dated July 21, 2015, so that the definition of the non-oil deficit more accurately measures the fiscal stance by: (i) comprehensively covering the consolidated budget (the Republican Budget, regional budgets, and the NFRK); and (ii) properly including customs duty on oil exports as an oil revenue item.*

- ***Prior Action 2**: The GoK submitted to the Parliament for approval a draft law titled "On Amendments and Additions to Some Legislative Acts of the Republic of Kazakhstan on Tax and Customs Administration", as evidenced by the Government Resolution No. 710, dated August 29, 2015, to increase non-oil revenues by reducing the VAT registration threshold for VAT payers from an annual turnover of approximately 30,000 Monthly Calculation Index (MCI) equivalent to 3,234 MCI equivalent.[15]*

[13] The GoK's fiscal accounting framework differs on several counts from the IMF's framework as well as the IMF's standard Government Finance Statistics (GFS) manual for fiscal accounts. Specifically, (i) national oil fund accounts, including most oil export revenues are kept off-budget; (ii) oil export revenues are only recognized when funds are transferred from the national fund to the budget; (iii) customs duty on oil exports is treated as non-oil revenues; (iv) capital gains on national oil fund assets, including the effects of devaluation are treated as cash revenues; (v) direct lending (on-lending) from the national oil fund to quasi-sovereign entities is not recognized as expenditure; and (vi) only a fraction of quasi-sovereign entity's foreign loans, which is directly guaranteed by the government, are recognized as contingent liabilities. IMF Article IV for Kazakhstan 2015, Annex VI.

[14] Republican Budget expenditures comprise budget expenses and acquisition of financial assets.

[15] Monthly Calculation Index (MCI) is a unit measure used in the budget to calculate pensions, social benefits, fines, taxes and other payments to the budget. In 2014, 1 MCI was equivalent to 1,852 tenge or approximately $10.

- ***Indicative Trigger 1****: (a) The 2015 non-oil deficit (GFS classification) is no larger than 12 percent of GDP in 2015; (b) The GoK approves (i) a revised Medium-Term Macroeconomic and Fiscal Framework that envisages a medium-term reduction in the non-oil deficit of the consolidate budget (GFS classification) to be no larger than 10 percent of GDP in 2016 and 9 percent in 2017, based on expenditure reduction as a share of GDP and non-oil non-mineral revenue increases; and (ii) an updated New Budget Policy Concept that prescribes a medium-term reduction of the non-oil deficit.*

- ***Indicative Trigger 2****: To further strengthen non-oil revenues, the GOK (a) adopted polices to increase non-oil non-mineral revenues; and (b) enhanced tax administration by introducing an appropriate framework for the provision of an Automatic Exchange of Information on tax matters with other countries (in line with the Global Forum standards).*

41. **Expected Results:** These measures will improve fiscal sustainability by reducing the non-oil deficit from 10.5 percent of GDP in 2014 to less than 9 percent in 2017 and increasing the level of non-oil revenues from 14.7 percent of non-oil GDP in 2014 to more than 15 percent in 2017. The measures would increase budget transparency and coverage by (a) extending the definition of the government fiscal accounts to include the full consolidated budget (the Republican Budget, regional budgets, and the NFRK); and (b) extending the definition of oil revenues to include customs duty on oil exports will allow policy makers access to a more accurate non-oil deficit figure on which to anchor fiscal policy. Non-oil GDP is used as a unit (denominator) to assess the adequacy of the revenue effort as it abstracts somewhat from fluctuations in oil revenues. The legislation supported by Prior Action 2 is expected to be passed by Parliament shortly as it is part of the "100 Steps program" which is expected to be implemented this calendar year.

Enhance the social assistance program to protect the vulnerable

42. **Enhancement of the current cash transfer program would go a long way to strengthen social protection in Kazakhstan** As the economy faces headwinds and lower growth increases household vulnerability, preserving the social contract with an effective conditional cash transfer program is a high priority for GoK, and an area where expenditure efficiency can result in large welfare gains. GoK's current Targeted Social Assistance (TSA) program introduced in 2002 suffered from a number of inadequacies, including poor targeting and a lack a "social contract" such as those in Conditional Cash Transfer programs popular in Latin America or the work-oriented programs used in Europe and the USA. The World Bank has supported GOK's efforts to transform its TSA program by increasing the eligibility threshold and introducing conditionality related to work and social behavior. This new program, re-branded as "Orleu", is being implemented in phases. The first phase started in February 2014 with piloting of the Orleu project in three oblasts. The pilot included an increase in the eligibility threshold to 60 percent of the "subsistence minimum" (the income level below which persons are eligible for the program) and the launch of a social contract in three oblasts. The second stage (2015-17) envisages implementation of the pilot project in the rest of the regions. The third stage will envisage introduction of targeted social support based on social contract will be implemented nation-wide starting from 2018. This stage will be preceded by the improvement of the legislation and an enhancement of the management information system to perform means testing and control fraud and error. All stages will require intensive training for social workers. The DPF series will support the rollout of the Orleu.

43. **The following indicative trigger is proposed:**

- ***Indicative Trigger 3****: The Ministry of Health and Social Development submitted legislation to the Parliament to roll out the Orleou conditional cash transfer system nationwide*.

44. **Expected Results:** The measure will support increased the share of persons covered by the active forms of the employment support to eligible employable recipients of targeted social support to more than 50 percent in 2017 (gender disaggregated) while enhancing the targeting of the cash transfers through better systems and means testing. While the program is designed to target the poor, increase motivation for employment, and create conditions to facilitate economic self-sufficiency of support recipients.

Support transition towards inflation targeting

45. **NBK's policy moved towards inflation targeting and a more flexible exchange rate regime to promote macroeconomic stability**. The NBK allowed the tenge to float on August 20, 2015 and announced a new policy interest rate on September 2. In May, 2015, the NBK adopted a medium-term monetary policy framework, "Monetary Policy of the Republic of Kazakhstan to 2020," which laid out a plan to switch to inflation rate targeting. NBK is implementing technical and legal changes needed to transition to inflation targeting, and a technical committee composed of the governor, the vice-governors and select department directors is guiding the transition.[16] It is expected that a draft law that regulates the adoption of the rules on conducting open market operations will be submitted to the Parliament in September 2015. NBK is also developing its technical and analytical capacity for liquidity forecasting, which is expected to be fully functional by June 2016. It is developing a communication strategy by end 2015 and a follow-on action plan to ensure transparent and timely communications on this transition to the population and the markets. As part of this strategy, it publicized a meeting schedule for 2015 specifying dates when meetings will be held to make decisions about interest rates and instruments of monetary policy. It is also drafting revisions to the law "On the National Bank of Kazakhstan" that will formalize the institutional structure to conduct inflation targeting and is expected to be submitted to the Parliament by mid- 2016. The draft revisions to the law is currently being discussed internally at the NBK. As the NBK has not been immune from political economy considerations in the past, the law "On the National Bank of Kazakhstan" is also to provide more independence to the institution to implement inflation targeting.

46. **The following prior actions and indicative triggers are proposed:**

- ***Prior Action 3**: The NBK undertook the following actions in accordance with the Monetary Policy of the Republic of Kazakhstan to 2020:*
  - *a) adopted a free-floating exchange rate regime, as evidenced by the Joint Statement of the GoK and the NBK, dated August 20, 2015, and the subsequent NBK Press Release No. 38, dated August 21, 2015;*
  - *b) adopted a new policy interest rate – a targeted interest rate, which, as the National Bank expects, will be formed in the financial market on one-day loans between market participants – to enable the process of transiting to inflation targeting, as evidenced by the NBK Press Release No. 43, dated September 2, 2015 and the NBK Press Release No. 49, dated October 2, 2015; and*
  - *c) submitted to the Parliament for approval a draft law titled "On Amendments and Additions to Some Legislative Acts of the Republic of Kazakhstan on Non-Performing Loans and Assets of Second-Tier Banks, Financial Services and Activities of Financial Institutions, and the National Bank of the Republic of Kazakhstan", as evidenced by the Government Resolution No. 391, dated May 29, 2015, which regulates the adoption of the rules of conducting open market operations for effective monetary policy management.*

[16] The NBK has received several technical assistance missions from the IMF's Monetary Policy and Capital Markets Department including most recently enhancing the monetary policy framework (needs assessment mission, 11/14); liquidity forecasting (3/15), enhancing the monetary policy framework (3-4/15), and modeling and forecasting (6-7/15). IMF Article IV for Kazakhstan Staff Report 2015 (IMF Country Report 15/241).

- ***Indicative Trigger 4**: The NBK launched new tools of monetary policy in accordance with the Monetary Policy of the Republic of Kazakhstan to 2020 by: (a) establishing the technical infrastructure for implementing interest rate targeting (finalize software development for the auctions of direct repurchase agreements and foreign exchange swap on the basis of an independent platform and the software with commercial banks; functional liquidity forecasting models); (b) implementing the communication strategy related to the policy to move to inflation targeting; (c) drafting the law "On the National Bank of Kazakhstan" with respect to creation of the necessary institutional structure to conduct inflation targeting policy (including Monetary Policy Committee (MPC) and Money Markets Committee (MMC).*

47. **Expected Results**: The expected results are greater transparency and predictability of monetary policy. One indicator is the reduction of volatility of market interest rates in the money market. A draft law, which regulates the adoption of the rules of conducting open market operations, will be submitted to the Parliament in September 2015.

Pillar 2: Help Improve Competitiveness of the Non-Oil Economy

48. **Macroeconomic adjustment under Pillar 1 is the first step for the non-oil economy to regain its competitiveness through an improvement in the external terms of trade and an adjustment of relative prices in the domestic economy in favor of tradables other than oil**. Yet, additional steps to improve the competitive environment of the non-oil economy are required if it is to create the good jobs Kazakhstan is seeking in the medium term. For Kazakhstan, with the extensive reach of the state sector in the economy, these additional steps are consistent with reducing the regulatory reach of the state, and improving the competitive environment so there is a more level playing field between the SOEs and private enterprise, and a course for reducing the role of SOEs in the non-oil economy. Over the last decade, employment growth in the oil and mining industry has been modest, with the bulk of new jobs – about 175,000 net new jobs per year – being created in the services and construction sectors. Yet, as in most oil-dependent countries, supporting the growth of the non-oil economy has been a challenge in Kazakhstan. Beyond the high profitability of the oil and mining sectors and the skewed relative prices in the domestic economy that favored the non-tradable sectors, the key challenges holding back further private development in non-oil sectors, include large non-performing loans (NPLs) which have hampered financial intermediation, the prominent role of the State in economy, skills mismatch in the labor market, a cumbersome regulatory environment, and weak market contestability and competitive pressures. The proposed DPF series will support GoK’s efforts to address some of these issues, focusing on financial sector reforms, measures to improve the trade, investment and regulatory policy regimes, the introduction of market-based approaches to industrial policy programs, measures to strengthen corporate governance of SOEs, and improvements to the competition policy framework. While in many countries, improvements in the regulatory framework are important in and of themselves to improve the operating environment for enterprises, in the case of Kazakhstan, they are also important because they curtail the extensive role of the state via SOEs.

Strengthen the financial sector by improving the legal framework for insolvency, strengthening prudential norms and increasing the role of second-tier institutions in agriculture

49. **The DPF series supports the GoK’s and NBK’s initiatives to address structural weaknesses that have led to a build-up of a large volume of NPLs since the 2008 global financial crisis.** Almost eighty percent of NPLs have been concentrated in the five largest banks, and nearly half were until recently concentrated in BTA Bank. Authorities have made progress to incentivize banks to reduce the level of NPLs on their balance sheets, and since June 2015 have de-licensed BTA Bank (previously the third-largest bank by assets and having more than 80 percent of its portfolio non-performing) which has completed a purchase-

and-assumption of performing assets and branch network with Kazkommertsbank, the largest bank by assets (Box 1). This action, along with the use of the PLF resources to write down NPLs has prompted a more than threefold reduction of the NPL ratio from January to t August 1, 2015. It is likely that a few banks (especially those recently the focus of ratings downgrades due to large FX exposures with significant exposures to unhedged borrowers) may see asset deterioration in the short-term due to depreciation of the KZT. However, the benefit of the new monetary policy approach to banks' access to liquidity is expected to ease banks' asset/liability mismatches in the medium-term, reducing risks of currency imbalance in their portfolio structures. The focus of the DPF complements the macro policies by supporting reforms that address weaknesses in the legal framework for working out insolvency of firms and individuals and improving risk management in commercial banks that should contribute further to cleaning up banks' NPLs.

Improve Legal Framework for Insolvency of Firms and Individuals

50. **Improving the legal framework for insolvency and creditors' rights is important for a more efficient process for greater recovery of value from insolvent entities and enabling future credit growth.** Of the system-wide NPLs, the volume of loans over 90 days due at 1 January 2015 was approximately evenly split between corporates and individual borrowers., While the legal framework for creditors' rights in Kazakhstan has been improved in many ways, significant weaknesses remain in credit enforcement, which constrain the development of credit markets. Inadequate corporate insolvency legislation and unsound practices of frequent company liquidation are key among those weaknesses.

51. **The GoK launched an ambitious and comprehensive reform of insolvency legislation in 2014.** Supported by a diagnosis done in the context of a World Bank-IMF Financial Sector Assessment Program,[17] GoK launched reforms aimed at introducing a modern business reorganization procedure, a speedy path for business winding up, and a new personal insolvency procedure. The GoK has also established a comprehensive framework for corporate insolvency, which strengthens the rights of collateralized creditors and expedites the insolvency procedure for legal entities. Legislation passed in 2014 resulted in a number of beneficial changes that: (a) made reorganization available to creditors,[18] (b) modified provisions related to voting on modifications to a reorganization plan, so that only those creditors whose rights are affected by the proposed modifications participate in the voting process; and (c) expedited the insolvency procedure for legal entities. GoK has subsequently enacted sublaws (also known as "Order") ensuring the correct implementation of the corporate insolvency reform.

52. **In addition, the GoK has developed a draft Concept Law on personal insolvency that is expected to be approved shortly.** The resulting legislation should support a more efficient workout of some 70 percent of NPLs in the banking system provided to individuals. Consistent with the international experience this concept law contains several useful provisions including regulating the insolvency of sole entrepreneurs as well as the insolvency of consumers; establishing an initial out-of-court stage where a debtor may achieve an amicable settlement with creditors under the supervision of a financial manager; and limiting the courts' intervention in personal insolvency.

Improve Risk Management of Banks through Stronger Prudential Norms

53. **NBK is also working to strengthen prudential norms in the banking sector.** The World Bank is providing technical advice to help NBK develop tools and methodologies for systemic risk monitoring

[17] In the context of joint World Bank-IMF Financial Sector Assessment Program (FSAP) in 2011-2012, the GoK undertook a review of its insolvency framework. The resulting Report on Observance of Standards and Codes (ROSC) for Insolvency highlighted key deficiencies which have formed the basis for GoK's efforts to develop this framework further.

[18] Prior to enactment of this law, creditors only had standing to petition for insolvency if they were owed at least 150 times the monthly calculated indexes (approximately $1450).

and to improve the effectiveness of bank supervision through risk-based inspections. In May 2014, the NBK introduced revisions to prudential norms that envisage a phased introduction of new requirements for calculation of capital adequacy in accordance with Basel III since January 1, 2015, and increase the required authorized capital of banks from 30 billion to 100 billion tenge since January 1, 2016. Other measures that will take effect from January 2016 include the introduction of consolidated financial reporting for financial institutions. A number of other measures have also been implemented to ensure that banks assess risk appropriately and provision adequately for non-performing loans. The DPF series supports the transition from compliance verification to risk-based oversight in the banking sector, a key step to mitigate the buildup of NPLs.

54. **The following prior actions and indicative triggers are proposed:**

- ***Prior Action 4****: The GoK enacted the following legislation to establish the legal framework for corporate insolvency*:

a) *approved a law No. 269-V, dated December 29, 2014, titled "On Amendments and Additions to Some Legislative Acts of the Republic of Kazakhstan on the Radical Improvement of Business Environment in the Republic of Kazakhstan", which establishes a strong corporate insolvency legal framework; and*

b) *approved sub-laws that enable the implementation of the corporate insolvency framework, namely: (i) the Order of the Minister of Finance No. 92, dated February 16, 2015, which provides for reimbursement of taxes owed by insolvent corporations and costs of bankruptcy administration; (ii) the Order of the Minister of Finance No. 131, dated February 26, 2015, which establishes the rights of a bankruptcy administrators in the context of cameral control activities in rehabilitation and bankruptcy; (iii) the Order of the Minister of Finance No. 132, dated February 26, 2015, which establishes the basis for a bankruptcy administrator's accountability for violations and sanctions; (iv) the Order of the Minister of Finance No. 183, dated March 18, 2015, which establishes minimum payouts to a bankruptcy administrator; (v) the Order of the Minister of Finance No. 130, dated February 26, 2015, which sets up the registration of bankruptcy administrators; and (vi) the Order of the Minister of Finance No. 178, dated March 17,2015, which establishes the rights and procedures for carrying out electronic auction of seized assets.*

- ***Prior Action 5****: The NBK issued revised prudential norms and accounting requirements that improve the risk management of banks, as evidenced by:*

  a) the amendment of the Financial Supervision Agency Board Regulation No. 358, as evidenced by the NBK Board Regulation No. 97, dated May 27, 2014 and which took effect on January 1, 2015, to revise risk weights toward alignment with Basel III, increase authorized capital of banks, and require banks to form conservation capital buffers; and

  b) the issuance of the NBK Board Regulation No. 256, dated December 24, 2014, to require banks to align with IFRS 13 for market-based, fair-value disclosure, and to call for more consistent, frequent, and electronically documented valuations of collateral.

- ***Indicative Trigger 5****: The GoK developed the Concept Law on Personal Insolvency.*

- ***Indicative Trigger 6****: The NBK undertook further actions to improve quality and completeness of prudential reporting and capturing the level of risk by:(a) implementing regulations that require financial institutions to conduct financial reporting on a consolidated basis in line with IFRS; and (b) enacting further revisions to NBK prudential norms that requires introduction of supervisory capital buffers by banks to ensure adequate capital to cover market and other risks.*

55. **Expected Results**: The expected result of these reforms will be: streamlined corporate and personal insolvency processes that allow for more value-recovery, an improved environment for continued lending, a more capitalized banking system, and increased availability of agricultural credit by commercial banks. An indicator that represents one aspect of these results, the improvement in prudential regulation, is the weighted average Tier-1 to risk-weighted assets of the banking system, as measured by National Bank of the Republic of Kazakhstan (K1-2 ratio); it is expected to increase from 13.2 percent in January 2015 to 15 percent on January 1, 2017.

Strengthen transparency and efficiency of the investment, regulatory, and competition policy regimes

56. **Further strengthening Kazakhstan's investment regime through WTO accession will be critical to foster investment and economic diversification.** Kazakhstan's accession to the World Trade Organization (WTO), scheduled for December 2015, will reaffirm the country's commitment to broaden and deepen economic development through trade and international integration. The accession protocol was signed in July 2015 in Geneva. WTO accession and related revisions to national laws are to be approved by the Parliament by end-October 2015 at the latest to ensure Kazakhstan complies with its commitments before its official accession in December 2015. The WTO accession process has provided an anchor for Kazakhstan's trade and investment regime reform and allowed a balancing of regional integration efforts within the framework of the Customs Union and the Eurasian Economic Union (EAEU) with multilateral efforts. As part of the WTO accession negotiations, Kazakhstan concluded 29 bilateral market-access agreements on goods and 15 bilateral market-access agreements on services. For goods, commitments will bring down tariffs to around 6 percent on average, similar to the levels prevalent before the EAEU accession. For services, commitments are in ten sectors, including telecommunication, insurance and banking, tourism, and distribution, and will be phased in during a two to five year transition period. These are expected to help boost productivity in these sectors and generate economy-wide benefits.

57. **The DPL series supports the phasing out, consistent with the WTO accession protocol, of trade related investment measures and local content requirements which hamper investors' access to more cost-efficient and higher quality services and goods.** In addition to local content requirements for SOEs, Kazakhstan applies local content requirements in procurement of goods and services within the framework of investment contracts in the oil and gas, and mining sectors and under investment agreements in the automotive sector. Such measures infringe national treatment principles for imported goods and/or create import or export restrictions. Kazakhstan has committed to amend its investment laws and regulations to ensure consistency with the WTO Agreement on Trade-Related Investment Measures from the date of its accession to WTO. Inconsistent measures applied under investment contracts concluded prior to January1, 2015 contained in investment contracts will cease to be enforced as of the date of expiration of the initial duration of the contracts or by January 1, 2021, whichever takes place sooner. In addition, WTO-inconsistent measures applied in accordance with industrial assembly agreements will be eliminated by July 1, 2018. With respect to tender for granting subsurface use rights, Kazakhstan also committed to limit the share of Kazakhstan content required for personnel or services to a maximum of 50 percent. These measures will be compounded by the facilitation of entry and temporary stay of intra-corporate executives, managers and specialists.

58. **The DPL series will also support strengthening market based approaches in the existing state programs for industrial development which are at the core of Government's efforts to guide and focus initiatives for economic diversification and increasing the competitiveness of the non-oil private sector**. GOK has chosen to complement its reforms related to enhancing the business environment and strengthening the financial sector with specific initiatives related to industrial policy. Done right, some of these initiatives have the potential to contribute to economic diversification by attracting investment in a number of industries without resulting in market distortions. The objective of the State Program for Industrial and Innovative Development (SPIID) 2015-2019 program is to improve economic diversification

and competitiveness of the economy, building on a multi-faceted approach covering all aspects of the business climate, and focusing on 14 industrial sectors, covering nearly all of Kazakhstan's manufacturing industry. GoK plans to allocate KZT 600 billion from the Republican Budget (approximately $3.2 billion) to achieving the objectives of SPIID 2015-19, with substantial additional funding for specific investments identified in each of the 14 industries. The "territorial clusters" program is one of the tools under the SPIID. As originally designed, the territorial cluster program presents short-comings which follow a supply-driven approach. The program as initially designed would likely have led to capture by large private enterprises, as well as prolonged industries that are not globally competitive, increasing private sector dependence on subsidies, rather than encouraging and guiding Kazakhstan's industry towards more sophisticated business segments with higher added-value potential.

59. **Authorities have committed to changes to the territorial clusters program under SPIID 2015-19 to address identified short-comings and favor market-based approaches and instruments.** Specific changes are needed to ensure that the cluster development program is driven by the competitiveness of economic clusters in domestic and global markets, to ensure open and active participation of the private sector in actions taken under the program, and to ensure the sustainability of the program. The Ministry for Investment and Development, KIDI and the World Bank team understand their roles and responsibilities in facilitating a maximum-possible effectiveness of the cluster program. These changes include:(i) eliminating the requirement for enterprises to form a cluster association in order to qualify for the program; (ii) making the commitment of public financing after preparation of action plans which comprise, as needed to enhance cluster competitiveness, complementary public financing, reforms, and private sector financing and actions; (iii) expanding of the role and capacity of the Kazakhstan Industry Development Institute (KIDI) to lead cluster identification and facilitation; and (iv) increasing the number of "territorial clusters" to at least 6 in order to take advantage of economies of scale and increase learning across clusters. The GoK has committed to implement these changes which would allow initiatives under the program to be better informed by market demand and to adjust to changes in market demand over time, thus helping to increase competitiveness of Kazakhstan's non-oil sector in a more sustainable way. The DPF series will support the implementation of these changes. Measures to increase the capacity for KIDI to play an enhanced role are being implemented through the World Bank-funded Kazakhstan SME Competitiveness Project.

60. **In addition to bringing domestic legislation in line with international commitments, authorities have taken additional measures seeking to attract and retain investments, especially in the non-oil related sectors**. Economic diversification efforts will require attraction and retention of more market- and efficiency-seeking investments in other non-oil sectors, including in logistics and infrastructure. Key areas identified for enhancing the investment regime include: improving coordination amongst different Ministries and agencies involved in FDI attraction; improving implementation of FDI arrangements, with more effective strategy planning, target setting and monitoring processes; strengthening mechanisms to prevent investor-state disputes; and enhancing Public Private Partnerships (PPPs) and the legal and regulatory framework. Measures supported under this DPL series will focus on the latter two.

61. **The GoK is taking steps to enhance the enabling environment to attract private sector investment in infrastructure through PPPs.** The GoK enacted a Concession law in 2006 (a form of PPP), and implemented other enabling legislation. Even with amendments to the Concession law to incorporate broader concepts, such as early termination and international arbitration, there remains substantial legal barriers due to excessive regulation and lack of clarity in implementation arrangements. Consequently, there have been no concessions awarded since the 2006 law. The GoK has committed to reducing the constraints in this area, and is implementing a number of initiatives, partly supported by a World Bank JERP. Specific reforms include the passage of a new law for PPPs to include all forms of private sector participation in building infrastructure and delivering services beyond concessions. However, the reform process needs to go beyond the new PPP Law. An ongoing Bank TA has found that there is a number of

inter-related legislative documents that need to be aligned and consistent to successfully structure a PPP. The DPF series will support appropriate changes in the legal framework applicable for PPPs.

62. **The reduction of administrative barriers and promotion of a business-friendly regulatory environment is also essential for stimulating industrial and innovative development and economic diversification away from natural resources.** Kazakhstan has undertaken a number of legislative initiatives in recent years aimed at reducing regulatory costs, including measures to overhaul its licensing and permit systems, inspection and enforcement practices, and to increase the use of ICT to promote regulatory transparency and transactions. High-level commitments to cut the number of permits by 50 percent and to introduce a new legislative framework for self-regulation underline the commitment to improve regulatory governance. Guided by international best practices, Kazakhstan is moving towards the establishment of procedures for ensuring the quality of new and existing regulation. In 2013, the GoK adopted a "Concept of State Regulation of Business Activities by 2020" in a policy paper which defined general principles for regulation and establishing the basis for a comprehensive approach to regulatory policy.[19] This Concept of State Regulation of Business Activities by 2020 also foresees the implementation of a formal impact assessment when developing new regulations. This operation will support GoK's efforts to implement the 2020 Concept, focusing on the adoption of rules on conducting regulatory impact analysis; the establishment of a technical Regulatory Oversight Unit in charge of day-to-day coordination and oversight regulatory regime; and the adoption of methodology on risk management system for the introduction of new regulations in line ministries.

63. **The GoK has renewed its efforts to try to balance the role of the state in markets and foster a more competitive environment supporting private sector enterprises development.** The economy continues to be dominated by three major holding companies (Samruk Kazyna, Baiterek, and KazAgro) and other associated companies which total over 600 entities, with aggregate assets accounting for about 50 percent of GDP.[20] Authorities are working to streamline the state's footprint in economic activities, and have launched an ambitious privatization program for 2014-2016. In April 2015, authorities also introduced a "yellow page rule" modelled on Singapore's experience, seeking to limit direct state participation in sectors where private operators are present.

64. **While recent legal changes confirm GoK's intention to strengthen the role of competition policy, there is significant room for improvement in the implementation of anti-monopoly policy**. The Yellow Page Rule Law amended the existing applicable regulation contained within the Competition Law (the existing anti-cartel enforcement provisions) and the State Property law, and introduced a positive and innovative competition principle to evaluate and rationalize direct government participation in markets. The Competition Agency is now mandated to assess whether a particular SOE complies with the subsidiarity principle that informs the direct participation of state in the economy, and has adopted a procompetitive analytical framework to identify SOEs not fulfilling a subsidiary role. It is expected to adopt market definition techniques that include relevant markets criteria by mid-September 2015.[21] Nevertheless, Kazakhstan is placed relatively low in terms of its competition policy in Global Competitiveness Report 2014-2015. Kazakhstan ranks 111st out of 144 countries regarding the intensity of local competition and 94th in terms of effectiveness of its anti-monopoly policy. The business community perceives that competition in local markets is weak compared to countries of similar GDP per capita. In

[19] These five principles are: balance of interests of the state, business and consumers; transparency of state authorities' activities; mutual liability and justified sanctions; feasibility and efficiency of regulatory instruments; and comprehensiveness and efficiency of reforms.

[20] According to the an estimate by the Ministry of National Economy

[21] According to this principle, the State has a subsidiary duty to perform only those tasks where private supply is not feasible and leave out those markets where private supply can attend demand.

Kazakhstan, 10 percent of the markets have either monopolistic or duopolistic market structures and only 44 percent of the firms surveyed compete against a large number of firms. However, it should be noted that Kazakhstan has significantly improved its positions on the above ratings in 2015. The 2015 Global Competitiveness Report ranked Kazakhstan 94th on intensity of local competition (moving up by 17 positions) and 68th on the effectiveness of anti-monopoly policy (moving up by 256 positions).[22]

65. **Given current market structures, operationalizing the implementation of pro-competition principles in the participation of the state in the economy is a key task for improving contestability of Kazakhstan markets.** Due to their privileged position, SOEs may require special attention from competition agencies, particularly in markets where the private sector might be better placed to deliver products or services more efficiently. The government of Kazakhstan could guarantee a policy of competitive neutrality to ensure a leveled playing field between the public and the private sector. The broadening of the mandate of the Competition Committee, i.e. the Antimonopoly body, with powers to approve the creation of SOEs strengthens the role of competition as a filter to analyze the public participation in economic activities. However, competition may be substantially restricted not only by the creation of an SOE but also by poorly designed privatization processes. The government authorities recognized the importance of the role of the Antimonopoly body in defining the methodological aspects and effectively analyzing markets where SOEs participate.

66. **The DPL series will support authorities' efforts to improve the competition policy framework and its implementation**. The first operation will focus on strengthening the ability of the antimonopoly body to detect and deter cartels and price fixing agreements by enhancing the effectiveness of some of their current tools: (1) introducing in the law the concept of cartels while prior to the reform the law used a more generic prohibition of anti-competitive agreements; (2) maximizing the current ability of the Anti-monopoly body to deter cartels by streamlining the process to obtain relevant information for cartel cases in line with their harmful effects; and (3) granting leniency applicants a full exemption from all administrative sanctions while at the moment this exemption covered only the so-called "monopoly rent." This first operation will also help define the criteria to assess the subsidiary role of the state in some markets of the economy through the approval of a regulation containing the methodology that will be applied by the Competition Committee for the subsidiarity assessment that will develop and systematize their legal mandate to issue opinions on the creation/maintenance of SOEs. Finally the first operation will support the improvements regarding the economic analysis of markets conducted by the competition agency, including the implementation of relevant markets criteria. Further strengthening of the competition policy framework will be supported under the second operation to increase its transparency and predictability, and increase the effectiveness of competition regulations to focus on most harmful anticompetitive practices and will include measures to eliminate the registry of dominant firms and introduce a mandatory requirement to publish the decisions of the antimonopoly body, among other things.

67. **Beyond the changes to the competition policy regime, SOE related reforms are expected to contribute to streamline state footprint in the economy while improving governance arrangements in SOEs that remain under state ownership.** Samruk-Kazyna (SK), Kazakhstan's largest SOE holding company is going through a significant transformation intended to transition it from an operational holding company to a portfolio investor. As part of this transformation process, SK adopted a new corporate governance code in April 2015. The DPF series supports the implementation of this code, which contains elements of good international practice and OECD guidelines related to the governance of SOEs, and some specific requirements given the local context. Going forward, the DPF would also support legislative amendments that would help develop a coherent policy for state ownership, in particular amendments to the law on State Property. A concept for the changes to this law is being developed, and will focus on streamlining the legal forms of SOEs. While the details of these changes are currently under discussion, the

[22] WB staff calculations using BEEPS data.

plan includes restructuring entities which do not have a corporate legal form to be either privatized, liquidated, or reorganized as a corporate entity as per the "Yellow Pages Rule" legislation.

68. **The following prior actions and indicative triggers are proposed:**

Prior Action 6*: In line with WTO commitments to the norms and rules of the WTO Agreement on Trade Related Investment Measures, the GoK submitted to the Parliament a draft law titled "On Amendments and Additions to Some Legislatives Acts of the Republic of Kazakhstan in Connection with the Accession to the World Trade Organization", as evidenced by the Government Resolution No. 775, dated September 11, 2015, to limit the minimum amount of local content in works and services.*

- ***Prior Action 7****: The Ministry of National Economy introduced mechanisms to assess the impact of regulations governing businesses though its:*

  a) adoption of rules on conducting regulatory impact analysis, as evidenced by the Order of the Minister of National Economy No. 32, dated January 21, 2015; and

  b) establishment of an inter-agency regulatory oversight unit located in the Ministry of National Economy with allocated positions reflecting adequate staffing, as evidence by the Order of the Executive Secretary of the Ministry of National Economy No. 44, dated September 3, 2015.

- ***Prior Action 8****: The GoK strengthened its l competition policy framework, as evidenced by its:*

  a) amendments to the existing anti-cartel enforcement provisions in the Competition Law No. 112-IV of2008 and the Code on Administrative Offenses of 2014, as amended for both by the law No. 312-V, dated May 5, 2015;

  b) adoption of market definition techniques that include relevant markets criteria, as evidenced by the Order of the Minister of National Economy No. 303, dated April 2, 2015.
- ***Prior Action 9:*** *The GoK approved by the Governmental Resolution No. 239, dated April 15, 2015, the "Corporate Governance Code of Samruk-Kazyna", consistent with good international practice.*

- ***Indicative Trigger 7****: The Ministry of Investment and Development introduced changes to the territorial clusters program under SPIID 2015-19, favoring market based approaches and instruments, including by: (a) eliminating the requirement that enterprises form cluster associations to benefit from the program; (b) making commitment of public financing contingent to preparation of cluster competitiveness action plans which may comprise complementary public financing, reforms, and private sector financing and actions; (c) expanding the Kazakhstan Industry Development Institute's role and capacity to lead cluster identification and facilitation; and (d) increasing the number of pilot "territorial clusters" for greater learning.*

- ***Indicative Trigger 8****: The GoK enacted and implemented proposed amendments to laws and decrees to create a more conducive environment for PPPs.*

- ***Indicative Trigger 9:*** *The GoK improved the efficiency and transparency of the regulatory framework for businesses by enacting a law titled "On introducing amendments and additions to some Legislative Acts on the Issues of Reducing Permit Documents and Simplifying Permit Procedures."*

- ***Indicative Trigger 10****: The Competition Committee submitted to the Parliament proposed amendments to the competition policy legal framework in order to increase its transparency and predictability, and reduce the burden of competition regulations. Specific measures include:(a)* *elimination of the state registry of dominant firms or monopolies; (b) establishing objective merger notification thresholds and developing and adopting a specific analytical framework for merger control policy; (c) introduction of mandatory requirement to publish the decisions of the Conciliation Committee, including, in addition to basic information, the motivation and analytical background underpinning the decision; and (d) introduction of methodology to identify barriers to competition at subnational level, including in markets related to natural monopoly dominated by an SOE.*

69. **Expected Results**: In combination, the expected results of these measures are to improve the competitiveness of the non-oil economy and support the private sector's ability to grow and create jobs. These measures would help the economy strengthen incentives to invest in Kazakhstan. They would enhance the predictability, transparency and quality of business regulation and help the government move towards more market-based approaches of facilitating increased competitiveness. Three indicators representing some of the expected results from these measures are: (i) the number of cluster development action plans prepared, which are expected to increases from zero in 2015 to 2 in Dec 2017; (ii) Kazakhstan's rating on the newly developed World Bank Citizen Engagement in Rulemaking indicator, which is expected to increase from 3.0 in 2015 to 3.5 in 2017 (on a scale 0-6); and (iii) the number of recommendations of the Competition Committee implemented by the Government to guarantee that SOEs participate in a market under the subsidiarity (non-competiveness) principle; the implementation of these recommendations is expected to increase from 0 in 2014 to 4 in 2017.

Analytical Underpinnings

70. **The policy actions in this DPF series are underpinned by analytical and advisory work.** This includes an extensive engagement with the authorities under the programmatic JERP. Details are presented below:

Table 7. DPF Policy Actions and Analytical Underpinnings

Prior Action	Analytical Underpinnings
PA1: Fiscal Consolidation	• Beyond Oil: Kazakhstan's path to greater prosperity through diversification, World Bank, CEM, 2013 • Kazakhstan's Oil Rules: Policy Options in a Downturn, World Bank, 2013
PA2: Revenue Mobilization	• Tax Strategy Paper (June 2008, WB report No. 36494-KZ) • Reforming the Tax System for Micro, Small and Medium Businesses (June 2010, report prepared under JERP) • Improving Real Property Taxation System • Taxing Road Transportation; • An Inquiry into Vat Refunds and Fraud and a Reverse Charge on Imported Capital Goods • World Bank Kazakhstan Customs Development Project (2007-2015). • Tax Administration Reform Project
PA 3: Exchange Rate Flexibility	• Epstein, Natan, Monetary Policy in Hybrid Regimes, IMF Working Paper WP/14/108 • National Bank of Kazakhstan, "Monetary Policy of the Republic of Kazakhstan to 2020" April 2015
PA4: Corporate Insolvency	• Joint World Bank-IMF Financial Sector Assessment Program (FSAP) in 2011-2012, and Report on Observance of Standards and Codes (ROSC) for Insolvency, 2012, and 2015 World Bank-GoK JERP technical assistance to Ministry of Finance for developing further the insolvency framework.

Prior Action	Analytical Underpinnings
PA5: NBK Prudential Norms	• Joint World Bank-IMF Financial Sector Assessment Program (FSAP) in 2011-2012, and 2015 World Bank-NBRK JERP technical assistance related to improving banking supervision and stress testing.
PA6: WTO related elimination of local content	• "Kazakhstan: Taking Advantage of Trade Openness for Development", Second Report under the Studies on International/Regional Trade Integration, Jul 2012;
PA7: Regulatory Governance	• World Bank Report: Towards a better performing RIA System in the Kazakh Government: Issues for consideration (2015).
PA8: Competition Policy	• Report on the Kazakhstan Competition Policy Framework, World Bank, 2014
PA9: Samruk Kazyna Corporate Governance Code	• Republic of Kazakhstan, Towards a Framework for Managing Risks Associated with Public Debt, including the Debt of State-Owned Enterprises. (GOK, World Bank, and OECD, June 2012)

C. LINK TO CPF AND OTHER BANK OPERATIONS

71. **The proposed DPF series is fully aligned with the FY2012-2017 Country Partnership Strategy (CPS).** CPS, approved in March 2012, focuses on government priorities of improving competiveness and fostering job creation; strengthening governance and public services; and ensuring development is environmentally sustainable. To this end, CPS's main instrument to support the government's program will be knowledge activities through programmatic knowledge products and capacity building products complemented by selective investment projects in strategic high-impact areas. CPS includes the possibility of deploying development policy lending to counter external shocks to the Kazakhstani economy, as was done in 2009. The two pillars of the proposed programmatic operation are aligned with the objectives of securing macro-economic stability and sustainability and promoting competitiveness in the economy. Several Bank analytical and capacity building products as well as operations are supporting the implementation of the identified reform agenda, including analytical products on investment policy and the business environment, macro-fiscal sustainability and the oil fund fiscal rule, and the financial sector.

72. **The design of the proposed programmatic operation benefits from the lessons learnt from the 2010 DPF.** A key lesson learned from the 2010 DPF was that a stand-alone budget support operation limits the ability of the Bank to support a sustained program of reforms. While the 2010 DPF relied on solid analytical work, in retrospect, in the absence of a second DPF operation, the engagement that characterized the Bank-government relationship at the height of the crisis was not sustained. This DPF supports a set of two programmatic operations, to ensure that a number of key reforms on macro management and competitiveness are appropriately implemented and followed through. Intensive consultation with the Government is ensuring that client priorities are fully taken into account and ownership of the reform program is high. Reforms included in the DPF are very much homegrown and are all derived from the reform agenda announced by the Government.

D. CONSULTATIONS, COLLABORATION WITH OTHER DEVELOPMENT PARTNERS

73. **The DPF program supports the ongoing reform agenda of the government, which is driven by the development vision laid out in Kazakhstan 2050 and its related implementation programs.** The development strategy and its related reform programs were developed in consultation with the private sector and civil society at the regional and city levels, and with the regional authorities. For example, the GoK increased its consultation efforts with the private sector and regional representative as the WTO accession

negotiations and the negotiations to join the Eurasia Economic Union picked up pace. The private sector was represented by the Chamber of Commerce and was very vocal and participatory in these discussions. Also, the authorities conducted road show presentations during the negotiations of the agreements to increase knowledge and understanding, answer questions and get feedback. Finally, a number of technical and policy conferences, training and workshops were held with the help of bilateral and multi-lateral partners to educate the national audience about the WTO rules, potential gains and losses of becoming a member of the WTO, trade policy, trade facilitation, and non-tariff measures. Brochures were also printed for the same purpose. Generally, President Nazarbayev and the GoK representatives regularly inform and update the populations about economic developments, intended reforms or programs and results – both expected and achieved. For example, major changes in macro-fiscal and budgetary policies are announced by the President, with the Minister of National Economy and Minister of Finance providing further information and details. The government also has a regular dialogue with the Chamber of Commerce and foreign direct investors to hear their perspectives on current economic developments and their impact on the private sector activities and proposals for reform.

74. **On legislative measures, draft laws are developed by individual ministries (and – as the case may be - the NBK) in close consultation with relevant stakeholders and circulated to ministries for comments.** The draft laws are then adopted by the GoK and sent to the Parliament by the Prime Minister's office. The website of the Parliament provides a list of the draft laws submitted for its consideration, the total number of laws under consideration, approved and signed by the president within during a parliamentary session (http://www.parlam.kz/en/legislative).

75. **The World Bank continues to collaborate closely with the IMF and ADB on the proposed programmatic operation.** The IMF performs annual Article IV economic surveillance and analysis. Also, in Spring 2015 it started a broad-scope and active technical assistance program with the NBK on transition to inflation targeting. The World Bank team has discussed the macro-economic framework and the content of the pillar one with the IMF country team at length. It has also kept in regular contact with the ADB, which had received a similar request for budget support from the Government. The ADB loan approved a $ 1 billion for Kazakhstan in August 2015.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. POVERTY AND SOCIAL IMPACT ANALYSIS

76. **The operation is expected to have positive poverty and social impacts in the medium term despite potential adverse impacts in the short term.** The DPF supports policies intended to strengthen macroeconomic sustainability and increase the competitiveness of the non-oil economy, which has been a source of rapid job creation (paragraph 3). While the adjustment to a new environment of lower oil prices entails some social and economic stress in the short term, for example due to higher consumer goods prices as a result of exchange rate depreciation, and lower government spending as a result of fiscal consolidation, GoK and the DPF series support protection of social expenditures and enhancement of social protection instruments. On August 29, 2015, GoK adopted a new *Forecast of Socio-economic Development of the Republic of Kazakhstan for the Years 2016-2020*, in which it listed fulfillment of its social engagements as a first priority, including a 25 percent increase in benefits to elderly, students and the vulnerable population to compensate for the recent exchange rate adjustment and, from January 1, 2016 a 27 percent salary increase for education and health care workers. Furthermore, a number of structural reforms supported by the DPF series should, in the medium term, support higher growth and job creation. The positive impact of the DPF series is expected to come from supporting a gradual adjustment based on policies that strengthen the competitiveness of the non-oil economy.

77. **Some policies supported under Pillar 1 could be welfare enhancing as they will support consumption at a time of low growth and economic hardship.** Poverty analysis indicates that growth rather than distributional changes has been the driving force behind the remarkable poverty reduction in recent years and that social safety nets have not been particularly strong. Hence measures included in the DPF series, such as those related to revenue mobilization and the roll out of a new social assistance program (which is a trigger for the second operation), will positively impact the vulnerable. While measures to increase revenue mobilization would strengthen Government's ability to finance social expenditures (including unemployment claims), a lowering of the threshold for firms that are required to collect VAT will increase the cost for compliance for small businesses. This cost may be mitigated somewhat by measures to facilitate tax payments (for example, the use of card terminals), which are also supported by the DPF. The impact of the VAT related action on small firms will be monitored in the context of ongoing TA on tax administration. Given the openness of the Kazakhstani economy and its reliance on imports that constitute a quarter of GDP, the floating of the tenge and the resultant depreciation could have a negative impact in terms of higher prices. However, given that prices of food and other essential goods are controlled (and food comprises almost half the consumption basket of the bottom 40), administered prices would mitigate some of this impact. In the medium term, measures related to inflation targeting would help control inflation which would also help support price stability.

78. **Policies supported under Pillar 2 should have an overall positive social impact as they should help increase access to credit, enhance the business environment and support job creation.** Prior actions related to corporate and personal insolvency as well as measures to strengthen financial stability will support the provision of credit to firms and household. The measure to enhance the investment climate, namely the elimination of local content rule, will help boost firms' competitiveness through improved access to more cost-efficient and higher quality inputs. The elimination of the local content rule will be phased out gradually, to enable firms to adjust. The measures on competition policy framework are also expected to have positive effect, in particular the measures seeking to strengthen the ability to detect and prosecute cartels and price fixing arrangements which could lead to significant savings for business and consumers. Improving the government's cluster development program by implementing more market-based approaches will help to generate more sustainable growth throughout regions of the country, including (but not limited to) more under-developed regions. Finally, improved SOE governance coupled with fiscal consolidation could lead to lower employment in the public sector; initiatives to increase private sector job creation could help mitigate this impact.

79. **It is expected that the focus on job creation will positively impact women in Kazakhstan.** Women constitute a large share of the workforce in Kazakhstan, though their labor participation rates and tertiary education rates at 85 percent and 55 percent respectively in 2013, are somewhat lower than those of men.[23] Moreover female employment shares have declined drastically in the lowest quintile of the population, from 41 percent in 2008 to 28 percent in 2013. Women tend to be engaged in informal economy or be self-employed; their participation in formal economy is less than that of men.[24] Female entrepreneurs are significantly underrepresented in managerial and government position. Poverty rates are comparable between men and women. Among specific prior actions, the prior action related to maintaining social spending should positively impact female headed households as poverty analysis reveals that women's pensions have a positive impact on poverty reduction, and that a large share of women retired from the labor force between 2012-13 before the enactment of a higher retirement age law in 2014 that would have

[23] Labor force participation rate is for the 35-44 cohort and female tertiary education rate is for the 26-30 cohort. Source: World Bank, Kazakhstan, Economic Mobility and the Middle Class, June 2015 (draft)

[24] ADB, 2013. Kazakhstan: Country Gender Assessment.

progressively increased the retirement age for women from 58 to 63 years of age. The team will monitor available sources of data to ensure that project impacts do not reinforce gender inequalities.

80. **Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank's non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit www.worldbank.org/grs. For information on how to submit complaints to the World Bank's Inspection Panel, please visit www.inspectionpanel.org.

B. ENVIRONMENTAL IMPACTS

81. **The measures supported by the DPF are expected to have mostly positive effects on the environment, natural resources and forestry**. As indicated in the World Bank Toolkit "Assessing the environmental, forest and other natural resource aspects of development policy lending" (2008), strengthening fiscal and macroeconomic sustainability would have beneficial effects through promoting and better collection of taxes, including environmental taxes as well as through more efficient use of the existing funds. At the same time, enhancing the competitiveness of the non-oil economy would contribute to further improving assessment of environmental impacts and the decision-making on financial allocations, in particular of the state-owned enterprise group KazAgro. The environmental impact of the prior action related to Samruk Kazyna's (SK) adoption of a Corporate Governance Code is likely to be also positive. SK is a Sovereign Wealth Fund, and to the extent that the adoption of a corporate governance code implies greater efficiency and transparency in operating this Fund, it might also include greater transparency on the assessment and management of the environmental impacts of what it invests in. This would also include the identification of any potential climate risks associated with these investments.

C. FIDUCIARY, DISBURSEMENT AND AUDITING ASPECTS

82. **Overall, Kazakhstan's fiduciary and Public Finance Management framework is adequate for development policy lending.** The administration and accounting of the loan will be the responsibility of the Ministry of Finance. The Government will maintain accounts and records, or ensure that such items are maintained, showing that loan disbursements were made in accordance with the provisions of the Loan Agreement. Such accounts and records will be maintained in a form acceptable to the IBRD. The proceeds of the loan deposited at the foreign currency account with NBK that forms a part of the country's official foreign exchange reserves. The Ministry of Finance will be responsible for the loan administration and for preparing the withdrawal application, and maintaining the withdrawal application as required. The Ministry of Finance, with the assistance of NBK, will maintain records of all transactions under the loan in accordance with sound accounting practices. No additional fiduciary arrangements will be required, including an audit of the account, but will require the Government to provide confirmation to the Bank in the form of an official letter from the Ministry of Finance on the amounts deposited into the foreign currency account within 30 days of receiving the funds.

83. **Foreign Exchange Management.** The joint Bank-IMF Financial System Stability Assessment (FSSA), conducted in May 2014 found that the safeguards and controls in the National Bank of Kazakhstan for foreign exchange management were adequate.

D. MONITORING, EVALUATION AND ACCOUNTABILITY

84. **Loan Administration.** The Bank would disburse the loan proceeds denominated in US dollars into an account in the NBK, which in turn would immediately credit the disbursed amount t the account of the Ministry of Finance. Within thirty days of this funds transfer, the Ministry of Finance will provide the Bank with a written confirmation.

85. **Monitoring and Evaluation.** The Ministry of National Economy has responsibility for the coordination, monitoring, and ensuring completion of the prior actions under the DPF. In addition, the Ministry of Finance has set up an inter-governmental working group –including the NBK-- that is actively coordinating the program of reforms to be supported by the DPF. The NBK is responsible for actions regarding monetary policy. The Bank has an extensive program in a number of the reform areas, and monitoring of results of the DPF actions will be continued through ongoing Bank engagement.

86. **Overall Conclusion.** The public financial management systems and proposed risk mitigation arrangements, together with the Borrower's commitment to reform, are adequate to support this operation.

VI. SUMMARY OF RISKS AND MITIGATION

87. **The overall risk rating of this operation is moderate and reflects macroeconomic and capacity and implementation risks in determining the success of this programmatic operation.** These risks are elaborated below.

- **The macroeconomic risk is rated as substantial**. Kazakhstan is experiencing a difficult adjustment to the large oil shock, the slowdown of Chinese economy, the recession in Russia, and global volatility, but the authorities are pro-active in addressing the situation. As described in this document, the authorities are taking measures to adjust the economy to a lower income level through fiscal consolidation and exchange rate flexibility. In the short run, this adjustment is expected to affect aggregate demand through two channels. Fiscal consolidation may lead to lower investments and the tenge depreciation in the wake of the free float of the currency is expected to affect private demand through higher inflation and wealth effect. Also, there is a likelihood that the recent tenge depreciation may result in asset deterioration of some banks with significant FX exposures to unhedged borrowers, although on the whole, FX lending has declined to 23 percent of total bank lending, and only 3.7 percent of bank lending is FX loans to individuals. Moreover, risks are more bank-specific, reducing the likelihood of a systemic crisis. The authorities have taken measures to mitigate the effects of the adjustment through higher wages for health and education workers, higher social benefits for the vulnerable groups and control of prices on 33 basic food products. Stronger prudential regulation and tougher asset valuation and risk weighting is expected to mitigate the systemic impacts of some banks' asset deterioration. Nonetheless, the economic outlook for Kazakhstan is subject to downside risks**.** Risks to the short-term outlook may emerge from a greater slowdown in China. Kazakhstan's economy will also be affected further by a more severe economic contraction in Russia that affects metal production and metal processing industries in Kazakhstan, and worsened investor sentiment and greater risk-aversion, if the Russia-Ukraine crisis and the Western sanctions against Russia get prolonged. Slower than expected recovery in the EU, Kazakhstan's main market, is an additional risk, as is the prospects of a U.S. Fed interest rate hike, which could lead to capital outflow from emerging economies – including Kazakhstan – and make attracting FDI and borrowing abroad more expensive. Moreover, if the global oil glut continues, oil prices may remain at their current low for several years and may further undermine Kazakhstani consumer and business sentiments and lead to lower GDP growth outcomes. To mitigate this risk, the Bank is working closely with the authorities and the IMF to monitor the economy and provide support as needed on economic management.

- **The institutional capacity of implementation and sustainability risk is substantial.** While recent progress has been made, the quality of institutions is varied, affecting the capacity to implement complex reforms. Implementation of this DPF series spans several ministries and capacity is limited in some of them. As the DPF series is ambitious, particularly related to fiscal management and private sector development reforms, there is a danger that delays would occur in reform implementation. A mitigating factor is that global volatilities, regional instability and geo-political developments related to Ukraine and Russia have weakened macroeconomic situation, which has increased Government's resolve to address the structural bottlenecks to accelerated development. While not all the identified risks can be mitigated, technical assistance and capacity building provided by the World Bank through the Joint Economic Research Program as well as projects - such as technical assistance project in the justice sector - the can help mitigate some of this risk by helping strengthen capacity in a number of implementation units.

Table 8. Systematic Operations Risk Rating (SORT)

Category	Risk	Rating (High, Substantial, Moderate, Low)
1	Political and governance risk	Moderate
2	Macroeconomic	Substantial
3	Sector strategies and policies	Moderate
4	Technical design of project or program	Moderate
5	Institutional capacity for implementation and sustainability	Substantial
6	Fiduciary	Low
7	Environment and social	Low
8	Stakeholders	Moderate
9	Others: Geopolitical risks	Moderate
	Overall	Moderate

Source: World Bank staff.

ANNEX 1: POLICY AND RESULTS MATRIX

DPF 1 Prior Actions – *by October 2015*	DPF 2 Triggers – *by July 2016*	Result Indicators – ***Baseline: 2014, Target: end-2017***
Pillar 1: Strengthen sustainability of the macroeconomic framework while protecting the vulnerable		
1. The GoK has made the following fiscal adjustments: (a) revised the 2015 Republican Budget expenditures and gross lending downwards by almost 8 percent from 7,855.1 to 7,244.5 billion tenge, to avoid an excessive widening of the non-oil deficit; (b) amended its Guidelines for the Preparation of the Medium-Term Macroeconomic and Fiscal Framework, so that the definition of the non-oil deficit more accurately measures the fiscal stance by: (a) comprehensively covering the consolidated budget (comprising the Republican Budget, regional budgets, and the NFRK); and (b) properly including customs duty on oil exports as an oil revenue item.	1. (a) The 2015 non-oil deficit (GFS classification) is no larger than 12 percent of GDP in 2015. (b) The GoK approves (i) a revised Medium-Term Macroeconomic and Fiscal Framework that envisages the reduction of the non-oil deficit of the consolidated budget (GFS classification) to be no larger than 10 percent of GDP in 2016 and 9 percent in 2017, based on expenditure reduction as a share of GDP and non-oil non-mineral revenue increases; and (ii) an updated New Budget Policy Concept that prescribes a medium-term reduction of the non-oil deficit.	Lowered non-oil deficit (GFS classification) as a share of GDP (%) Baseline (2014): 10.5 Target (2017): no larger than 9

DPF 1 Prior Actions – ***by October 2015***	DPF 2 Triggers – ***by July 2016***	Result Indicators – ***Baseline: 2014, Target: end-2017***
2. The GoK submitted to the Parliament for approval draft legislation aiming to increase non-oil revenues by reducing the VAT registration threshold for VAT payers from an annual turnover of approximately 30,000 Monthly Calculation Index (MCI) equivalent to 3,234 MCI equivalent.	2. To further strengthen non-oil revenues, the GOK (a) adopted polices to increase non-oil non-mineral revenues; and (b) enhanced tax administration by introducing an appropriate framework for the provision of an Automatic Exchange of Information on tax matters with other countries (in line with the Global Forum standards).	Increased non-oil non-mineral revenues of the state budget Baseline (2014): 4,649.4 billion tenge Target (2017): an increase of 24 percent from the base indicator.
	3. The Ministry of Health and Social Development submitted legislation to the Parliament to roll out the Orleou conditional cash transfer system nationwide.	Increased the share of persons covered by the active forms of the employment support to eligible employable recipients of targeted social support. Baseline (2015): 34 percent Target (2017): more than 50 percent (gender disaggregated)
3. The NBK undertook the following actions in accordance with the Monetary Policy of the Republic of Kazakhstan to 2020: (a) adopted a free-floating exchange rate regime; (b) adopted a new policy interest rate in the process of transitioning to inflation targeting; and,	4. The NBK launched new tools of monetary policy in accordance with the Monetary Policy of the Republic of Kazakhstan to 2020 by: (a) establishing the technical infrastructure for implementing interest rate targeting (finalize software development for the auctions of direct repurchase agreements and foreign exchange swap on the basis of an independent platform	Lowering the volatility of the money market rates (methodology to be developed). Baseline (2014): 100 Target (2017): 10 percent reduction

<table>
<tr><th>DPF 1 Prior Actions –
by October 2015</th><th>DPF 2 Triggers –
by July 2016</th><th>Result Indicators –
Baseline: 2014, Target: end-2017</th></tr>
<tr><td>(c) submitted to the Parliament for approval a draft law, which regulates the adoption of the rules of conducting open market operations for effective monetary policy management.</td><td>and the software with commercial banks; functional liquidity forecasting models) ;
(b) implementing the communication strategy related to the policy to move to inflation targeting;
(c) drafting the law "On the National Bank of Kazakhstan" with respect to creation of the necessary institutional structure to conduct inflation targeting policy (including Monetary Policy Committee (MPC) and Money Markets Committee (MMC).</td><td></td></tr>
<tr><td colspan="3">**Pillar 2: Enhancing the competitiveness of the non-oil economy**</td></tr>
<tr><td>4. The GoK enacted legislation to establish the legal framework for corporate insolvency that will:
(i) establish a strong corporate insolvency legal framework; and,
(ii) enable the implementation of the corporate insolvency framework, which will: (a) provides for reimbursement of taxes owed by the insolvent corporations and costs of bankruptcy administration; (b) establish the rights of bankruptcy administrators in the context of cameral control activities in rehabilitation and bankruptcy; (c) establish the basis for a bankruptcy administrator's accountability for</td><td>5. Develop a Concept Law on Personal Insolvency.</td><td>Number of corporate rehabilitation cases initiated in calendar year, and the percentage of total annual corporate bankruptcies, which they represent, as measured by the Ministry of Finance of Republic of Kazakhstan.
Baseline (2010): 43 cases, representing 2 percent of corporate bankruptcies.</td></tr>
</table>

DPF 1 Prior Actions – ***by October 2015***	DPF 2 Triggers – ***by July 2016***	Result Indicators – ***Baseline: 2014, Target: end-2017***
violations and sanctions; (d) establish minimum payouts to a bankruptcy administrator; (e) set up the registration of bankruptcy administrators; and (f) establish the rights and procedures for carrying out electronic auction of seized assets.		Target (2017): at least 200 cases, representing at least 10 percent of corporate bankruptcies.
5. The NBK has issued revised prudential norms and accounting requirements that improve the risk management of banks by: (a) amendment to the NBK Board Regulation No. 358 to revise risk weights toward alignment with Basel III, increase authorized capital of banks, and require banks to form conservation capital buffers; and, (b) issuing the NBK Board Regulation No. 256 to require banks to align with IFRS 13 for market-based, fair-value disclosure, and to call for more consistent, frequent, and electronically documented valuations of collateral.	6. The NBK undertook further actions to improve quality and completeness of prudential reporting and capturing the level of risk by: (a) implementing regulations that require financial institutions to conduct financial reporting on a consolidated basis in line with IFRS; and, (b) enacting further revisions to NBK prudential norms that requires introduction of supervisory capital buffers by banks to ensure adequate capital to cover market and other risks.	Weighted average Tier-1 to risk-weighted assets of the banking system, as measured by National Bank of the Republic of Kazakhstan (K1-2 ratio). Baseline (end-2014): 13.2 percent. Target (end-2016): 15 percent.
6. In line with WTO commitments, the GoK submitted to the Parliament amendments to national legislations to limit the minimum amount of local content in works and services.	7. Territorial clusters program SPIID 2015-19, adapted by: (a) eliminating the requirement that enterprises form cluster associations to benefit from the program; (b) making commitment of public financing contingent to preparation of cluster	Number of Cluster Development Actions Plans conducted. Baseline (2014): None. Target (2017): 2

DPF 1 Prior Actions – ***by October 2015***	DPF 2 Triggers – ***by July 2016***	Result Indicators – ***Baseline: 2014, Target: end-2017***
	competitiveness action plans which may comprise complementary public financing, reforms, and private sector financing and actions; expanding the Kazakhstan Industry Development Institute's role and capacity to lead cluster identification and facilitation; and, (c) increasing the number of pilot "territorial clusters" for greater learning.	
	8. The GoK enacted and started implementing proposed amendments to laws and decrees to create a more conducive environment for PPPs.	
7. The Ministry of National Economy introduced mechanisms of regulatory impact assessment through: (a) adoption of rules on conducting regulatory impact analysis; and, (b) establishment of a regulatory oversight unit located in the Ministry of National Economy with allocated positions reflecting adequate staffing.	9. The GoK submitted to the Parliament a draft law titled "On Introducing Amendments and Additions to Some Legislative Acts on the Issues of Reducing Permit Documents and Simplifying Permit Procedures" to reduce barriers for business.	Improved performance on the Citizen Engagement in Rulemaking indicators (on a scale from 0-6). Baseline (2015): 3.0. Target (2017): 3.5.

DPF 1 Prior Actions – ***by October 2015***	DPF 2 Triggers – ***by July 2016***	Result Indicators – ***Baseline: 2014, Target: end-2017***
8. The GoK strengthened its competition policy framework by: (a) amendments to the existing anti-cartel enforcement provisions in the Competition Law and the Code on Administrative Offenses; (b) adoption of market definition techniques that include relevant market criteria.	10. The Competition Committee submitted to the Parliament proposed amendments to the competition policy legal framework in order to increase its transparency and predictability, and reduce the burden of competition regulations. Specific measures include: (a) elimination of the state registry of dominant firms or monopolies. (b) establishing objective merger notification thresholds and developing and adopting a specific analytical framework for merger control policy. (c) introduction of mandatory requirement to publish the decisions of the Conciliation Commission, including, in addition to basic information, the motivation and analytical background underpinning the decision. (d) introduction of methodology to identify barriers to competition at subnational level, including in markets related to natural monopoly dominated by an SOE.	Number of recommendations of the Competition Commission implemented by the Government following the subsidiarity methodology to guarantee that SOEs limit their role to the provision of goods and services that could not otherwise be provided by the private sector increases from 0 in 2014 to 4 in 2017. Baseline (2015): 0. Target (2017): 4
9. The GoK approved the “Corporate Governance Code of Samruk-Kazyna”, consistent with good international practice.		

ANNEX 2: LETTER OF DEVELOPMENT POLICY

ҚАЗАҚСТАН РЕСПУБЛИКАСЫ
ҰЛТТЫҚ ЭКОНОМИКА
МИНИСТРЛІГІ

MINISTRY
OF NATIONAL ECONOMY OF THE
REPUBLIC OF KAZAKHSTAN

010000, Астана қаласы, Есіл ауданы,
Орынбор көшесі, № 8 үй, тел.: 8 (7172) 74-38-01,
факс: 8 (7172) 74-38-24, e-mail: info@economy.gov.kz

8, Orynbor street, area "Esil", Astana, 010000
tel.: 8 (7172) 74-38-01, fax: 8 (7172) 74-38-24,
e-mail: info@economy.gov.kz

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Mr. Jim Yong Kim
President of the World Bank

Dear Mr. Kim!

Please allow us to express our appreciation for the close cooperation that we have received from the World Bank in recent years for achieving our development goals. Today we are seeking the support of the World Bank Group as Kazakhstan works to adjust its economy to a new economic reality of lower oil prices.

Economic context: changes in external factors

After 2013, two external factors significantly increased the pressure on our economy and affected our long-term development prospects. The first factor was the sharp decline in oil prices, which have fallen by more than 50.0% of the end of the period 2013 to 2015. The second factor was the impact of the economic downturn in the Russian Federation and the slower GDP growth rate in China. Kazakhstan's economy is largely dependent on the oil and gas sector, which accounts for around 20 percent of GDP, 76 percent of exports and 50 percent of fiscal revenues. These two factors have triggered a slowdown in economic growth in 2015 and lowered prospects for the medium term. The two factors are a timely reminder that we need to accelerate our preparation for a time of lower oil abundance, and to manage the transition aptly.

A critical aspect of managing the transition is enabling the macroeconomic adjustment to occur while continuing to put together the building blocks for a more diversified economy through the adoption of market reforms. We believe that the macroeconomic adjustment and the structural reforms are necessary, and will make our economy more competitive.

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Managing the transition – macroeconomic adjustment with prioritized public spending

Our top priority in managing the transition is to enable external and internal adjustment. We need to restore the balance of the external account and the fiscal account. In doing so, we expect to shift to a more favorable external terms of trade vis a vis our trading partners, and shift the domestic terms of trade more in favor of non-oil tradable goods and services, and less towards non-tradables which have burgeoned during the period of oil abundance.

We have a two pronged approach to macroeconomic adjustment. The first prong is fiscal adjustment. With the benefit of high oil prices since 2010, our government has had the space to expand its economic activities, by extensively supporting the state enterprises in selected sectors of the economy and lessening the tax burden on the private sector. We recognize that the extensive state reach affects the competiveness of the non-oil economy. We are initiating a fiscal adjustment that aims to reduce the non-oil deficit of the consolidated budget from an expected 9.7 percent of GDP in 2015 to 7.8 percent of GDP in 2017 by our current classification, or from an expected 11.9 percent of GDP to 6.8 percent of GDP by the IMF GFS classification which includes off budget oil fund investments as capital expenditures and net lending. We will achieve this deficit reduction by limiting reducing expenditures of the Republican budget, raising non-oil non-mineral revenues, and limiting additional use from the oil fund, including off-budget direct lending.

In the next two years, our most significant means of fiscal adjustment will be expenditure prioritization and efficiency, which will lead to a contraction in public spending relative to GDP. In 2014-15 we were able to group our top economic and social priorities into two counter cyclical programs to implement projects endorsed by the President –the 1 trillion tenge package and Nurly Zhol. We are maintaining these priorities in our expenditure reduction exercise for 2015-16.

At the same time, over 2015-16, and part of the fiscal adjustment we are protecting the vulnerable and adjusting civil service salaries while revisiting the investment budget. We have provided some increases in pensions for 2016 (2 percentage point increase to the planned 7 percent annual increase for 2016, with room for additional increases if we assess economic conditions dictate it), and budgeted a delayed increase in the salaries of education and health sector workers and civil servants of up to 30 percent. We are reviewing our investment budget, cutting the overall envelop postponing non-priority investments and working to improve its efficiency.

Clearly however, a significant reduction in the non-oil deficit will require an increase in non-oil non-mineral revenues. This increase will form an integral part of our fiscal adjustment. For 2016 and 2017, we are looking at administrative measures to raise revenues by broadening the tax base though bringing in informal activities. This is being accomplished by various actions including lowering the VAT registration threshold, incentivizing the use of bank cards in place of cash, pilot introduction of universal filing in 2018 with full rollout in 2020, further improvements in VAT administration and reduction of VAT benefits, revision of special tax regimes for SMEs and agricultural producers, transition to contemporary retail formats in 2017 (from flee markets to department stores), simplification of legalization procedures, possible transition from VAT to Sales Tax. In addition, we are considering to increase the Personal Income Tax rates. However, beyond these actions which will materialize starting in the 2016 budget, we are identifying other measures that will lead to a sustainable increase in non-oil non-mineral revenues and a more balanced approach to reducing the non-oil deficit that relies on expenditure cuts and on revenue increases. Our goal is to increase non-oil non mineral revenues by 24 percent in 2017, compared to 2014. We will consider additional measures to increase non-oil non-mineral revenue to the government budget.

The second prong of our strategy to manage the transition is to facilitate the adjustment to a flexible exchange rate. We want to ensure that our economy (and our terms of trade) adjusts to lower oil prices in the most efficient way possible. We therefore believe that floating of the exchange rate is critical to enabling this adjustment to happen soonest and most efficiently (the alternative being a reduction in domestic prices and wages –internal devaluation– which was not desirable). To this end, on August 20, the National Bank of Kazakhstan floated the tenge. Its value depreciated from 189 KZT/USD to about 270 KZT/USD by end September. Of course, we do need to accelerate our capability for inflation targeting, which is discussed in the next section. We also need to maintain fiscal discipline.

Our two pronged strategy involves significant downside implementation risks on the growth of the economy. Nevertheless, we have opted for this strategy because we believe that this crisis is an opportunity to act fast to put the economy on a more sustainable growth path in the medium to long term. We also believe that a quick adjustment is more efficient than a protracted one especially as we are able to maintain a social support infrastructure. We also want to limit recourse to the oil fund. However, we are continuously monitoring the evolving global and domestic economic developments and are ready to adjust our approach should downside implementation risks materialize, or should the price of oil drop further. In this light, the premise of a fiscal adjustment and preservation of NFRK assets may be reviewed.

Preparing for a period of low oil prices

Foundations for a sustainable macroeconomic policy and for protecting the vulnerable

One of the foundations of a more competitive non-oil economy is the reduction of the consolidated central government non-oil deficit. We expect this deficit, as measured by the IMF Government Financial Statistics methodology to be lowered to the range of 3-5 of GDP (as measures by IMF GFS classification) percent of GDP by 2020, well within the sustainable range. In the absence of such discipline, a high non-oil deficit would contribute to real appreciation pressures, and lead to an overvalued currency which will undermine our productivity growth. The dividend of floating the nominal exchange rate will be lost.

We will also need to increase the transparency of our budget and strengthen our budgetary institutions to attain international budgetary accounting standards according – the International Monetary Fund's Government Financial Statistics. To this end, we have already included a consolidated view of the central government spending in the Medium Term Budget Framework which presents the Government's medium term economic policies to Parliament, and have widened the definition of the non-oil deficit, for the purpose of more transparent accounting, by the excluding customs duties of oil exports (which came to 2% of GDP in 2014) from non-oil revenues. Our next critical step is to include the direct investments into state owned-enterprises (SOEs) as net lending in the consolidated budget accounts in order to be fully compliant with the International Monetary Fund's Government Financial Statistics methodology of 2001.

We also need to strengthen our monetary policy institutions. In 2015 the NBK's monetary policy will lay the groundwork for the transition to inflation targeting in the medium term under a floating exchange rate. We expect that inflation targeting will increase the real incomes of tenge denominated savings and lower inflation expectations. Improvements in monetary policy management also include the introduction of a new base policy interest rate, the establishment of the Committee on Monetary Policy, and a new communication strategy. Yet we know that adopting inflation targeting in an economy that is highly dollarized is difficult and is fraught with technical challenges. We expect that the rate of dollarization will drop as maintain a predictable and credible floating of the tenge, and we move to formalize our economy.

Adjustment of the economy to a new reality of lower oil prices will result in social costs, some of which will need to be borne by the state, though in the era of budget cuts, the state will need to be much more efficient with its public resources. An effective targeting mechanism needs to be introduced to ensure that social funding is used only by the most needy. The Orleou program is our approach to targeting. A new targeting mechanism has been piloted in 2014 and 2015, and we expect to continue implementing it in 2016.

Strengthen the financial sector by improving the legal framework for insolvency, strengthening prudential norms

We have taken steps to reduce the share of non-performing loans (NPLs) left after the global financial crisis of 2008-2009. These include: (i) introducing thresholds for reduction of NPLs (was set at 15% by the end of 2014 and 10% from 1 January 2016); (ii) amendments to three laws, which make it easier to write off NPLs and issuance of sub-laws for the implementation of the enacted law on corporate insolvency which make insolvency proceedings more efficient and strengthen creditor rights; (iii) GoK has incentivized banks' writing-off bad loans from their balance sheets.. In 2014, 1.4 billion dollars were allocated from the NFRK as a targeted capitalization of the Problem Loans Fund (PLF) for the purchase of non-performing loans from banks. As a result of these measures, the NPL share was reduced from 33.7 percent (about US$ 26 billion) in April 2014 to 23.1 percent (US$ 17.6 billion) of the total bank loan portfolio by the end of 2014 and further down to 9.4 percent by August 2015. About 70 percent of these write offs are the results of revising the tax code to allow two banks to undertake such write off, Kazkommertsbank (KKB) and BTA Bank (BTA). KKB in 2014 acquired 46.5 percent of BTA and BTA was converted into an asset management company for NPL resolution.

We are also taking actions to mitigate against potential increase in the non-performing loans in the future and instruments to help resolve them should they increase. If NPLs start to rise as a result of the recent move to free-floating of the tenge, we are ready to take prompt actions to prevent their escalation. In particular, NBRK has amended Regulation 358 in May 2014 to introduce stronger prudential regulation and tougher asset valuation and risk weighting since January 2015 to mitigate potential deterioration of banks' assets.

Strengthening the building blocks for competiveness in the non-oil economy

Macroeconomic adjustment is the first step for the non-oil economy to regain its competitiveness. Additional steps to improve the competitive environment of the non-oil economy are required if it is to create the good jobs Kazakhstan is seeking in the medium term. For Kazakhstan, with the extensive reach of the state sector in the economy, these additional steps are consistent with reducing the regulatory reach of the state, and improving the competitive environment so there is a more level playing field between the SOEs and private enterprises, and a course for reducing the role of SOEs in the non-oil economy. Over the last decade, employment growth in the oil and mining industry has been modest, with the bulk of new jobs – about 175,000 net new jobs per year – being created in the services and construction sectors.

As part of economic diversification efforts, our main objectives are to foster fair competition and attract private capital to the economy by reducing the state's share of ownership to the level of the OECD countries (assets at 15 percent of GDP by 2020). To reduce the footprint of the state in the economy, we are moving ahead using own resources, with an ambitious privatization of state-owned enterprises and better governance of the SOEs that remain. The privatization list will include companies of the three major national holdings Samruk-Kazyna, Baiterek, and KazAgro . The priority list will be made up of 60 large companies, the so-called top 60 (from Samruk-Kazyna - 38 companies, from Baiterek - 4, from KazAgro - 4) and 14 other entities that are publically owned. We are planning to sell the largest assets to strategic investors. We will ensure that the privatization process will be as transparent.

Yet, privatization alone is not enough. As in most oil-dependent countries, supporting the growth of the non-oil economy has been a challenge in Kazakhstan. Beyond the high profitability of the oil and mining sectors and the skewed relative prices in the domestic economy that favored the non-tradable sectors, the key challenges holding back further private development in non-oil sectors, include large non-performing loans (NPLs) which have hampered financial intermediation, the prominent role of the State in economy, skills mismatch in the labor market, a cumbersome regulatory environment, and weak market contestability and competitive pressures. The World Bank Group's proposed DPF series will support GoK's efforts to address some of these issues, focusing on financial sector reforms, measures to improve the trade, investment and regulatory policy regimes, the introduction of market-based approaches to industrial policy programs, measures to strengthen corporate governance of SOEs, and improvements to the competition policy framework (especially ensuring that the subsidiarity methodology which seeks to guarantee that SOEs limit their role to the provision of goods and services that could not otherwise be provided by the private sector is up to international practice). While in many countries, improvements in the regulatory framework are important in and of themselves to improve the operating environment for enterprises, in the case of Kazakhstan, they are also important because they curtail the extensive role of the state via SOEs.

To improve the business environment, we would like to streamline regulations and facilitate better international trade links as part of our WTO commitments. We are introducing a special regulatory impact assessment (RIA) unit in the Ministry of National Economy, which will be monitoring and evaluating impacts of new legislative initiatives on the private sector development. The accession to the WTO (expected by end-2015) will help us to integrate better into global trade and enhance competitiveness in our markets. Our WTO membership will be coordinated with the Eurasian Economic Union, where our partners, Russia, Armenia, and the Kyrgyz

Republic, are already members of the WTO, and Belarus is planning to join the WTO.

To foster economic diversification and increase the competitiveness of the non-oil private sector, we are also planning to use an improved «cluster program». In particular, we are planning to introduce changes to the cluster program that will help us to move away from central planning towards more market-based approaches. The changes seek to make private sector actions and investments a key element of the cluster program and a driver for increased competitiveness. By design, the proposed approach is dependent on strong engagement, participation, and ownership of the private sector, particularly SMEs. We are committed to implement the SME Competitiveness Project, financed by the World Bank, which is focused on SME growth and diversification through both cross-cutting and sector-specific approaches. The SME Competitiveness Project will underpin the changes introduced to the cluster program and help us to implement the territorial clusters program. This will be done through a US$ 6 million component on clusters («competitive sectors»), which will support application of the approach in six clusters (or more, if resources permit) across three regions.

Monitoring and reporting

The Government monitors the implementation the national reform agenda closely. Firstly, we are monitoring the impact of our planned fiscal consolidation on the main macroeconomic and financial indicators. Secondly, the Government, through the Ministry of Finance and other government bodies monitors implementation of the budget and the flow of funds to support countercyclical measures. NBK and the management board of the NFRK are responsible for the asset management NFRK and monitors the expenditures of the NFRK and is

WB Partnership

The reform agenda we are implementing with the support of the World Bank Group, be it through the DPF, the analytical and technical assistance reimbursable services or through projects, is in line with the goals outlined in the Country Partnership Stratregy 2012-2016. Our collaboration is further strengthened through the Partnership Framework Agreement (PFA) we, together with the WBG, the ADB and other international financial institutions have developed a PFA Implementation Program for investment and institutional projects in priority areas and technical assistance that will help to accelerate the diversification and improve the competitiveness of our economy to achieve sustainable and inclusive growth.

Conclusion

Kazakhstan is facing challenging macroeconomic conditions and will face challenges in adjusting its economy to the new realities of lower oil prices in the medium term. Nevertheless, the Government of the Republic of Kazakhstan remains committed to the continuation of the long-term reform and development programs. In this light, we will be grateful for the positive response to our request for support and further cooperation in the framework of the proposed loans to support this economic transition to more sustainable economic growth model.

Yours sincerely,

Minister of National Economy
of the Republic of Kazakhstan **Erbolat Dossaev**

ANNEX 3: IMF PUBLIC INFORMATION NOTICE FROM IMF BOARD MEETING[25]

Press Release No. 15/367
August 5, 2015

On July 31, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Kazakhstan and considered and endorsed the staff appraisal without a meeting.[2]

Against the backdrop of external shocks, economic growth and inflation have decelerated, financial conditions have tightened, and external imbalances are emerging. Real GDP growth slowed to an annualized 2 percent during the first quarter of 2015, down from around 4 percent in 2014 and 6 percent in 2013. In addition to weaker external demand, slower growth was driven by the impact of lower income and profitability (resulting from lower oil prices) and confidence effects (reflecting regional developments) on private consumption and domestic investment. The external position has deteriorated largely due to the fall in oil prices, with the current account balance turning negative in the second half of 2014, although there has been some improvement in the current account during the first quarter of 2015. At the same time, Kazakhstan's real effective exchange rate (REER) has appreciated over the past year, mainly reflecting the depreciation of the ruble and sharp appreciation of the U.S. dollar, against which the tenge is managed. In the face of slowing demand and a more stable exchange rate, headline inflation fell from 7.4 percent year-on-year at end-2014 to 3.9 percent year-on-year at end-June, 2015. In mid-July, following the decline in sovereign spreads and reduced currency pressures, the authorities successfully issued a $4 billion sovereign bond and widened the exchange rate band from 170–188 to 170–198 tenge/dollar.

Real GDP growth is projected to decelerate to 2 percent in 2015. Weaker demand from Russia and China, lower oil prices, confidence effects, and continuing delays in the Kashagan oil field are the main factors behind the projected slowdown. Next year, growth is projected to pick up to 3.25 percent, driven by gradual recovery in oil prices and external demand. Still, the medium-term growth outlook is less favorable than projected last year, given the impact of lower oil prices and continued slow growth in Russia on non-oil potential growth in Kazakhstan.

The fiscal stimulus aimed at supporting growth has led to deterioration in the fiscal accounts, with the overall fiscal surplus falling from 5 percent of GDP in 2013 to 1.7 percent of GDP in 2014. Monetary conditions have tightened, which, together with lower economic activity, have slowed lending activity sharply. At the same time, the NBK has made progress in improving its monetary policy framework and operations, while administrative and prudential measures have succeeded in lowering the level of non-performing loans (NPLs). In line with the 2014 FSAP recommendations, the authorities have started to undertake bottom-up stress tests for banks. The NBK has also initiated discussions with bank supervisors in other jurisdictions to strengthen cross-border supervision. The authorities have embarked on an ambitious structural reform program, bolstered by extensive engagement with the Multilateral Development Banks. In June, 2015 Kazakhstan completed negotiations to become a formal member of the WTO.

[25] This Public Information Notice was issued on the basis of economic data provided to the Fund team at the time of the Article IV Consultation. The IMF is currently updating its projections in preparation of the Fall World Economic Outlook.

Executive Board Assessment[3]

In concluding the 2015 Article IV consultation with Kazakhstan, Executive Directors endorsed staff's appraisal, as follows:

Amid slower economic growth, tighter financial conditions, and emerging imbalances, policies should balance ensuring sustainability while alleviating the impact of shocks in the near term. In recent years the authorities have successfully harnessed oil resources to bolster economic growth and build buffers. However, economic growth has now decelerated largely as a result of likely long-lasting external shocks and is expected to remain subdued this year and next year. Moreover, the outlook for growth is subject to predominantly downside external risks. In view of weaker growth, the large and likely long-lasting nature of the shocks, and the accumulated buffers, the policy response in the short term should be geared toward supporting the economic recovery. Over the medium term, there is a need to further strengthen macroeconomic policy frameworks, to bolster resilience to shocks and promote durable growth.

To ensure fiscal sustainability, the stimulus must be accompanied by credible medium-term fiscal consolidation and more transparent fiscal policy framework. The stimulus is justified on countercyclical grounds and is appropriately frontloaded and tailored to support growth. However, to ensure a sustainable path for the non-oil deficit, the stimulus must be accompanied by credible medium-term consolidation measures, especially on the revenue side. In particular, there is scope to strengthen the enforcement of tax collection, reduce tax exemptions, including in the Special Economic Zones, and make income tax rates more progressive. Moreover, enhancing the fiscal policy framework is critical to ensuring transparency and medium-term sustainability. Key priorities include expanding the budget coverage to all fiscal activity, in line with GFSM 2001, and integrating fiscal policy into a broader macroeconomic policy framework.

Greater exchange rate flexibility in tandem with the introduction of new monetary policy instruments is needed to enhance the policy architecture and address imbalances. The authorities have taken confidence-building measures to overhaul the monetary policy framework in support of their medium-term goal of adopting inflation targeting, and have widened the exchange rate band. However, with the aim of more effectively managing liquidity and signaling the stance of policy, the authorities should speed up the planned introduction of a new policy interest rate, supported by open market operations. Moreover, strengthening the policy architecture requires further exchange rate flexibility, which will support a more independent interest rate policy and help reduce imbalances. To avoid undermining financial stability, and anchor expectations about policy intentions and operations, the authorities should communicate their plans openly and consistently.

In view of rising vulnerabilities, further actions are needed to bolster financial sector resilience. Efforts underway to reduce the level of NPLs are paying off. However, more needs to be done to bring down the level of NPLs to sustainable levels, while ensuring that the achievement of the 10 percent prudential ceiling by end-2015 does not compromise proper loan classification and provisioning. In this regard, while the recent plans to refocus the NPL resolution framework at the merged KKB-BTA entity is appropriate, weaknesses in the bank should be addressed and an asset quality review be undertaken within a broad strategy to ensure long-term viability. Strengthening financial sector resilience also requires introducing higher risk weights or exposure caps on corporate lending, limiting FX lending to unhedged borrowers, and tightening net open position limits to mitigate credit risk. Further steps in implementing the FSAP recommendations include adopting risk-based assessment tools and supervision and finalizing legislative amendments in insurance, pensions, and the securities market.

The structural reform agenda is appropriately ambitious, but effective implementation is essential to achieving sustainable and inclusive growth. Priority areas include strengthening human capital, building institutions, bolstering the rule of law, enhancing financial intermediation, and improving the business climate. Close collaboration with MDBs in these areas should facilitate greater efficiency in the procurement and implementation process. Moreover, diversification away from the oil sector and the reduction of the state footprint in the economy are necessary conditions to ensuring successful implementation of the broader private-sector-led growth strategy.

Kazakhstan: Selected Economic Indicators, 2012–20

(IMF Press Release No. 15/367 August 5, 2015)

	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	0.5	7.1	5.3	5.2	4.4	4.7
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	2.3	2.3	5.9	4.7	4.1	7.3
Real imports	19.4	5.0	-6.7	5.8	5.9	4.4	4.3	4.5	4.5
Output gap (in percent of potential 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	6.0	6.0
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	-2.6	7.0	6.0	6.1	6.0	5.5
Exchange rate (tenge per U.S. dollar; eop)	1.5	2.2	18.7	3.1	…	…	…	…	…
	(In percent of GDP, unless otherwise indicated)								
General government fiscal accounts									
Revenues and grants	26.9	25.3	23.8	19.8	20.8	20.8	20.5	20.0	19.7
Of which: Oil revenues	13.4	11.8	11.3	8.1	8.8	8.7	8.4	8.0	7.6
Expenditures and net lending	22.4	20.3	22.1	23.1	22.3	21.9	21.3	21.1	20.7
Overall fiscal balance	4.5	5.0	1.7	-3.2	-1.6	-1.1	-0.8	-1.0	-1.0
Financing	-4.1	-3.3	1.9	3.2	1.6	1.1	0.8	1.0	1.0

(cont.)

Kazakhstan: Selected Economic Indicators, 2012–20 (continued)

(IMF Press Release No. 15/367 August 5, 2015)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections			
Domestic financing	2.7	2.1	1.5	2.6	2.5	3.4	3.9	4.6	5.0
Foreign financing	0.2	0.2	1.6	0.9	1.7	1.1	1.0	0.6	0.2
NFRK	-7.0	-5.5	-1.3	-0.3	-2.6	-3.4	-4.1	-4.1	-4.2
Non-oil fiscal balance (percent of GDP)	-8.9	-6.8	-9.6	-11.4	-10.4	-9.8	-9.3	-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	-11.3	-10.8	-10.3
	(Annual percent change, eop, unless otherwise indicated)								
Monetary accounts									
Reserve money	1.9	-2.2	20.8	6.9	7.5	8.3	8.3	8.3	8.3
Broad money	7.9	10.2	2.4	14.5	10.4	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	2.9
Credit to the private sector 2/	11.6	12.7	5.7	-5.5	3.7	6.0	11.0	10.6	10.8
Credit to the private sector (percent of GDP) 2/	41.5	40.2	37.9	37.7	37.5	37.5	37.5	37.5	37.5
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	-3.3	-2.9	-1.9	-1.2	-1.1	-0.8
Exports of goods and services	91.8	90.7	85.4	60.0	64.6	70.6	76.1	80.1	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	52.2	55.7	58.6	61.5	64.5	67.5
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	28.9	28.9	28.9	28.9	28.9

(cont.)

Kazakhstan: Selected Economic Indicators, 2012–20 (continued)

(IMF Press Release No. 15/367 August 5, 2015)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Projections				
In months of next year's imports of goods and services	5.4	5.3	6.7	6.2	5.9	5.6	5.4	5.4	5.1
NFRK assets (eop)	57.9	70.8	73.6	74.2	80.2	88.9	100.6	113.6	128.2
Total external debt 4/	136.9	149.9	157.1	168.9	181.3	193.1	203.7	214.3	224.2
In percent of GDP	67.3	64.7	71.2	79.8	78.6	75.3	71.6	68.1	64.3
Excluding intracompany debt (percent of GDP)	34.1	32.8	35.3	41.3	42.3	41.8	40.6	39.3	37.7
Memorandum items:									
Nominal GDP (in billions of tenge)	30,347	35,275	39,530	39,285	43,365	48,194	53,502	59,156	65,522
Nominal GDP (in billions of U.S. dollars)	203.5	231.9	220.6	211.7	230.7	256.3	284.6	314.7	348.5
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. 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	96.2	58.9	64.2	67.1	69.9	71.0	71.5

Sources: Kazakhstani authorities and IMF 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.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

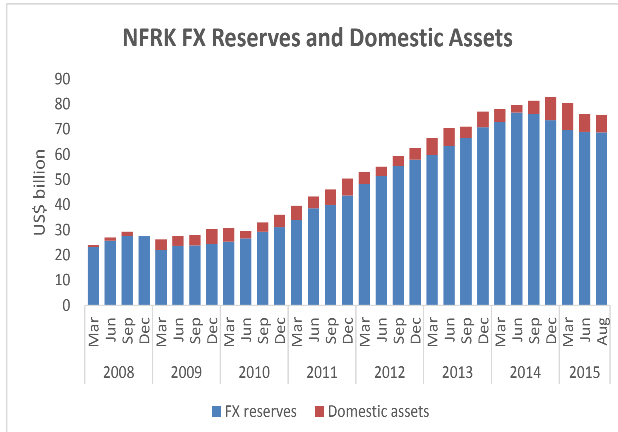
[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

ANNEX 4: OIL FUND AND BUDGET TRANSPARENCY

Background

Kazakhstan has the largest recoverable crude oil reserves in the Caspian region. The hydrocarbon industry is estimated to account for roughly 50 percent of government's fiscal revenues. Kazakhstan's proven oil reserves are estimated at 30 billion barrels. Current oil production, approximately 1.7 million barrels/day, is dominated by two giant fields: Tengiz and Karachaganak, which produce about half of Kazakhstan's total output. Proven natural gas reserves are estimated at 1.3 trillion cubic feet (*Source:* BP Statistical Review of Energy 2014). Kazakhstan also produces 36 percent of the world's uranium and has extensive mineral resources such as chromium, copper, gold, iron, lead, manganese, and zinc (*Source:* USGS Minerals Yearbook Kazakhstan).

Oil Fund Transparency and Governance



Source: World Bank staff calculations based on NBK data.

The National Fund of the Republic of Kazakhstan (NFRK) is a sovereign wealth (oil) fund, which is integrated into the government's consolidated budget. The NFRK performs two functions: (i) a stabilization function to reduce volatility from oil revenue inflows; and (ii) a savings function to address inter-generational equity from the oil windfall. As part of the stabilization function, the government appropriates $8-15 billion annually, while the rest of an annual fiscal gap (implicitly capped at 3 percent of GDP) is financed through domestic and external borrowing. As part of the savings function, most of oil revenue inflows (net of annual appropriations/transfers to the consolidated budget) are invested abroad, while about 10 percent of total NFRK assets are invested domestically into bonds issued by four state-owned enterprises and development institutions. The NBK is put in charge of implementation of the NFRK asset investment strategy. The NBK hires private asset management companies and rewards them according to their performance benchmarked against interest return earned. The NFRK financial accounts are subject to an annual external audit. Monthly and annual reports of the NFRK are published at the official website of the Ministry of Finance and are also placed in the online legal database (http://www.minfin.gov.kz/irj/portal/anonymous?NavigationTarget=ROLES://portal_content/mf/kz.ecc.roles/kz.ecc.anonymous/kz.ecc.anonymous/kz.ecc.anonym_budgeting/budgeting/national_fund_fldr).

Implementation of the Extractive Industries Transparency Initiative (EITI)

Kazakhstan achieved a full EITI compliance status in October 2013 and now is deepening the EITI implementation by including environmental payments in Kazakhstan's 2014 EITI Report (to be published in late 2015). The latest 2012 and 2013 EITI Reports were published in December 2014 and are compliant with the EITI Standards. These Reports covered about 99.9 percent of all oil, gas, and mineral companies operating in Kazakhstan (above a proposed threshold). Recently, the EITI reporting has been streamlined through implementation of an online EITI data-reporting portal.

Accountability of State-owned Enterprises (SOEs)

All major SOE groups publish their audited financial statements in their websites. For instance, the largest SOE conglomerate Samruk-Kazyna publishes its consolidated financial statement in its website: http://sk.kz/section/69. As for the rest of the SOE sector, the government instituted a depositary of financial statements (www.dfo.kz) where SOE financial statements are filed and can be accessed by the general public.