



Kazakhstan: Staff Concluding Statement of the 2018 Article IV Mission

June 27, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit to a member country. Missions are undertaken as part of regular consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

With economic recovery gaining strength, Kazakhstan should seize the opportunity and move decisively with reforms to transform the economy and bring the country closer to achieving its development goals. The new growth model should avoid cementing a culture of reliance on state subsidies, with the government and National Bank (NBK) focusing on ensuring the necessary conditions—including infrastructure and business environment—to foster a dynamic and competitive private sector. After several years of fiscal stimulus and significant support to the banking sector in 2017, consolidation is needed to put the public finances on a sustainable path and restore buffers. The authorities recognize that and have taken steps to reduce the deficit starting from this year. Adjustment plans are based on revenue administration measures and expenditure optimization, including scaling up public-private partnerships. The initiative to lower the tax burden for low-income earners is welcome but more could be done to make the tax system more equitable and efficient. Substantial efforts have been made to strengthen the financial sector but challenges remain. Legislative amendments that address regulatory gaps should be adopted promptly. Banks should undergo an assessment of their asset quality to clarify the magnitude of problem loans and additional capital needs. Measures to promote credit should be market-based; whenever state support is needed, it should be targeted, transparent, temporary and funded by the budget.

Context and outlook

Recovery of Kazakhstan's economy is continuing from shocks that began in 2014. After two years of subdued activity—with lower oil prices and a slowdown in key trading partners—real GDP increased by 4 percent in 2017. Growth was driven by strong exports, especially oil and metals, reflecting both favorable external conditions and new supply from

the large Kashagan field. Mining, manufacturing, and investment activity also contributed to growth. Export growth helped reduce the current account deficit. Inflation has remained within the target band of the NBK, and expectations have stabilized.

Financial sector repair is underway, and credit has begun to recover. Lending to households has picked up more than corporate sector credit, reflecting ongoing banking sector repair and scarcity of creditworthy borrowers in a state-dominated economy. This has contributed to calls on the NBK to cut interest rates and for continued state support to the economy (subsidies, financing).

Going forward, growth is expected to remain robust, but there are risks. Overall growth was strong in 2017, partly due to a surge of oil production with higher prices and the major Kashagan field coming on line. Non-oil growth also picked up last year and is projected to increase further to 4 percent over the medium term, reflecting business environment and public administration reforms, privatization, investment, and a pickup of credit, with strengthening of bank balance sheets and financial deepening. Downside risks are related to commodity prices—including reduced impulse for reforms due to higher oil and metals prices and risks of lower export earnings and pressures on the tenge from lower commodity prices. Slower growth in Russia or China is another risk, along with tighter (or volatile) global trade or financial conditions. On the upside, the Belt and Road Initiative (BRI) provides an opportunity to deepen integration and diversify, and reforms in Uzbekistan open opportunities for trade and investment.

Growth strategy

Implementation of the authorities' various structural reform initiatives appears to be advancing. This includes the “100 Concrete Steps,” which aim to improve the business climate, public administration, and governance. More than half of the steps to strengthen civil service, the rule of law, industrialization, diversification, nation-building, and accountability have been completed. Small-scale privatization is advancing, and preparations are underway for IPOs for major SOEs in aviation, telecoms, and nuclear materials. The Astana International Financial Center (AIFC) will open in July with the aim of becoming a regional hub for financial services. Achieving this objective and building demand for AIFC services will take time, and success will depend on adhering closely to international best practices in governance, transparency, and operations.

New initiatives have been launched. A “Kazakhstan 2025” strategic plan was launched earlier this year, focusing on high-quality growth and raising living standards through productivity and competitiveness gains, modernization and technical upgrades, and public administration and governance improvements. Kazakhstan 2025 is supported by specific efforts that target industrial investments and digitalization. A plan to improve Kazakhstan's

ranking in the World Economic Forum's Global Competitiveness Index is underway, and President Nazarbayev identified "5 Social Initiatives" in March that aim to provide affordable housing, reduce the tax burden for lower-income earners, improve accessibility and quality of higher education, expand access to financing for SMEs, and build a gas pipeline to Astana. The initiatives have implications for taxation, public expenditures, and monetary and financial policies.

Reducing the state's footprint is critical. A thriving private sector is needed to realize the aspiration of joining the 30 most developed countries by 2050, calling for a decisive change in the approach to supporting private activity. While the various reform initiatives are ambitious and comprehensive and implementation is reported to be progressing, the state remains predominant, and some stakeholders consider that reforms are moving more on paper than in practice. With recovery now established, government and NBK financial support risks cementing a culture of reliance on subsidies. The growth impetus should move to the private sector, with the state facilitating the business environment and enhancing infrastructure and connectivity. Successful IPOs would send a strong signal, along with modernizing rail and road networks, strengthening performance of state holding companies and SOEs, further liberalizing trade, enhancing domestic competition, and aligning land use and agriculture infrastructure to take advantage of export prospects. Increased use of public-private partnerships (PPP) is welcome, provided they are well designed and managed. The opportunity to enhance connectivity and diversify under the BRI should be seized. Finally, improved coordination among agencies, regular reporting on implementation, and comprehensive evaluation of results would increase credibility of the reform agenda.

Fiscal policy

Fiscal consolidation is underway. With the winding down of projects under the Nurly Zhol public infrastructure development program, conclusion of the Astana Expo, and the more favorable environment, sizeable adjustment is envisaged this year, with higher oil revenues and lower spending on goods and services and investment. The consolidation is warranted after countercyclical spending has been completed, as is restoring buffers, given risks. Several complex reforms are underway that will affect public spending. A new "capitation" approach aims to provide funding to service providers on a per capita basis and to streamline health and education outlays, while increasing flexibility and service quality through expanded PPPs and outsourcing. Another initiative will review public sector jobs and align wages to private-sector remuneration, with a new system to recognize performance. The IMF team sees merit these ambitious reforms and notes that they need to be very effectively planned and managed. To preserve National Fund (NFRK) assets, budget transfers are being reduced, while the government is considering issuance of a tenge-denominated Eurobond that would aim to attract foreign investors and establish a new benchmark.

Further gradual fiscal adjustment is expected over the medium term. The non-oil deficit is set to decline and reach a level that is in line with IMF staff estimates of the sustainable long-term position. The adjustment is driven by higher revenues, mainly from tax administration gains, especially improved VAT administration and enhanced technology. Recent tax code changes focused on simplification, clarifying ambiguities, reducing the compliance burden, and improving dispute resolution. Other measures aim to enhance compliance by small businesses and the self-employed, and to expand electronic invoicing and filing. In addition, as part of the new 5 Social Initiatives, the effective personal income tax rate for low-income earners will be cut from 10 percent to 1 percent. The IMF team supports these administration and policy measures, although the projected revenue gains from tax administration reforms may prove to be ambitious. In addition, a moderate increase of PIT rates could be considered for higher-income earners to further enhance progressivity (along with universal income declaration requirements). A review of tax holidays, exemptions, incentives, and zones should be undertaken. Incentives should be well targeted and limited in time, with links to investment through allowances or accelerated depreciation. There may be scope to consider a moderate increase of the VAT rate once administrative improvements have been put in place. Finally, while the team sees merit in the authorities' expenditure reforms, the level of capital spending going forward is low by international standards, and some additional high-quality expenditures should be considered, in tandem with higher non-oil revenues.

Recent revisions to the fiscal regime for extractive industries aim at encouraging exploration. For *oil and gas*, a key change was introduction of an optional, "alternative" tax, aimed at deep-water exploration, replacing production- and sector-specific profit-based instruments. Revisions also eliminate a discovery bonus and introduce more favorable tax treatment of exploration expenses. A licensing round for deep-water areas is planned for later this year. While the changes are positive, further gains in the investment and regulatory environment appear likely to be needed to secure major new investment. For *mining*, changes include removal of an excess profits tax and increased reliance on regressive *ad valorem* royalties. As prospects for increased mining activity appear to be favorable, a comprehensive tax regime review should be considered, possibly with IMF technical assistance (TA). The authorities and investors are encouraged to increase transparency around existing contractual arrangements.

Fiscal transparency and risk management should be further improved. Measures taken by the authorities to align fiscal reporting to international standards are welcome. Areas for further gains include: adopting IMF GFSM methodology to formulate and evaluate policy; strengthening risk management practices, e.g., in monitoring PPPs and SOEs; and introducing a more comprehensive and detailed medium-term fiscal framework.

Monetary and exchange rate policies

The focus of monetary policy should remain on price stability. Declining inflation and stabilization of inflation expectations has allowed the NBK to undertake interest rate cuts, most recently to 9 percent in June. The cuts have been appropriate, given developments and the outlook, and are consistent with keeping real interest rates close to neutral levels. Going forward, the NBK should resist calls for accommodation; as the NBK noted at the time of its most recent rate decision, the changing balance of risks warrants a cautious approach to further easing.

The existing flexible exchange rate (ER) regime is important to inflation targeting. The flexible exchange rate is serving Kazakhstan well by helping to absorb changes in the macroeconomic environment and supporting dedollarization. Changes in the ER reflect fundamental factors, including oil prices and dynamics of the Russian ruble. The NBK would benefit from strengthening communications and transparency with respect to purchases and sales of foreign exchange, including on behalf of the NFRK and the pension fund (UAPF).

Efforts to improve monetary operations and domestic financial markets should continue. NBK notes have helped manage liquidity and build the short end of the yield curve. Money-market rates have stayed within the NBK's corridor, close to the lower bound. A project with Clearstream aims to facilitate foreign-investor access and enhance the local securities market. There is scope for strengthening cooperation between the NBK and the government on liquidity management and market issues, including management of SOE deposits/funds. A review of reserve requirements is also needed. Staff sees a case for unifying resident and non-resident reserve requirements, possibly higher rates, remuneration, maintaining differentiated rates for FX and tenge liabilities, and gradual elimination of cash from eligible reserves.

Financial sector policy

Significant efforts have been made to strengthen the financial sector. The state supported the merger of the two largest banks, Halyk and KKB, and five banks received capital support through NBK subordinated loans. This funding helped secure the stability of the sector. Legal changes to enhance the NBK's supervisor and regulatory powers are under consideration by parliament. The NBK also withdrew or suspended the licenses of several smaller banks that were in violation of prudential requirements. Several initiatives to provide further funding have been designed and will be implemented shortly.

Despite these actions, important challenges remain. Most importantly, Kazakhstan's banks need to fully adopt a strengthened business model, with enhanced governance, management, and operations. Some banks continue to experience difficulties from weak

credit-risk management and problem loans. Further strengthening of the resilience of the banking sector would contribute to sound macro-financial linkages and growth, while reducing risks.

Policy actions are needed in the following areas:

- *Asset-quality and governance.* Banks should undergo an updated assessment of their assets to clarify the magnitude of possible problem loans, with a prompt write-off of bad loans to follow. Last year's state support to banks should be followed by decisive operational improvements to ensure sound governance and operations.
- *Strengthening supervision and regulation.* Adoption of amendments to the Law on the NBK and the Law on Banks and Banking Activity would address regulatory deficiencies. Follow-up regulations should be issued by the NBK to formalize its use of broader powers. In particular, transparency of principles underlying supervisory judgment is important for building trust. This is an area for possible IMF TA. Other regulations, including on loan classification, should be improved.
- *Emergency liquidity assistance (ELA).* The NBK is continuing work to strengthen the framework for ELA to banks. ELA should be provided only to institutions that are solvent and should be collateralized, and in the view of the IMF staff, provided under government guarantee.
- *Credit subsidies.* State-supported initiatives—including the new “7-20-25” mortgage program and support to SMEs and the agriculture sector—should be targeted, transparent, and temporary, from the budget and not the NBK, not compromise credit assessment or management by commercial banks, and be rigorously evaluated *ex post* for cost effectiveness. As noted, with economic recovery now in place, state funding and subsidies should be limited, given risks of cementing a culture of reliance on state support. Where possible, existing agencies should be utilized, with reforms as needed, rather than creating new institutions.
- *Financial sector infrastructure.* There is a need to further improve financial sector infrastructure, particularly in collateral valuation and foreclosure and disposal of distressed assets. Remaining legal, institutional, and operational constraints affecting the Problem Loan Fund (PLF) should be addressed, so that the PLF can make progress in resolving bad assets acquired as part of the KKB-Halyk merger.
- *UAPF.* Management of pension fund assets should aim at achieving sound returns for contributors with appropriate risk management and transparency provisions, rather

than supporting fiscal or monetary policy objectives. Efforts to return part of UAPF assets to non-NBK management with appropriate safeguards are welcome.

Unlocking credit is best achieved through policies that foster a dynamic private sector along with stronger banks. Some measures under consideration aimed at promoting credit growth, such as allowing banks to sell part of their holdings of securities connected with past state funding, or possible purchase of commercial bank bonds by the UAPF, could bring some benefits—with appropriate risk-sharing and on market terms—through more predictable long-term funding. However, these are unlikely to be fully effective, given constraints on credit demand. Actions should aim to encourage private initiative and improve monetary transmission by reducing dollarization, phasing out loan subsidies, and removing interest rate regulations. Further strengthening the banking sector is key.

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The IMF team would like to thank the authorities and other stakeholders for their hospitality and constructive discussions. The IMF staff stands ready to provide additional policy advice and technical assistance to Kazakhstan.