

**INTERNATIONAL MONETARY FUND**  
**Middle East and Central Asia Department**



**Kazakhstan: Concluding Statement of the 2017 Article IV Mission**

*Astana, February 8, 2017*

*Kazakhstan continues to withstand challenges related to lower oil prices and slower growth in Russia, China and Europe. The authorities' response—targeted fiscal support, exchange rate (ER) adjustment, strengthened domestic liquidity management, and structural reforms focusing on the business climate and public administration—has helped stabilize conditions. While growth slowed in 2016, a pickup is expected in 2017. Medium-term prospects are subdued, however, due to continued lower oil prices and weak conditions in key trading partners. Policies should continue to address these conditions. The nonoil deficit should be reduced in the medium term, with higher non-oil revenues to support sufficient social and capital spending. Monetary policy should further strengthen the inflation-targeting framework, including ER flexibility. Financial sector weaknesses should be addressed promptly, and implementation of the ambitious structural reform agenda should be accelerated and better communicated.*

**Context and Outlook**

1. **The authorities' policy response is helping the economy recover from shocks that began in 2014.** Growth in 2016 was positive, 1 percent, reflecting an increase in oil production and supportive policies, notably Nurdy Zhol, which provided funding for infrastructure, SMEs, and housing. Actions of the National Bank (NBK) stabilized markets and restored confidence in the tenge. Inflation came down during the year, and NBK reserves increased by \$2 billion, owing to strong financial inflows.
2. **Growth is expected to pick up in 2017 and over the medium term.** Growth is projected to reach 2.5 percent in 2017 and non-oil growth should reach 4 percent by 2021. This will reflect a further increase in oil production, the impact of structural reforms, and an unlocking of bank lending. The external current account is projected to improve with higher

exports, and inflation should fall within the NBK target band of 6 to 8 percent in 2017. Uncertainty is significant, however, given dependency on commodity price developments.

### **Monetary and Exchange Rate Policies**

#### **3. Significant progress has been made in the transition to inflation targeting and the conduct of monetary policy, including a flexible ER; however, challenges remain.**

After reinstatement of the policy rate in early 2016, the NBK has kept short-term market rates within its corridor through open market operations, standing facilities, and NBK notes. This has contributed to greater stability and a reflow of deposits back to tenge. After FX purchases in the first half of 2016, the NBK largely stayed out of the FX market, consistent with the inflation-targeting framework. ER flexibility is serving Kazakhstan well, helping to absorb changes in the external environment. Challenges include the following:

- *Excess liquidity.* Tenge liquidity has increased with deposit dedollarization and public spending. Excess liquidity likely reflects structural factors, as bank lending has stalled.
- *Yield curve.* NBK notes have played a key role in building the short end of the tenge yield curve. Continued close cooperation is needed with the Ministry of Finance (MOF) to develop the yield curve at longer maturities and to deepen the market and enhance market liquidity. This, in turn, will help the authorities manage liquidity, as well as help banks engage in maturity transformation. The financial markets would also benefit from greater participation by institutional investors who focus on returns rather than on support of issuers.
- *Long-term FX swaps.* Most of the remaining NBK long-term FX swaps expire in 2017. They should not be renewed as banks now have ample tenge liquidity.
- *Exchange rate policy.* The authorities should refrain from FX market intervention, with buying/selling limited to dampening excess volatility. The NBK should continue to communicate that the tenge will be flexible in the future.
- *Analytical capacity and communication.* The NBK has made substantial progress in building up its analytical capacity and communicating policy decisions. This should continue.

**4. Monetary policy should continue to focus on inflation.** The deceleration of inflationary pressures has allowed the NBK to reduce its base rate by 500 basis points since February 2016. Indications are that the deceleration of inflation is continuing, supported by tenge appreciation and lower government spending. Lower expected inflation in the 12-to-18-month horizon would allow the NBK to continue easing, thus providing support to activity. Maintaining price stability should remain the primary objective of monetary policy,

and a change in the NBK mandate to explicitly include growth is not advisable. Efforts to anchor inflation expectations will support private savings and investment needed to foster diversification and growth. An explicit mandate to support growth would undermine these efforts and the NBK's independence. Monetary policy is not well-suited to deal with structural issues—especially the lack of “bankable” projects. Addressing structural issues is the role of fiscal policy and structural reforms.

## **Financial Sector**

5. **Financial sector weaknesses should be addressed promptly.** Vulnerabilities from the slowing of growth and the depreciation persist, and bank lending is depressed. The NBK recently intervened at two small banks, and other banks may need additional capital to address high non-performing loans (NPLs). The government has provided support through placement of state deposits and subsidized lending programs. There is uncertainty in the sector, and the IMF staff supports strong and timely action to deal with weak institutions. The banking sector has long been characterized by complex and opaque finances and operations. This has inhibited investment in the sector and its contribution to growth. Addressing this complex history will be critical for the sector to move forward. Close cooperation between the NBK and the government is essential. Actions should involve:

- *Reporting and diagnostics.* Consolidated reporting should be re-established to present a clear picture on NPLs and capital adequacy. The NBK should proceed with diagnostics for the sector (stress testing, asset quality review) to support necessary actions in the near term. In the longer term, the NBK should develop internal risk-based supervisory methodology and include an assessment of bank reporting practices and the quality of independent audit in its final supervisory evaluation.
- *Additional capital and mergers.* Recognition of loan losses and capital injections by shareholders will be key to sectoral strengthening. Further forbearance on capital requirements should be strictly limited. Banks should raise the required capital or exit. Mergers should take place on a voluntary, market basis, and mergers involving weak institutions should be avoided. Transactions should proceed only if robust due diligence is completed, and the authorities are convinced that the resulting bank will be sound and viable. Credible capital and business plans will be essential, especially for mergers that create large institutions with potential implications for competition and concentration.
- *Liquidity provision.* Work on the NBK's Lender of Last Resort (LoLR) provisions should be accelerated. The NBK should not provide unsecured funds to banks, and the government and state enterprises (SOEs) should review placement of bank deposits. The pension fund (UAPF) should not place deposits in weak banks and should keep

its focus on ensuring strong and sound investment returns, rather than supporting monetary or fiscal policy initiatives. Emergency liquidity support should only be made available only to viable banks, be fully collateralized, include a guarantee by the MOF where needed, be provided at penalty rates, and include a time-bound repayment plan to facilitate monitoring and follow-up action.

- *Intervention.* Timely intervention at weak banks is necessary, as postponing action may make losses larger. The NBK should have strong support from the presidential administration and the government, as well as the necessary resolution tools, including an adequate legal basis for its powers and actions. Where necessary, the NBK should replace bank management and require transactions to be pre-approved. A key risk is that courts may delay or reverse resolution actions. It may be necessary to proceed with fast-track legislation to ensure that the NBK has sufficient authority and tools to assess solvency and act quickly and decisively, including bail-in of shareholders, assumption of management authority, and resolution of assets.
- *Capital support.* Public financial support for bank resolution should be provided only under strict conditions to ensure that costs and future risks are limited. Robust due diligence is needed to ensure that excessive public funding is not provided. Public funds should be used only for viable, systemic institutions and when financial stability is at risk, and shareholders should be fully diluted on a consolidated basis before public funds are used. Shareholders should not retain claims on assets. Capital support should come from the state budget—from the NFRK or from domestic or international debt issuance—and not from the NBK (or the UAPF). The MOF should consider providing capital support in the form of regular marketable, liquid government securities (this would also help deepen the securities market and absorb excess liquidity).
- *Liquidation of bad assets.* Bad assets obtained from the banks, including land and real estate, should be liquidated quickly to resolve long-standing problems and allow assets to be purchased by new investors and thereby jump-start economic activity. This should be done by the Problem Loan Fund (PLF) in a transparent, auction-type approach. Legal and regulatory changes and external advisors may be needed to support stepped-up PLF operations.

With these principles in mind, the IMF staff supports strong and timely actions to deal with weak institutions.

## Fiscal policy

6. **Fiscal policy has been supportive of growth.** Nurly Zhol has helped bolster activity in SMEs, housing, construction, and transportation. With recovery, the authorities rightly recognize that medium term consolidation is needed, given persistently lower oil prices.

- *Expenditure.* Spending under Nurly Zhol will be reduced as it is phasing out. Some spending categories, notably social expenditures, are expected to rise.
- *Revenue.* The tenge depreciation supported non-oil revenues in 2016, especially VAT receipts. The pick-up of oil prices is expected to boost revenues in 2017.
- *Financing.* Deficit financing will continue to rely primarily on transfers from the NFRK. Fiscal buffers remain large, and public debt remains relatively low. New NFRK rules are welcome as they aim to reduce dependency on oil and maintain strong buffers.

7. **Medium-term fiscal consolidation would benefit from a clear strategy.** The fiscal path described in the new NFRK concept envisages a decline of the non-oil deficit to 7 percent of GDP by 2020 and 6 percent by 2025. This path is in line with the IMF staff's long-term estimates of a sustainable non-oil deficit consistent with updated oil price projections and with accumulation of a substantial savings buffer in the NFRK. However, the path will require adjustment of around 4-5 percent of GDP, and it is important that the authorities clarify the specifics of this consolidation and take actions to implement the necessary revenue and expenditure measures. The IMF staff considers that the adjustment should come through cuts in low-priority spending and especially increases of non-oil revenues. The new tax code should rationalize tax exemptions and preferential treatments; higher and more progressive tax rates are likely to be needed. A comprehensive review of the non-oil and oil tax regimes by the IMF Fiscal Affairs Department would be important to identify options to raise revenues. Also, staff again calls on the authorities to fully adopt the IMF's Government Financial Statistics reporting standards and more comprehensive coverage of the fiscal accounts to improve clarity of fiscal policy operations. The IMF stands ready to provide TA in this area and to strengthen the medium-term fiscal framework. Also, while public debt remains manageable, close monitoring of SOE debt (30 percent of GDP) is warranted, along with other contingent liability risks.

## Structural Reforms

8. **An ambitious reform program is underway to support diversification and broad-based growth and improved efficiency of public administration.** Under the flagship 100 Concrete Steps initiative, key efforts are underway to adopt legal and regulatory changes and spell out actions for implementation. Importantly, key assets have been identified for privatization.

9. **Success of the reform agenda hinges on implementation.** The far-reaching nature of the 100 Concrete Steps requires coordinated, decisive efforts, given that reforms reinforce each other. Not all items yet have detailed legislation or action plans, and in some cases where legislation has been passed, follow-up implementation plans are not yet clear. The authorities should continue to develop and communicate their strategy and step up implementation to ensure that positive effects materialize. A key milestone will be the successful conclusion of the first wave of IPOs (Air Astana, KazakhTelekom, KazAtomProm). Other IPOs and asset sales should follow (e.g., KazMunaiGas, Samruk Energy and electricity distributors, etc.). In light of diversification and development objectives, special attention is needed for reforms and productivity in the agriculture and transportation sectors.

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