Republic of Kazakhstan—2015 Article IV Consultation

Concluding Statement of the IMF Mission

May 26, 2015

An IMF mission, led by Hossein Samiei, visited Almaty and Astana during May 13-26 to conduct the 2015 Article IV consultations. The mission met with government and central bank officials, and representatives of the private sector and civil society. In view of large and likely long-lasting external shocks, discussions centered on the policy response, including (i) the implications of the fiscal stimulus for medium-term sustainability and (ii) overhauling the monetary and exchange rate policy framework. The mission thanks the authorities and other counterparts for their hospitality and very helpful and productive discussions.

Outlook and risks

1. Against the backdrop of mostly external shocks, economic growth has decelerated, financial conditions have tightened considerably, and external imbalances are emerging. Real GDP growth slowed to 2.2 percent year-on-year in the first quarter of this year, down from 4.3 percent in 2014 and 6 percent in 2013, driven by spillovers from the slowdown in key trading partners, lower oil prices and output, and weaker domestic demand. Bank lending growth has also decelerated sharply and latest figures point to a nominal contraction in private sector credit of about 1 percent year-on-year. As a result inflation has been falling, reaching 4.6 percent year-on-year in April—well below the authorities' objective range of 6–8 percent. Despite weaker domestic demand, we project a current account deficit of around 4 percent of GDP by end-2015, primarily because of lower revenues from oil exports. At the same time, the propensity for speculative currency attacks in the context of a tightly-managed exchange rate has contributed to an increase in dollarization over the past year.

2. The outlook for growth has weakened, with risks predominantly on the downside. GDP growth is projected to decelerate to 2 percent this year, despite the fiscal stimulus. Lower oil prices, weaker demand from Russia and China, and continuing delays in the Kashagan oil field are the main factors behind the projected slowdown. The medium-term growth outlook is also less favorable than seen earlier as lower oil prices and the secular slowdown in Russia are expected to weigh down on non-oil potential growth in Kazakhstan. We now estimate potential growth at around 4¾ percent (vs. previous estimates of 5½–6 percent). Downside risks to the economic growth outlook are mainly external, and are mostly related to oil prices and regional uncertainty, while prolonged tightness in credit is a source of downside domestic risk.

Fiscal Policy

3. The multi-year fiscal stimulus package is justified on countercyclical grounds and infrastructure needs, and given large buffers. The Economic Support Package (Nurly Zhol), financed two-thirds from the national oil fund and one-third from multilateral development banks (MDBs), is expected to total around $20 billion or 7.3 percent of GDP over the next 3-5 years. Despite the stimulus, we project growth to remain well below potential during 2015-16 (averaging about 2½ percent). The stimulus is appropriately frontloaded, and aimed at modernizing critical infrastructure deficiencies, promoting private sector development, including lending through commercial banks to small -and medium-sized enterprises (SMEs), and recapitalizing the Problem Loan Fund (PLF). Large fiscal buffers, including the sizable oil fund (35 percent of GDP) and low public debt (15 percent of GDP), can accommodate the countercyclical policy response. We also welcome the involvement of multilateral development banks (MDBs) in selecting and monitoring infrastructural projects.

4. However, to ensure fiscal sustainability, the stimulus must be accompanied by medium-term fiscal consolidation. The consolidated nonoil deficit of the general government (measured on IMF methodology) is expected to widen this year, reaching 11.3 percent of GDP. Based on announced policies, and given a small decline in expenditure as a share of GDP over the medium term, we project the nonoil deficit to fall gradually to 8.7 percent of GDP by 2020. This compares with our estimated medium-term sustainable nonoil deficit of 5.5 percent of GDP. To close this projected gap, the authorities have suggested improvements in tax administration (including the recent integration of the tax and customs administrations) and unspecified cuts in expenditure. In our view, to maintain a reasonable expenditure path, measures to boost the revenue base are needed, which will also help reduce the reliance on oil revenue. Potential measures could include (i) reducing tax exemptions, including those associated with the Special Economic Zones, (ii) strengthening enforcement of tax collection, and (iii) making income taxes more progressive. In the period ahead, we expect the authorities to specify more clearly their plans to close the gap over the medium term.

5. Enhancing the fiscal policy framework is critical to ensuring transparency and medium-term sustainability. Despite important improvements introduced in the authorities' 2013 fiscal strategy, in particular to enhance fiscal projections, the framework remains fragmented with ambiguous anchors. Key priorities include integrating fiscal policy into a broader macroeconomic policy framework and expanding the budget coverage to all fiscal activity. Moreover, budget transparency could be strengthened by fully incorporating the oil fund into fiscal accounts and using the implied consolidated non-oil deficit for the general government to anchor fiscal policy. The IMF stands ready to further assist the authorities in enhancing their fiscal policy framework, including aligning the methodologies for reporting overall fiscal and non-oil fiscal balances.

Monetary and Exchange Rate Policy

6. Tight monetary policy has helped lower inflation, but weak output and credit growth require caution in keeping interest rates too high for too long. Over the past year, under the impact of mounting speculative strain on the currency and rising dollarization of bank deposits, tenge liquidity conditions have tightened and money market interest rates trended higher. Since December, with the use of overnight currency swap and repo instruments, the National Bank (NBK) has managed to stabilize short-term interest rates at around 11-13 percent, which has helped dampen pressure on the tenge. At the same time, in view of rapidly declining inflationary pressures, subdued output growth, and weak lending conditions, the authorities should carefully evaluate the tradeoffs between the need for a tightening bias to contain the pressure on the currency and the goal of reviving lending and economic activity and stabilizing inflation around its objective range.

7. Steps being taken to overhaul the monetary policy framework in support of inflation targeting are laudable, including strengthening communication, the imminent introduction of an effective policy interest rate, and enhanced governance. The recently published monetary policy guidelines for 2015 and 2020 stress the planned introduction of a new policy interest rate, supported by open market operations, during the early phase of the transition to inflation targeting. The NBK has also recognized the need to strengthen its governance structure. In this regard, we welcome the proposed setting-up of a monetary policy committee (MPC) and greater central bank independence in policy decision making. Moreover, the NBK should also establish a money market committee responsible for the implementation of monetary policy, including the daily assessment of banking sector liquidity conditions and interbank market developments. Modernizing the monetary policy framework will also help the plans to develop Astana as an international financial center.

8. Greater exchange rate flexibility in tandem with the introduction of new monetary policy instruments is needed to enhance the policy architecture and alleviate imbalances. While buffers allow the NBK to continue to manage the exchange rate tightly for a reasonable period of time, increasing flexibility will help the economy absorb external shocks and alleviate external imbalances. It is also a precondition for a successful introduction of inflation targeting and an effective channel for the transmission of interest rate policy. Greater exchange rate flexibility could be introduced by widening the exchange rate band initially, with the aim of removing the band altogether when conditions allow. To ensure financial stability, it is critical for the NBK to communicate its plans consistently and credibly.

Financial Sector

9. In view of rising vulnerabilities, further actions are needed to bolster financial sector resilience. Slowing economic activity is weighing down on the banking sector. Tight liquidity is weakening bank profitability and exerting downward pressure on capital adequacy. Moreover, dollarization and tenge shortages are increasing balance-sheet vulnerabilities, with potential widening of currency and maturity mismatches. In this regard, we welcome the authorities' plans to shore up macroprudential policy by strengthening capital adequacy requirements through increasing risk weights on loans denominated in foreign currency. We encourage adherence to prudential limits on loan concentration, aiming toward reducing exposures to single counterparties. On the other hand, measures are also needed to ease liquidity constraints and spur credit growth in order to reverse the decline in financial intermediation—a key driver of private sector led growth. Finally, we welcome the progress made toward implementing the Financial Sector Assessment Program (FSAP) recommendations and encourage the NBK to adopt risk-based supervision as a priority and implement recommendations to buttress the crisis resolution framework.

10. Efforts to reduce the large stock of NPLs are paying off. We welcome the removal of some of the legal and tax obstacles to NPL write-offs and transfer to Special Purpose Vehicles (SPVs), which has helped reduce the level of NPLs to 23.5 percent of total loans (from around 34 percent a year ago). The decline in NPLs has also been helped by the 10 percent prudential ceiling. We support the recapitalization of the PLF to help in achieving this ceiling and stress the need for the PLF to operate on a commercial basis. Looking ahead, the significant weakening in economic growth, especially in certain segments of the non-oil sector that borrow from banks, could give rise to new NPLs. In this regard, and in line with the FSAP recommendations, we urge that an asset quality review of banks be undertaken by an independent party, starting with the merged KKB-BTA entity, which accounts for 70 percent of total NPLs, following the completion of the merger. As stipulated in the relevant legal acts, the use of public funds to help resolve the NPLs of KKB-BTA should be transparent and the entity's operations should be on a commercial basis.

Structural Reforms

11. The recent shocks to the economy reinforce the urgency of implementing structural reforms, to ensure durable long-term growth and shared prosperity. Socio-economic indicators are moving in tandem with the slowing economy. Despite concerted efforts, income disparities persist along the urban-rural divide and between regions. Diversification away from the extractive industry and the reduction of the state footprint in the economy are necessary to sustain improvements in public welfare and to help create jobs for the growing population. Addressing infrastructure bottlenecks, strengthening human capital, building institutions, bolstering the rule of law, enhancing financial intermediation, and improving business climate have been identified by both the authorities and development partners as key areas where further improvements are essential to achieve broad and inclusive growth. In this regard, we welcome the planned project finance and budget support programs with the MDB's, which offer a framework for implementing structural reforms in these priority areas.