INTERNATIONAL MONETARY FUND

Kazakhstan: Staff Concluding Statement of the 2021 Article IV Mission

November 17, 2021

Washington, DC: An International Monetary Fund (IMF) mission, led by Mr. Nicolas Blancher, conducted discussions on the 2021 Article IV consultation during Nov 4-17 in Almaty and Nur Sultan. This statement summarizes the main conclusions and recommendations of the mission. At the end of the visit, the mission issued the following statement:

Recent developments, outlook, and risks

1. Kazakhstan's economy is recovering from the combined COVID pandemic and oil market shock. In 2020, output contracted for the first time in over 20 years—by 2.5 percent—due to reduced oil production and domestic activity. The turnaround that began in late 2020 has fostered real GDP growth in 2021 of 3.5 percent through October, returning output to its pre-Covid level. Inflation has exceeded the 4-6 percent target band of the National Bank of Kazakhstan (NBK) since the onset of the pandemic, and stood at 8.9 percent in October, driven mostly by food prices. Credit growth accelerated to 16 percent in September 2021, reflecting rapid growth in consumer lending and large state support programs. Labor market and poverty indicators have remained resilient throughout the pandemic, with unemployment stable at about 5 percent.

2. The authorities' policy response played a key role in mitigating the impact of the shocks on livelihoods and economic activity. Policy measures included regulating prices for socially important goods, cash transfers to vulnerable households, and targeted assistance to hard-hit sectors and small and medium-sized enterprises, including subsidized lending and tax exemptions. Projects under the "Employment Roadmap" program helped support employment. After raising the policy rate in early 2020, the NBK maintained an accommodative monetary policy. The authorities also eased regulatory and prudential requirements for banks, while encouraging them to grant loan repayment deferrals to eligible borrowers.

3. **The economic recovery is expected to continue, with risks broadly balanced.** Growth should reach 3.7 percent in 2021 and converge to its potential (4 percent for the non-oil sector) over the medium term. Inflation may remain elevated in the near term due to strong domestic demand and global supply disruptions but should ease towards the NBK's target band in late 2022. After a significant improvement in 2021 due to favorable commodity prices, the current account would gradually return to a deficit of about 3 percent of GDP in the medium term. The main risks to this outlook are lower-than-expected vaccination rates, slower growth of trading partners, lower oil prices, and persistent inflationary pressure, which could require further monetary policy tightening. By contrast, higher-than-expected oil prices would be an upside and strengthen buffers against shocks.

Monetary and exchange rate policy

4. **Further monetary policy tightening may be needed in the short term to contain inflation.** Headline inflation and inflation expectations have increased well above target for most of 2020 and 2021 due to rising international food prices, pent-up domestic demand, and imported inflation. Gradual increases in the policy rate in recent months were warranted, and further tightening may become necessary to ensure that inflation expectations remain anchored. Given existing weaknesses in monetary transmission, recent efforts to better coordinate monetary and fiscal policy implementation, as well as government initiatives to mitigate the impact of domestic supply chain disruptions, should also help curb inflation.

5. **Continued progress has been made in the transition to full-fledged inflation targeting.** The flexible exchange rate served Kazakhstan well during the pandemic. Recent improvements in the monetary policy framework relate to (i) policy transparency, with the publication of the NFRK's FX transactions and increased communication; (ii) policy independence, with the new Monetary Policy Committee and NBK's planned exit from subsidized credit programs; and (iii) efforts to enhance analytical capacity to inform policy decisions. Going forward, in line with the NBK's 2030 strategy, strengthening monetary policy effectiveness will require efforts to further develop domestic capital markets, reduce dollarization, coordinate with fiscal policy, manage excess bank liquidity, and eliminate non-core mandates and quasi-fiscal activities of the NBK. Regular surveys to gauge inflation expectations could also be improved.

Financial sector stability

6. **Financial sector policy should continue to balance supporting the economic recovery and safeguarding financial stability.** Following the 2019 asset quality review and subsequent supervisory interventions, the banking system has weathered well the impact of the COVID shock, with bank profitability, liquidity and capitalization remaining strong. As the recovery continues, the authorities plan to unwind most of the anti-crisis regulatory measures introduced last year by the end of 2021. In this transition, the authorities should carefully monitor any new risks, including from fast-growing consumer lending, which may require targeted macro-prudential measures to avoid an excessive debt build-up in the household sector.

7. Recent efforts to strengthen financial oversight are commendable. A stronger and more risk-based supervisory framework will be critical to promote sound risk management practices, prevent the recurrence of severe banking sector distress, and limit public liabilities in the future. The recently created financial regulatory agency (ARDFM) is actively building capacity to align this framework with international standards, including through the introduction of regular asset quality reviews and stress tests in collaboration with financial institutions. Close cooperation between the ARDFM and the NBK in ensuring financial stability will be essential going forward and would benefit from clearer accountability and more formalized protocols for information exchange.

8. Further strengthening the bank resolution framework will also be important. While the framework was upgraded in 2019 and special resolution tools were introduced, the exact mandate and scope of the resolution authority could be clarified further, and its staff should be granted stronger legal protection. Recently, the ARDFM revoked the licenses of several small banks and relied on court-based liquidation procedures, sending important signals about changes in policy implementation and the responsibilities of bank managers Ongoing efforts to develop a distressed asset market are also welcome. Going forward, continued efforts to strengthen the resolution framework will be needed to ensure effective and orderly resolution of failing banks. The next FSAP for Kazakhstan, expected in 2022, will be an opportunity to assess fully its financial stability framework.

Fiscal policy and framework

9. Gradual fiscal consolidation post-COVID should help preserve buffers. Kazakhstan appropriately used its substantial buffers to cushion the impact of the pandemic. For 2021, the projected non-oil fiscal deficit of 8½ percent of GDP for 2021 strikes an appropriate balance between fiscal prudence and targeted support for the economy. On this basis, government net financial assets would decline to 5 percent of GDP by end-2021, from 14 percent of GDP in 2019. By 2025, the authorities plan to reduce the non-oil deficit to 6 percent of GDP, which would require an additional adjustment of 1-2 percent of GDP and allow Kazakhstan to remain a net creditor and foster intergenerational equity.

10. Medium-term fiscal consolidation could build on a range of reforms. Non-oil tax revenues in Kazakhstan are low by international standards, and the targeted non-oil deficit should be achieved in part through increased non-oil revenues to avoid spending cuts that would unduly weigh on economic activity. The authorities' plans to strengthen revenue administration, reduce informality, and promote digitalization should be complemented by additional measures to broaden the tax base (e.g., by streamlining CIT exemptions and taxing capital income), raise tax rates (e.g., VAT rates, which are comparatively low), and introduce a progressive income tax and possibly a carbon tax consistent with the country's net emission commitment under the Paris agreement. There is also scope to prevent excessive pressure on spending needs on infrastructure and social programs by increasing the efficiency of public expenditure. This would benefit from detailed performance reviews and from reforms to streamline public employment and improve the efficiency of the civil service.

11. The authorities' goal to introduce new fiscal rules to safeguard sustainability and intergenerational equity, and make fiscal policy more countercyclical, is welcome. Based on international experience, these goals can be best achieved through a simple set of rules, which is easy to monitor and communicate. Specifically, (i) a long-term anchor (i.e., preserving positive net financial assets for the public sector) would be consistent with fiscal sustainability and intergenerational equity, and could be complemented by (ii) a limit on the non-oil deficit as a share of non-oil GDP, or on the growth of government expenditure. Additional fiscal rules may unnecessarily constraint annual budgets, hamper sound execution, and ultimately weaken policy credibility. To preserve flexibility, escape clauses should also be incorporated, and an independent fiscal council should be created to monitor the implementation of the fiscal rules.

12. A sound fiscal framework requires stronger public financial management institutions and transparency. To be fully effective, fiscal rules should apply to a broad definition of fiscal accounts, encompassing the general government, in line with international standards. Managing fiscal risks is also essential to support the credibility and effectiveness of fiscal policy, and ongoing preparations of the first annual Fiscal Risks Statement (FRS) are welcome. Given their large size and complexity, the FRS should cover quasi-government entities, and public debt reporting should be expanded to adequately cover their debt, which is substantial. These efforts would benefit from a Fiscal Transparency Evaluation (FTE) by the IMF.

Structural reforms

13. In the long term, increasing the level, resilience, and sustainability of economic growth in Kazakhstan will necessitate greater economic diversification. The current development model based on the production and exports of natural resources will not be sustainable in the transition to a low-carbon global economy. New sources of growth and job creation, driven by the private sector, will depend critically on the pace of structural reforms to make the economy more market-based and to manage the impact of climate change. Reform plans articulated recently as part of 10 National Projects (including supporting agriculture and non-carbon sectors, promoting entrepreneurship, and improving access to social services) will support this transition. Given the multiplicity of challenges and needed actions, reform prioritization will be essential.

14. Private sector development calls for a deep transformation of the public sector. The state retains a heavy footprint in the economy via sector-specific interventions and broad public ownership, especially post-COVID. The rationale for the activities of state-owned enterprises (SOEs) should be reevaluated, and SOE risk management, governance, and transparency enhanced. The authorities' plan to resume privatizations post-COVID is welcome. In addition, the recent creation of an independent competition agency is a promising reform that should help reduce barriers to market access, trade, and investment.

15. The focus on improving governance and anti-corruption reforms should continue. Measurable benchmarks would help monitor the implementation of the 2015–25 National Anti-Corruption Strategy. Ongoing digitalization of tax and custom administration will help enhance public spending control. The recently amended public procurement law will also further support competition and aims to enhance transparency in public spending by requiring the disclosure of beneficial ownership of entities contracting with the government. A new asset declaration law has entered into force and can contribute to the fight against corruption if properly implemented. Further efforts are needed to align the AML/CFT regime with international standards and to improve its efficacy in fighting corruption.

16. The authorities are to be commended for their commitment to achieve carbon neutrality by 2060. Climate issues are particularly challenging for Kazakhstan given its outsized hydrocarbon sector, reliance on coal, and high per-capita greenhouse gas emissions. Early policy planning will be key to manage the medium- to long-term impact of climate change: specific actions will need to be identified to meet these goals and prepare for the transition to a low-carbon world. In particular, the costs of required public investments should be incorporated into the macroeconomic and fiscal frameworks. Raising the price of carbon, including by gradually eliminating the substantial energy subsidies, would align incentives to achieve the emissions reduction targets, while providing resources to finance a just transition. However, such reforms should proceed gradually, so that social safety nets can be adequately developed to mitigate the impact on vulnerable population groups, while providing room for the private sector to also achieve its structural transformation.

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The staff team is grateful to the authorities and a broad range of public and private sector counterparts for constructive discussions and their hospitality.

Kazakhstan: Selected Economic Indicators, 2019–23

	2019 (est.)	2020 (est.)	2021 (proj.)	2022 (proj.)	2023 (proj.)
Output					
Real GDP growth (%)	4.5	-2.5	3.7	3.9	3.1
Real oil	0.1	-4.7	0.5	1.6	0.0
Real non-oil	5.9	-1.8	4.6	4.6	4.0
Crude oil and gas condensate production (million tons)	90	86	86	88	88
Employment					
Unemployment (%)	4.8	4.9	4.8	4.7	4.7
Prices					
Inflation (%)	5.4	7.5	8.5	6.0	4.5
General government finances					
Revenue (% GDP)	19.7	17.5	18.8	19.3	19.3
Of which: oil revenue	6.9	3.4	6.0	6.3	5.8
Expenditures (% GDP)	20.3	24.6	21.4	20.4	20.0
Fiscal balance (% GDP)	-0.6	-7.1	-2.6	-1.0	-0.7
Non-oil fiscal balance (% GDP)	-7.5	-10.5	-8.7	-7.3	-6.5
Gross public debt (% GDP)	19.9	26.4	24.7	25.7	27.5
Money and credit					
Broad money (% change)	2.4	16.9	13.4	10.5	9.5
Credit to the private sector (% GDP)	21.3	22.0	20.9	20.9	21.1
NBK policy rate (%, eop)	9.3	9.0	…	…	…
Balance of payments					
Current account (% GDP)	-4.0	-3.8	-0.9	-1.4	-2.6
Net foreign direct investments (% GDP)	-3.2	-3.5	-1.4	-2.3	-2.6
NBK reserves (in months of next year's imports of G&S)	7.7	8.5	8.4	8.3	8.1
NFRK assets (in months of next year's imports of G&S)	16.4	14.0	13.6	14.1	14.4
External debt (% GDP)	87.6	96.0	83.0	79.5	77.5
Exchange rate					
Exchange rate (y-o-y percent chage; Tenge per U.S. dollar; eop)	-0.8	10.4	…	…	…

Sources: Kazakhstani authorities and Fund staff estimates and projections.