

KAZAKHSTAN COUNTRY ECONOMIC REVIEW UPDATE

I. RECENT ECONOMIC DEVELOPMENTS

A. Growth, Investment, and Wages

1. The economy began to recover from the recession caused by the weak world commodity markets and the Russian crisis in the second half of 1999. Economic performance has continued to improve in 2000, with GDP growth accelerating to about 11 percent in the first seven months of the year.¹ The strong rebound was driven mainly by increases in domestic production, exports, and capital investment, which benefited from two favorable external factors: rising world prices for oil and metals (Kazakhstan's major exports) and the robust recovery in Russia.

2. Industrial output grew by 4.6 percent in 1999 and growth accelerated to 16 percent in the first seven months of 2000, mainly because of sharp increases in production of oil, gas and metals. In response to mounting world prices, in the first eight months of 2000 output of crude oil and gas condensate expanded by 15.1 percent to 22.4 million tons, while output of gas rose by 25.5 percent to 5.7 billion cubic meters. Production of metals went up by 45 percent in the first half of 2000. Processing industries, notably chemicals, machinery, and textiles, also experienced growth.

3. The agriculture sector grew rapidly by 22 percent in 1999, but growth slowed to 4.6 percent in the first half of 2000. Kazakhstan achieved a good grain harvest in 1999, with total output of grain of 14.3 million tons, more than double the 1998 output. As a result, the country exported about 3 million tons of grain to neighboring countries such as Turkmenistan and Ukraine. However, the Government projects that output of grain in 2000 will be slightly less than the 1999 level due to unfavorable weather conditions.

4. After a modest increase of 3.8 percent in 1999, capital investment expanded by 29 percent in the first half of 2000 as the Government increased development expenditures to stimulate economic recovery. Because of the expansion of investment, construction activities remained strong, as reflected by work on the export pipeline in the Caspian Sea areas and the continuing construction and refurbishing of Astana, the new capital.

5. Rapid economic growth has resulted in an increase in wages. Average nominal monthly wages in the first quarter of 2000 were T12,362 (equivalent to \$90), a 28 percent rise over the same period of 1999. This represented an increase in the real average monthly wages by 7 percent in the first quarter of 2000. Since late 1999, the Government has taken action to reduce wage arrears. Total wage arrears at the end of March 2000 were reduced by 30 percent to T17.9 billion (\$126 million) compared with the same period of last year.

B. Fiscal Developments

6. The fiscal situation has improved, helped by strong economic growth, higher oil export revenue and the Government's efforts to strengthen tax collection and improve public

¹ The higher growth rate resulted, in part, from the low base in the first half of 1999, when the economy was at the bottom of the recession.

expenditure management. In 2000, the Government has maintained a tight fiscal policy to further improve the fiscal position. In the first half of 2000, the state budget achieved a surplus of T19.5 billion (1.8 percent of GDP) because of better revenue collection. Government revenues were recorded at T266 billion (25.1 percent of GDP), an increase of 67 percent compared with the same period of 1999. Tax revenue reached 22 percent of GDP, up from 17 percent of GDP in 1999. Government expenditures amounted to T246 billion (23.3 percent of GDP), rising by 56 percent over the same period of 1999. However, as the Government plans to increase budgetary expenditures significantly in the second half of 2000, the state budget is projected to experience a deficit of about 3 percent of GDP for 2000 as a whole.

7. As budgetary revenues become highly dependent on volatile oil exports, the Government has recently established an offshore state oil fund to maintain stable resource flows to the budget and preserve national wealth generated from the oil sector for the country's future economic and social development.

C. Monetary Developments and Inflation

8. Since late 1999, the monetary policy has been designed and implemented to stimulate economic recovery while keeping inflation under control. Three major policy measures were adopted by the central bank. First, the refinancing rate was reduced three times from 25 to 18 percent in 1999 and further to 14 percent in the first half of 2000. Second, the requirement that exporters must sell 50 percent of their export earnings to the central bank was abolished in November 1999. Third, reserve requirements for commercial banks were lowered from 10 to 8 percent of demand and 1 to 3-month time deposits. As a result, the monetary stance has eased and growth of monetary aggregates has accelerated. In the first half of 2000, money supply (M2) and bank credits increased by 80 percent and 56 percent, respectively, over the same period of 1999.

9. The rate of inflation was 17.8 percent in 1999, largely due to the effect of currency devaluation. However, inflation has subsided since the second half of 1999 and was 5.1 percent in the first eight months of 2000, much lower than 13.7 percent in the same period of 1999. Slower inflation was due to increased productivity, improved fiscal position, and the stable national currency. The national currency, the tenge, which depreciated sharply against the US dollar after the authorities floated it in April 1999, has largely stabilized since the second half of 1999. In the first eight months of 2000, the tenge was stable at around T138-143 per US dollar, depreciating only by 2.5 percent against the US dollar since the beginning of 2000.

D. External Trade and Balance of Payments

10. The balance of payments situation experienced encouraging developments. The external current account deficit was reduced from 5.6 percent of GDP in 1998 to 1.1 percent in 1999, and a current account surplus (7.9 percent of GDP) was achieved in the first half of 2000. This resulted mainly from the improvement of the trade account from a deficit of \$0.8 billion in 1998 to a surplus of \$0.6 billion in June 2000 due to export expansion. Exports, particularly oil and metal exports, have climbed since late 1999 because of the growing world prices, increased oil export quota through the Russian pipeline,² and the effect of the currency devaluation. In the

² Russia raised Kazakhstan's annual oil export quota through its pipeline from 12.5 million tons to 14 million tons in April 2000.

first half of 2000 exports doubled, while imports grew by 16 percent compared with the same period of 1999.

11. Foreign direct investment (FDI) increased in the first half of 2000, as investor confidence improved after the Russian crisis. Inflows of FDI were estimated to reach about \$1 billion over the past 12 months. As the first CIS country to return to the global capital markets after the Russian crisis, Kazakhstan issued a five-year Eurobond totaling \$300 million during September-November 1999, and a seven-year Eurobond in an amount of \$350 million in April 2000.³ The Eurobonds were received well, helping the country to raise external funds for domestic needs. Due to the improved economic performance, Standard & Poor's in July 2000 raised Kazakhstan's long-term foreign currency rating from "B+" to "BB-" and its long-term local currency rating from "BB-" to "BB". The upgrading will further boost the confidence of investors in Kazakhstan.

12. Strong export growth, renewed inflows of FDI, and the issuance of the Eurobonds have helped strengthen Kazakhstan's international reserves position. Gross international reserves began to recover in the second half of 1999 and rose to \$2.1 billion (equivalent to about 3 months of imports) at the end of August 2000, the highest level since the country attained independence in 1991. External debt decreased from \$7.9 billion (50 percent of GDP) at the end of 1999 to \$7.5 billion (39.7 percent of GDP) in June 2000, owing to the Government's early repayment of its outstanding debt (\$390.5 million) to IMF in May 2000. Due to growing export revenue, the debt-service ratio declined from 27.3 percent in December 1999 to 26 percent in June 2000.

E. Structural Reform

13. Progress has been made on structural reform. In the fiscal area, the Government has set up a system of monitoring the financial performance of companies that have received its guarantees. The first two companies (i.e., Kazakhstan Electrical Grid Operation Company and Kazakhstan Temir Zholy, the National Railway Company) under the new system have submitted the necessary documents to the Government and established the required escrow account. A program to improve collections of excise duties on oil products has been introduced and a new tax code is under preparation.

14. Steps have been taken to strengthen the financial system. The Government in late 1999 sold 16.7 percent of its share in the Halyk Savings Bank. With the consolidation efforts, the number of commercial banks operating in Kazakhstan declined from 57 to 48 in the first half of 2000. The central bank introduced deposit insurance covering short-term deposits for households in early 2000. Parliament in March 2000 approved amendments to the legislation on banking secrecy, which contain the powers of the tax authorities on banking transactions and provide confidentiality for households. Amendments to the Law on Banks and Banking, which require banks to submit consolidated financial statements, were submitted to Parliament in July 2000. Because of the progress on financial sector reform, depositors regained their confidence and bank deposits rose sharply by 90 percent in the first half of 2000.

15. In the trade area, the Government in March 2000 issued a decree converting the remaining items (except for alcohol) subject to specific tariffs into *ad valorem* rates so as to

³ The five-year Eurobond was priced at 777 basis points over the US treasury notes, with coupon interest of 13.625 percent. The seven-year Eurobond was comparatively cheaper, with 500 basis points over the US treasury notes and coupon interest of 11.125 percent.

strengthen duty collection. While a crude oil export quota was introduced in late 1999 to improve the supply for domestic refineries, the quota was abolished in late April 2000. The Government submitted a new application for membership of WTO in April 2000.

16. Efforts have been made to develop a legal framework necessary for a market economy. Parliament approved a new Labor Law in late 1999 and a new Leasing Law in July 2000. New draft laws on bankruptcy and collateral have been submitted to Parliament. A new draft Land Law was resubmitted to Parliament in early 2000 and was published for public discussion; Parliament plans to consider the draft Land Law in late 2000. A series of decrees have been issued on implementing the rules and regulations under the new Civil Service Law.

17. Despite the progress, reform has been lagging in some areas. The pace of privatization of large state-owned enterprises (SOEs) has been slow, with only four large companies having been sold so far in 2000. This resulted in privatization proceeds accounting for 0.9 percent of GDP in the first half of 2000, considerably lower than the Government's target. A number of measures were also adopted to restrict trade activities in early 2000. These included introducing an export ban on fuel oil and diesel, which remains in place; and renewing temporary tariffs of up to 30 percent on inputs for the construction industry, drilling tools and some electrical devices. The Government needs to enhance its efforts to accelerate privatization of large SOEs and to reduce and eventually eliminate trade barriers.

II. ECONOMIC PROSPECTS

18. The short-term economic outlook appears positive. The Government has revised upward its projection of GDP growth for 2000 from 3 percent to about 7 percent, based on higher world prices for oil, gas, and metals and the continuing economic recovery in Russia, the major trading partner of Kazakhstan. The energy and mining sectors are projected to perform well and production of crude oil and metals will likely continue to surge, given the favorable external environment, growing FDI, and the projected expansion of oil export capacity.⁴ The state budget deficit for 2000 will likely shrink to about 3 percent of GDP, as the Government is committed to achieving medium-term sustainability of public finance. Inflation for 2000 is projected to decline to about 9 percent, provided the central bank keeps tight control on credit growth and money supply. The balance of payments situation for 2000 should further improve with a projected current account surplus, as exports of oil and metals are expected to grow steadily and inflows of foreign capital continues to increase. The economic prospects over the medium term, however, will depend on development of the domestic oil sector and export capacity, the world commodity markets, and the economic performance of Russia.

19. In August 2000, a new oil field containing an estimated 50 billion barrels was discovered in Kashagan, West Kazakhstan. This could enable Kazakhstan to produce 100 million tons of crude oil a year in the future. With this discovery, Kazakhstan may become among the top five oil and gas producing countries in the world. However, Kazakhstan will need a huge amount of capital both to extract the oil from Kashagan and deliver it to the world markets.

20. The Government remains committed to implementing its economic program for 2000-2002. The program, which is supported by the IMF under a three-year Extended Fund Facility (EFF) approved in December 1999, is aimed at achieving rapid economic growth and macroeconomic stabilization by adopting prudent fiscal policies that consolidate public finances,

⁴ The new oil export pipeline from the Tengiz oil field of Kazakhstan to the Russian Black Sea port of Novorossisk is expected to become operational in the second half of 2001.

reducing inflation while maintaining a free-floating exchange rate, and accelerating structural reforms. The IMF's EFF program remains on track. While the Government does not plan to draw on IMF's resources soon, it intends to use IMF's program to pave the way for seeking financial assistance from other donors and attracting FDI into the country.

III. MAJOR ECONOMIC ISSUES

21. Despite the recent economic rebound and the positive short-term economic prospects, Kazakhstan needs to address four major issues so as to realize sustained, equitable economic development. These are (i) diversification of the economic structure, (ii) external debt management, (iii) corporate sector reform, and (iv) reduction in unemployment and poverty.

22. First, the economy is highly dependent on the exports of oil and metals, which are in turn reliant on the world market conditions. Such an economic pattern not only raises the risk of "Dutch-disease", but also makes Kazakhstan vulnerable to world commodity price fluctuations. While the present surging world prices of oil, gas and metals have benefited the economy, this situation is unlikely to be sustainable over the medium term. To reduce the risks, Kazakhstan needs to diversify the economy by broadening the production base, developing new industries, and promoting production of value-added products in the resource-based sectors.

23. Second, until 2000 external public debt had risen sharply. By the end of 1999, total external public debt amounted to \$4.1 billion (25.3 percent of GDP) and interest payments in the 2000 state budget account for 21 percent of revenues. The large external public debt burden can place macroeconomic stability in jeopardy since heavy debt repayments pose serious difficulties for the government's fiscal position and the balance of payments situation. Moreover, large external public debts will have adverse effects on the sustainability of economic growth, because a sizeable portion of government expenditures must be used for debt servicing, thus leaving limited resources for public investment projects and other development purposes. The Government needs to formulate and implement a sound borrowing strategy so as to reduce external public debt to manageable levels.

24. Third, despite the Government's initial enterprise reforms, the corporate sector remains weak. Many enterprises have limited operational experience in a market-based economy. Old management remains in control of some privatized firms, while the Government still intervenes in operations of privatized or corporatized enterprises. This has resulted in extensive corporate losses and inter-enterprise arrears. About half of all enterprises were estimated to be unprofitable at the end of 1999. By March 2000, total inter-enterprise arrears amounted to nearly T1.4 trillion (\$9.6 billion), a 35 percent increase over the same period of 1999. Strong efforts are required to develop an efficient corporate sector through the enforcement of bankruptcy and merger proceedings, accelerated enterprise restructuring, and improved corporate governance.

25. Finally, the current economic growth is narrow-based (mainly oil, gas and metals subsectors) and has not led to a widespread improvement of the people's living standards. Unemployment and poverty remain serious problems. The officially recorded unemployment rate was 4.4 percent in May 2000, up from 3.9 percent in December 1999. However, actual unemployment is higher because some of the officially employed are on forced- or unpaid-leave and many unemployed persons are not officially registered. The Government indicates that 43 percent of the population lived below the poverty line at the end of 1999, compared with 25 percent in 1992. Regional income disparities are widening, with south Kazakhstan and the Almaty region being the lowest. In June 2000, the Government approved a State Program on

Fighting Poverty and Unemployment. The program, which will be implemented during 2000-2002, aims to reduce poverty and unemployment through the creation of income-generating job opportunities, improvement of social services delivery, and strengthening of the social safety net. Efforts are needed to develop an action plan and effective monitoring mechanisms to ensure that the program can be implemented successfully.

Major Economic Indicators, 1997-2000 ¹

	1997	1998	1999	2000 Jan-Jun	2000 Projection
Real GDP Growth	1.7	-1.9	1.7	10.5	7.0
Fiscal Balance (% of GDP)	-7.0	-8.0	-3.5	1.8	-3.0
Inflation Rate (end of period)	11.3	1.9	17.8	4.5	9.5
Money Supply (M2) Growth	29.2	-13.3	83.4	80.2	40.8
Current Account Balance (% of GDP)	-3.6	-5.6	-1.1	7.9	6.3
External Debt (% of GDP)	26.7	33.8	49.9	39.7	n.a. ²
External Debt Service (% of exports)	27.5	22.8	27.3	26.0	n.a. ²
Gross International Reserves (\$ million)	2,244	1,964	2,003	1,911	2,200
Exchange Rate (Tenge/\$, end of period)	75.9	84.0	138.2	142.6	146.2

¹. Figures for the period from 1997 to the first half of 2000 are actual, and figures for 2000 are projection.

² Not available.