INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

Republic of Kazakhstan — Assessment Letter for the Asian Development Bank
April 20, 2020

Recent Developments, Outlook, and Risks

1. **Kazakhstan's economy has been affected significantly by the COVID-19 and oil price shocks.** The authorities reacted early and strongly to contain the spread of the coronavirus and minimize health risks. They closed the border with China in late January/early February, and President Tokayev announced a 30-day state of emergency from March 16, which was later extended to end-April. The largest cities have been quarantined, including with strict entry/exit provisions, non-essential businesses have been temporarily closed, and social distancing measures have been put in place. While the measures appear to have been successful in stemming the rapid spread of COVID-19, there has been an increase in cases outside Almaty and Nur-Sultan in recent days and the measures are weighing on economic activity. The decline in oil prices and production adds to an already difficult situation.

2. **GDP is expected to contract this year.** Growth was relatively strong (above 4 percent) in January and February 2020, but the twin shocks have worsened the outlook. Staff now projects a decline in real GDP of about 2.5 percent in 2020, due to both lower oil production and a decline in the non-oil sector, reflecting disruptions from the coronavirus containment measures and falling demand due to losses of jobs and income and heightened uncertainty. The contraction would have been sharper—in the range of 5-5½ percent—in the absence of the authorities' strong response. External demand will also be weaker as most of Kazakhstan's key trading partners are experiencing a deep recession. Under the baseline, a pick-up is expected in 2021; over the medium term, non-oil growth would stabilize around its potential. This is predicated on a relatively rapid conclusion of physical-distancing measures to control the virus and relatively limited structural damage to the Kazakhstan economy. It also assumes a resumption of structural reforms aimed at diversification, regional integration, improving the business environment and governance, and strengthening the agriculture sector.

3. **Inflation has increased above the National Bank of Kazakhstan's (NBK) target band.** In March, the consumer price index rose by 6.4 percent year-on-year and exceeded the upper bound of NBK's target band (4-6 percent). Inflation has been on a rising trend over the past year, reflecting increases of wage and social payments in 2019. Core inflation (excluding fruit, vegetables, fuels, and utilities) has come down in recent months but is still above 7 percent. Inflationary pressures are likely to be fueled by the recent depreciation of the tenge by over 10 percent vis-à-vis the U.S. dollar since the beginning of the year. The pass-through from depreciation may be partially offset by the weakening of demand and price controls on essential goods (flour, bread, rice, beef, eggs) imposed in early April for the duration of the state of emergency.

4. **A substantial terms-of-trade deterioration will increase the current account deficit.** At the time of the 2019 Article IV consultation, Kazakhstan's external position was assessed as moderately weaker than implied by economic fundamentals and desirable policies. The current

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account deficit was 3.6 percent of GDP in 2019, and outflows in the financial account (mostly portfolio investment) contributed to a decline in international reserves. The current account deficit is now expected to increase further in 2020. Oil exports are projected to contract significantly in value terms, due to lower prices and reduced volumes. Non-oil exports will be affected by weaker external demand. Imports are also expected to adjust, as a result of lower consumption and investment activity and expenditure-switching following the tenge depreciation. An increase in the external debt ratio is primarily driven by the tenge depreciation (along with lower oil prices and GDP), underscoring the sensitivity of debt to the exchange rate.

5. **The outlook is characterized by significant downside risks.** A key external risk for Kazakhstan is that oil prices remain at the current low levels or decline further, while oil production levels may be lower, possibly significantly lower. This would lead to a prolonged slow-down, higher fiscal and current account deficits, further depreciation of the exchange rate, and/or loss of reserves. Another risk is lower-than-projected activity in the EU, Russia, and China. Domestic risks are mainly associated with the duration and depth of COVID-19 containment measures (or spread), including on unemployment, the fiscal position, companies, and banks. There is significant uncertainty as to how events will unfold in period ahead and when restrictions will be lifted.

Economic Policies

6. **With the benefit of strong buffers and fiscal space, the authorities have launched a sizable crisis response package to support activity.** The size of the overall support is estimated at KZT 5.9 trillion (9 percent of GDP). It includes cash payments to the unemployed and self-employed (equivalent to $95 per month per person), a 10-percent increase in pension and social benefits, additional health-sector spending (e.g., wage increase, medical equipment), and support to employment and businesses. Subsidized loans will be provided through expansion of a state program, “Economy of Simple Things” (up to KZT 1 trillion), and an additional KZT 600 billion will be placed in banks in the form of deposits to finance working capital for SMEs. KZT 1.8 trillion will be allocated to support employment under the “Employment Roadmap” program. Tax and loan payments deferrals are also part of the package, and President Tokayev called on state-owned enterprises to sell all their export proceeds on the FX market. The authorities have indicated that the support package will be implemented in full in 2020; at this time, no reprofiling or offsetting of other expenditures is anticipated.

7. **With falling revenues and additional expenditure, the fiscal deficit will increase significantly.** Revenue will be adversely affected by reduced oil receipts and lower collections from the non-oil sector, especially from product and income taxes. Expenditure is projected to increase by about 3 percent of GDP, bringing the overall deficit to more than 5 percent of GDP. The deficit will be financed with a larger transfer from the National Fund (NFRK) and borrowing; the authorities have approached international financial institutions for fiscal support.

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8. Kazakhstan has substantial fiscal space, and use of buffers in the current juncture is justified. The immediate priority is to mitigate the effect of the shocks on the economy. The authorities' anti-crisis package has the appropriate mix of measures and targeting to achieve this, but it will be important to monitor the implementation and effectiveness of the various measures carefully and to make adjustments as needed. Once the effects of the coronavirus shock abate, fiscal consolidation should resume. Consolidation should come through cuts in lower-priority spending and increases of non-oil revenues, while protecting growth-enhancing social and capital spending. Fiscal risks, including from macroeconomic shocks, debt of state-owned enterprises and subnational governments, government guarantees (including new guarantees to some banks), and public-private partnerships should be closely monitored and managed. A rules-based fiscal framework would help enhance fiscal discipline. With consolidation over the medium term, public debt is projected to rise moderately—from 20 percent of GDP in 2019 to 29 percent in 2025. Debt remains sustainable, and buffers are expected to remain strong—at around 30 percent of GDP, in line with the threshold under the authorities' fiscal rules.

9. In early March, the NBK raised its policy rate and intervened for a time to stabilize the foreign exchange (FX) market; it has since adjusted its policies given developments. Pressures on the tenge intensified in early March, following the drop of oil prices, prompting the NBK to raise its policy rate from 9.25 percent to 12 percent and widen the interest-rate corridor from 100 to 150 bps. The NBK also intervened on the FX market by selling close to $1.5 billion in March. Interventions were intended to avoid disruptive corrections and did not target any particular level of the exchange rate. The NBK introduced a limit on the bid-ask spread for cash transactions and lowered the ceiling of FX purchase without supporting import documents for the duration of the state of emergency. The tenge initially depreciated by about 18 percent; it has stabilized and regained some of its value recently. On April 3, amidst increasing concerns about weak demand, the NBK lowered the base rate to 9.5 percent, with a further widening of the corridor to 200 bps.

10. In the current challenging environment, it is important that monetary policy continues to focus on price stability, maintaining exchange rate flexibility. The confluence of shocks poses difficult trade-offs to monetary policy as the depreciating tenge and rising inflation suggest tightening, while falling demand calls for accommodation. The NBK should deploy its full array of instruments to meet its mandate of maintaining price stability, while helping to mitigate the loss of output and employment. FX interventions could be used to prevent excessive volatility, while letting the tenge adjust, and liquidity should be provided to banks facing shortages. The NBK should also continue its work to improve the effectiveness of its framework and to enhance transparency and communications in line with past staff advice.

11. An asset quality review of the largest banks was recently completed. The NBK completed in February an asset quality review (AQR) of Kazakhstan's 14 largest banks, accounting for 87 percent of the assets of the banking system. The AQR identified a capital shortfall of almost $1 billion as of April 2019, concentrated in four banks. Measures taken during 2019 by the banks reduced this amount by half; the rest will be covered by shareholders (KZT

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40 billion in the course of 3 months), with the benefit of state guarantees—and in the case of one bank, a loan from the NBK—following implementation of well-defined plans.

12. **The AQR is a welcome step after several years of large-scale state support to ailing banks.** Its coverage, degree of transparency, and communication of results are commendable; the AQR should help regain trust in the banking sector. Going forward, it is important that banks put in place a new, sustainable business model, with less reliance on funding of deposits by SOEs and improved risk management and lending practices. In this regard, the newly established Agency for Regulation and Development of the Financial Market has an important role to play. It is critical to ensure that its operations are aligned with international best practices, including in coordination, oversight, crisis preparedness, safety net, and resolution. It is a cause for concern that the contraction of economic activity brought about by the COVID-19 and oil price shocks may have an adverse impact on bank finances. Banks may incur losses on their loan portfolios, which may require additional provisions. Capital buffers should be used where available, and the supervisor should ensure that the dividend policy is adjusted accordingly. It is important not to relax classification and provisioning rules and to report NPLs as accurately as possible. The authorities should continue to monitor this closely and reassess the status of exposures and the level of provisioning on a regular basis.

13. **The current crisis once again underscores the importance of structural reforms.** Kazakhstan's economy continues to be heavily reliant on hydrocarbons, and while the various reform initiatives launched by the authorities are ambitious and comprehensive, the pace of diversification has been slow, and the state remains predominant. When the economy recovers from the shocks, state support should be scaled back, and structural reforms aimed at diversification, regional integration, improving the business environment and governance, and strengthening the agriculture sector should proceed. Continuation of privatization, especially of "blue-chip" IPOs would send a strong signal, along with further efforts to modernize rail and road networks, liberalize trade, promote financial deepening and inclusion, enhance domestic competition, and improve land use and agriculture infrastructure. Sound governance arrangements are also key to inclusive growth and reducing corruption risks. The authorities are continuing to take steps to reduce vulnerabilities, including through investigation and prosecution of corruption cases.

IMF Relations

14. **Article IV consultations are conducted annually, and Kazakhstan receives technical assistance (TA) from the IMF.** Relations with Kazakhstan continue to be characterized by a fruitful policy dialogue, and recent TA has focused on monetary operations, revenue administration, public financial management, and statistics. The last Article IV consultation was concluded on January 27, 2020 and the staff report was published shortly thereafter (IMF Country Report No. 20/32). The report noted that the authorities' track record of macroeconomic management prior to the shock had been generally sound and that growth performance had been strong, in an often-challenging environment. It noted that further work is needed to step up structural reforms and diversification and to improve governance.

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Table 1. Kazakhstan: Selected Economic Indicators, 2016–2025

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
							Projections			
			(Annual percent change, unless otherwise indicated)							
National accounts and prices										
Real GDP	1.1	4.1	4.1	4.5	-2.5	4.1	3.7	5.0	3.1	3.1
Real oil	-1.3	10.5	4.5	0.1	-5.2	6.6	1.5	8.8	0.0	-0.1
Real non-oil	1.8	2.4	4.0	5.7	-1.8	3.5	4.3	4.0	4.0	4.0
Real consumption	1.6	1.5	2.9	6.7	-3.1	3.6	3.8	4.2	3.1	3.1
Real investment	2.7	2.9	3.4	5.4	-1.2	1.8	4.0	3.9	4.4	4.4
Real exports	-4.3	7.8	10.2	2.4	-7.9	7.6	3.5	6.7	2.7	2.6
Real imports	-1.8	0.8	7.1	7.9	-8.0	4.0	4.0	4.0	4.0	4.0
Output gap (in percent of potental GDP)	-1.6	-0.4	1.1	3.0	-2.1	-0.8	-0.3	1.2	0.5	0.0
Consumer price index (eop)	8.5	7.1	5.3	5.4	8.1	6.5	5.5	5.0	4.5	4.0
GDP deflator	13.6	11.2	9.2	6.3	-1.7	7.5	7.1	6.4	5.9	5.6
Real effective exchange rate	-26.7	7.0	-0.8	...	...	...	...	...	...	...
			(In percent of GDP, unless otherwise indicated)							
General government fiscal accounts										
Revenues and grants	17.0	19.8	21.4	19.9	18.0	18.0	18.0	18.0	17.8	17.5
Oil revenues	4.1	5.9	7.4	7.0	5.4	5.6	5.4	5.5	5.2	4.9
Non-oil revenues	12.9	13.9	14.0	12.9	12.6	12.5	12.6	12.6	12.6	12.6
Of which : Income Tax	5.5	5.6	6.3	6.0	5.4	5.4	5.4	5.4	5.4	5.3
VAT	3.2	3.1	3.3	3.9	3.5	3.7	3.9	3.9	4.0	4.0
Expenditures and net lending	21.6	24.1	18.9	20.5	23.3	20.8	20.3	20.0	19.9	19.9
Current expenditure 1/	18.0	20.4	15.8	17.3	19.4	17.5	17.1	16.7	16.6	16.6
Of which : Wages	2.9	2.6	2.5	2.7	3.1	2.8	2.8	2.7	2.7	2.6
Goods and services	6.1	5.9	4.1	3.9	4.3	3.8	3.7	3.6	3.5	3.5
Net transfers to other levels of government	0.0	0.0	1.5	1.5	1.5	1.5	1.4	1.4	1.4	1.4
Capital expenditure	2.8	3.2	2.7	2.7	3.4	2.8	2.8	2.8	2.8	2.8
Overall fiscal balance	-4.5	-4.3	2.5	-0.6	-5.3	-2.7	-2.3	-1.9	-2.1	-2.4
Excluding the financial support to SOEs and banks	-4.5	-0.5	2.5	-0.6	-5.3	-2.7	-2.3	-1.9	-2.1	-2.4
Statistical discrepancy	-1.0	-0.4	2.9	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Financing 2/	3.6	3.9	0.3	-0.2	5.3	2.7	2.3	1.9	2.1	2.4
Domestic financing	2.0	2.2	-0.5	1.7	0.6	2.7	3.3	3.3	3.5	3.9
Foreign financing	-0.1	-0.1	0.6	0.3	1.5	0.4	0.3	0.2	0.1	0.1
NFRK (net)	1.6	1.7	0.2	-2.2	3.2	-0.4	-1.3	-1.6	-1.6	-1.6
Gross public debt (percent of GDP)	19.7	19.9	20.3	20.2	23.1	23.7	25.0	25.8	27.3	29.0
Non-oil fiscal balance (percent of GDP)	-8.7	-10.2	-4.9	-7.6	-10.7	-8.3	-7.7	-7.4	-7.2	-7.2
Non-oil fiscal balance (percent of non-oil GDP)	-10.6	-12.5	-6.2	-9.6	-13.3	-10.4	-9.6	-9.3	-9.0	-8.9
Structural non-oil fiscal balance (percent of non-oil GDP)	-10.5	-7.6	-6.2	-10.0	-12.5	-10.2	-9.6	-9.3	-9.1	-8.9
			(Annual percent change, eop, unless otherwise indicated)							
Monetary accounts 3/										
Reserve money	8.7	7.3	20.1	3.6	-1.0	6.6	7.6	7.0	5.7	5.3
Broad money	15.6	-1.7	7.0	2.4	2.1	10.5	9.2	10.1	8.2	7.8
Credit to the private sector	0.1	1.0	-0.2	5.5	1.0	15.0	13.5	13.7	11.3	10.4
Credit to the private sector (percent of GDP)	29.6	25.8	22.7	21.5	22.7	23.3	23.8	24.3	24.7	25.0
NBK policy rate (eop; percent) 4/	12.0	10.3	9.3	9.3	...	...	...	...	...	...
			(In billions of U.S. dollars, unless otherwise indicated)							
External accounts										
Current account balance (percent of GDP)	-5.9	-3.1	-0.1	-3.6	-6.8	-5.5	-4.8	-4.0	-3.8	-3.7
Exports of goods and services	41.6	53.8	67.1	65.6	44.4	48.7	52.1	57.2	60.3	63.1
Oil and gas condensate	19.3	26.6	37.8	33.6	17.6	20.9	22.9	26.3	27.4	28.3
Non-oil exports and services	22.3	27.2	29.3	32.0	26.8	27.8	29.2	30.9	32.8	34.8
Imports of goods and services	36.1	40.7	46.2	50.1	42.9	43.9	45.7	47.8	50.4	53.1
NBK gross reserves (eop)	29.7	31.0	30.9	29.0	26.7	26.6	27.1	28.4	30.1	31.7
NFRK assets (eop)	61.2	58.3	58.0	61.9	57.1	57.7	60.1	63.3	66.8	70.7
Total external debt (percent of GDP) 5/	119.0	100.2	88.6	87.4	103.5	97.2	90.4	83.4	78.8	74.6
Excluding intracompany debt (percent of GDP)	42.9	37.8	32.2	33.1	38.3	37.1	36.0	34.2	33.3	32.4
Memorandum items:										
Nominal GDP (in billions of tenge)	46,971	54,379	61,820	68,639	65,744	73,613	81,765	91,331	99,793	108,733
Nominal GDP (percentage change)	14.9	15.8	13.7	11.0	-4.2	12.0	11.1	11.7	9.3	9.0
Nominal GDP (in billions of U.S. dollars)	137.3	166.8	179.3	179.3	150.1	163.6	181.7	203.0	221.8	241.6
Total Gross Transfers from the NFRK (in billions of U.S. dollars)	8.4	10.2	7.6	8.1	10.9	5.8	4.4	4.4	4.4	4.4
The NFRK assets (in percent of GDP)	44.6	35.0	32.3	34.5	38.0	35.3	33.1	31.2	30.1	29.3
Crude oil, gas cnds. production (millions of barrels/day) 6/	1.60	1.77	1.86	1.86	1.77	1.88	1.90	2.07	2.07	2.07
Oil price (in U.S. dollars per barrel)	42.8	52.8	68.3	61.4	35.6	37.9	40.9	43.2	45.0	46.4

Sources: Kazakhstani authorities and Fund staff estimates and projections.

1/ For 2017 it includes the support of the banking sector of about $6.4 (4 percent GDP) billion.

2/ Does not include revenues from IPOs.

3/ The presentation of monetary accounts has been revised based on Standardized Report Form (SRF). Transactions carried out by the NBK on behalf of the custodian transactions related to the NFRK management are excluded. Credit to the private sector comprises credit to non-financial private enterprises and other resident sectors (mainly households).

4/ Refinancing rate through 2014 and base interest rate of the NBK from 2015. For 2019, latest available observation.

5/ Gross debt, including arrears and other short-term debt.

6/ Based on a conversion factor of 7.5 barrels of oil per ton.