

## NATIONAL FUND OF THE REPUBLIC OF KAZAKHSTAN

### A. Background

1. The National Fund of the Republic of Kazakhstan (NFRK), established in 2000, is a sovereign wealth (oil) fund, which is integrated into the government's consolidated budget. The NFRK performs two functions: (i) a stabilization function to stabilize the fiscal spending across economic cycles and reduce volatility from oil revenue inflows; and (ii) a savings function to address inter-generational equity from the oil windfall. The NFRK accumulated funds mainly from the tax revenues from the oil sector, privatization proceeds, proceeds from sale of agriculture land by the government, and investment income from the management of NFRK.

2. As part of the stabilization function, "guaranteed" and "targeted" transfers to the budget are the main expenditures of the NFRK. The targeted transfers are discretionary and can be used to fund specific fiscal initiatives (e.g. the Nurlı Zhol fiscal support package announced in 2014). The targeted transfers can be allocated only by the decision of the president of the country, mainly for financing of anti-crisis programs during economic crises. Until 2016, guaranteed transfers were set at \$8 billion ( $\pm 15\%$  depending on the cyclical position of the economy and the financing needs). In late 2016, the government adopted a new NFRK framework of rules, which envisaged gradual reduction of guaranteed transfers to T2 trillion (about \$6 billion at 2016 exchange rates) by 2020 (see para. 5). Both guaranteed and targeted transfers must go through the state budget. As part of the savings function, most of oil revenue inflows (net of annual appropriations/transfers to the consolidated budget) are invested abroad. While previously a small share (about 10%) of NFRK assets were invested domestically into bonds issued by government's development institutions, from 2016 onwards NFRK is prohibited from investing in domestic securities issued by the government, quasi-government or private sector. The investment policy of NFRK has evolved recently, with an increasing focus on equities and alternative instruments (see para. 9).

3. The National Bank of Kazakhstan (NBK) (monetary authority) is in charge of implementing NFRK's asset investment strategy. The NBK hires private asset management companies and rewards them according to their performance benchmarked against interest return earned. The NFRK financial accounts are subject to an annual external audit. Monthly and annual reports of the NFRK are published at the official website of the Ministry of Finance and are also placed in the online legal database.<sup>1</sup>

4. The NFRK is a member of the International Forum of Sovereign Wealth Funds (ISWF), which is a voluntary organization of global sovereign wealth funds committed to working together and strengthening the community through dialogue, research and self-assessment. All ISWF members endorse the Santiago Principles on a voluntary basis and conform to the definition of a sovereign wealth fund as set out in the Santiago Principles. Every three years ISWF members reassess their implementation of the Santiago Principles. The self-assessments are accompanied by an analysis of the documents, highlighting trends in sovereign wealth fund purposes, governance structures and investment practices. NFRK has completed and published such self-assessment under Santiago Principles most recently in 2016.

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<sup>1</sup> Government of Kazakhstan. Ministry of Finance. [http://www.minfin.gov.kz/irj/portal/anonymous?NavigationTarget=ROLES://portal\\_content/mf/kz.ecc.roles/kz.ecc.anonymous/kz.ecc.anonymous/kz.ecc.anonym\\_budgeting/budgeting/national\\_fund\\_fldr](http://www.minfin.gov.kz/irj/portal/anonymous?NavigationTarget=ROLES://portal_content/mf/kz.ecc.roles/kz.ecc.anonymous/kz.ecc.anonymous/kz.ecc.anonym_budgeting/budgeting/national_fund_fldr).

## **B. Fiscal Rules**

5. In 2005, the government approved the first medium-term concept for the formation and use of funds of NFRK. The concept fixed a guaranteed transfer to the republican budget in the amount of \$8.0 billion and included an option of adjusting it by 15% depending on the situation in the economy. The concept also determined the minimum balance of the NFRK in the amount of 20% of the gross domestic product (GDP), which was further increased to 30% of the GDP in 2016. Regulations stipulate that in case of non-compliance with the minimum balance limit, the size of the guaranteed and/or targeted transfers should be reduced by the corresponding amount.

6. In 2016, with the aim of maintaining the financial stability of the country, the government also stipulated that the policy of managing the external debt of the government (taking into account the external debt guaranteed by the state) and the external debt of the quasi-public sector should be linked to the policy of using the NFRK. In this regard, an additional restriction was introduced on the volume of the government's external debt (taking into account the external debt guaranteed by the state) and the external debt of the quasi-public sector, which should not exceed the size of the currency assets of the National Fund.

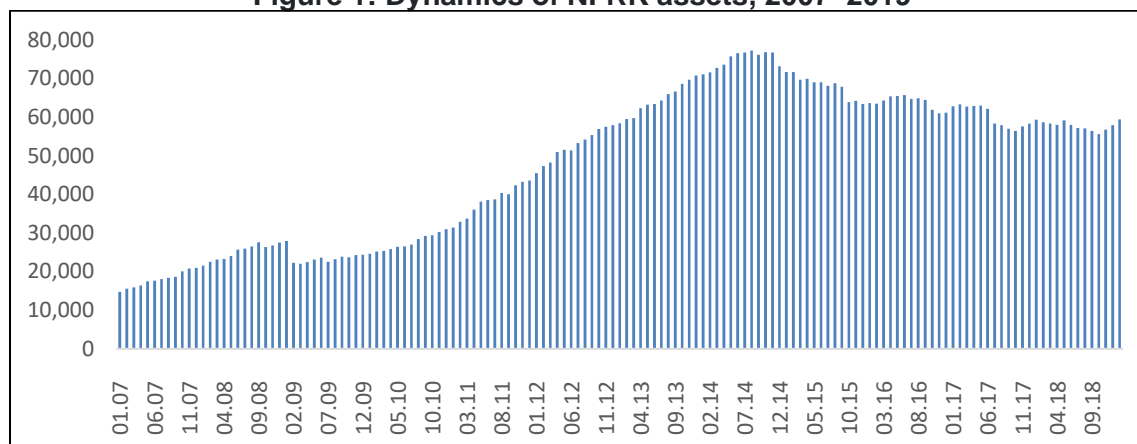
7. In summary, the NFRK's new management rules, developed with the advice from the World Bank and IMF, include the following:

- The nonoil deficit, the main anchor of fiscal policy, was to be progressively decreased to 7% of GDP by 2020, and 6 % by 2025;
- Guaranteed transfers from the NFRK were to be reduced from the US\$8 billion of the time to the equivalent of US\$6 billion by 2020;
- The NFRK assets are to be maintained at least at 30% of GDP;
- Privatization revenues are to flow to the NFRK; and
- General government debt and external debt of state-owned enterprises are not to exceed the size of NFRK assets.

8. These rules are enforced by special high-level Commission on Control of Usage of NFRK Funds, which is chaired by NBK Governor and includes Prosecutor General, Chairman of National Security Committee, Chairman of Accounts Committee, Chairman of Anti-Corruption Committee, as well as ministers of finance and national economy as members. Any deviation from the rules need to be approved by the President of the Republic of Kazakhstan and the Parliament.

## **B. Recent performance**

9. Since its inception, the fund's assets mostly grew steadily (with the exception of the global financial crisis of 2008–2009, in which there was a short-term reduction in connection with the massive allocation of funds for anti-crisis measures) until 2014. Since then, the volume of assets of the NFRK began to decline and this decline has been ongoing for several years (Figure 1).

**Figure 1: Dynamics of NFRK assets, 2007–2019**

Sources: National Bank of Kazakhstan; Asian Development Bank staff estimates.

10. The average return on the portfolio of the National Fund over the past five years (2014–18) was 0.43%, while in the previous five years it was higher, at 3.68. In 18 full years of the National Fund’s existence, the average return on its assets in the base currency was 3.28%. In other words, the profitability of NFRK has been declining more rapidly over the past five years. This trend was largely due to the unfavorable situation on World markets during this period, which is also noted in the comments of the NBK.<sup>2</sup> Among the reasons that caused negative returns, NBK mentioned negative corrections in the stock market, as well as the strengthening of the US dollar against most currencies, in which the assets of the National Fund are also invested.

11. The impact on the return on assets of the National Fund was proportional to the structure of their placement in certain financial instruments. The bulk of the fund’s funds is traditionally placed in bonds (about 70%), mainly government bonds with maximum ratings, about 15% falls on stocks, and the rest on money and money market instruments—this part is mainly represented in the stabilization portfolio. In August 2019, the government introduced changes to the structure of the savings portfolio, which accounts for the bulk of its assets (about 85%), to increase the diversification of assets. The changes involve a transition from a conservative distribution (80% in bonds of 20% in shares) to a balanced distribution (60% of bonds, 30% of shares, up to 5% of alternative instruments and up to 5% of gold), aimed at increasing long-term expected yield.<sup>3</sup>

12. As the main classes of financial instruments in the structure of the NFRK assets are bonds and stocks, the situation on the global stock markets and bond markets has a major impact on the fund’s valuation and yield. The third key factor is the dynamics of the US dollar against other currencies, since the dollar is the base currency of the NFRK: its strengthening leads to a decrease in the return on investment in assets in other currencies. The 2019 analysis of the NFRK by Kazakhstan Institute of Strategic Studies found high degree of dependence of the yield of the NFRK National Fund from the global FTSE World stock index (positive correlation of 0.92) and the dollar index (negative correlation of 0.88).<sup>4</sup>

<sup>2</sup> National Bank of Kazakhstan. 2019. *Report on National Fund of the Republic of Kazakhstan for 2018*. Almaty.

<sup>3</sup> Decree of the President of the Republic of Kazakhstan dated August 2, 2019 No. 86 “On amendments to the Decree of the President of the Republic of Kazakhstan dated December 8, 2016 No. 385” On the Concept of the formation and use of funds of the National Fund of the Republic of Kazakhstan.

<sup>4</sup> Kazakhstan Institute of Strategic Studies under the President of Kazakhstan. 2019. *The Effectiveness of Asset Management of the National Fund of the Republic of Kazakhstan: The Main Factors and Challenges*. Astana.

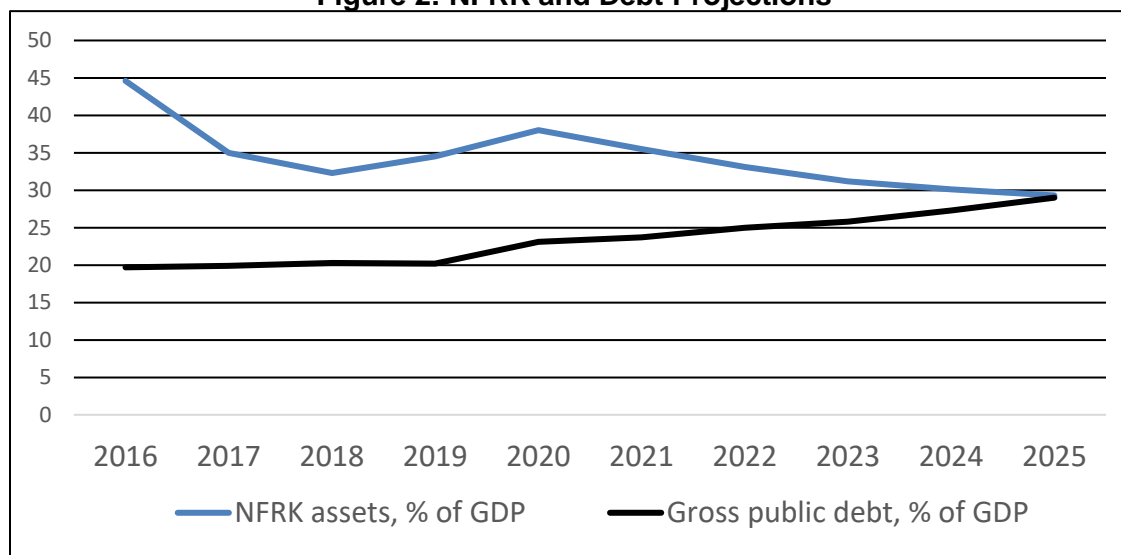
### C. NFRK Role in government's COVID-19 response and Risk of Depletion

13. The additional financing needs of the government's current anti-crisis response are estimated close to \$13.0 billion, including \$7.0 billion of on-budget financing needs and \$5.6 billion of off-budget financing of activities. The 2020 budget, approved in September 2019, stipulated a guaranteed transfer of \$6.0 billion from NFRK. In response to COVID-19 pandemic and plummeting global oil prices, in April 2020 the government has decided to mobilize additional transfers of \$4.7 billion from NFRK to finance increasing budget deficit. Thus, overall transfers from NFRK to budget in 2020 will amount to a historically record of more than \$10.7 billion (17% of current NFRK assets),<sup>5</sup> signifying the magnitude of economic and social challenges facing Kazakhstan.

14. At the same time, the government was forced to increase NFRK transfers amidst depletion of its assets as a result of lower oil revenues, which feed the NFRK. As global oil prices went down from \$55 per barrel in end of 2019 to \$20 per barrel, and Kazakhstan was forced to cut the oil production from 90 million tons to 86 million tons under revised OPEC++ agreement, the 2020 NFRK revenues are expected to decline by 50%, from T2.1 trillion to T1.0 trillion, further exacerbating downward pressures on its assets and long-term mandate.

15. As a result, NFRK assets, which amounted to around \$62 billion, or 34% of GDP, by the end of 2019 are projected to decline to about \$57 billion by the end of this year. Further depletion of its assets at a faster pace may put this mandate at risk. In fact, it is now projected that by 2025 the (falling) financial assets under NFRK will be at par with the (rising) government debt at 30% of GDP, a key benchmark of the fiscal rules. In other words, by 2025, Kazakhstan may no longer be a net creditor as its financial liabilities may exceed its financial assets (Figure 2).

**Figure 2: NFRK and Debt Projections**



NFKR = National Fund of the Republic of Kazakhstan; GDP = gross domestic product

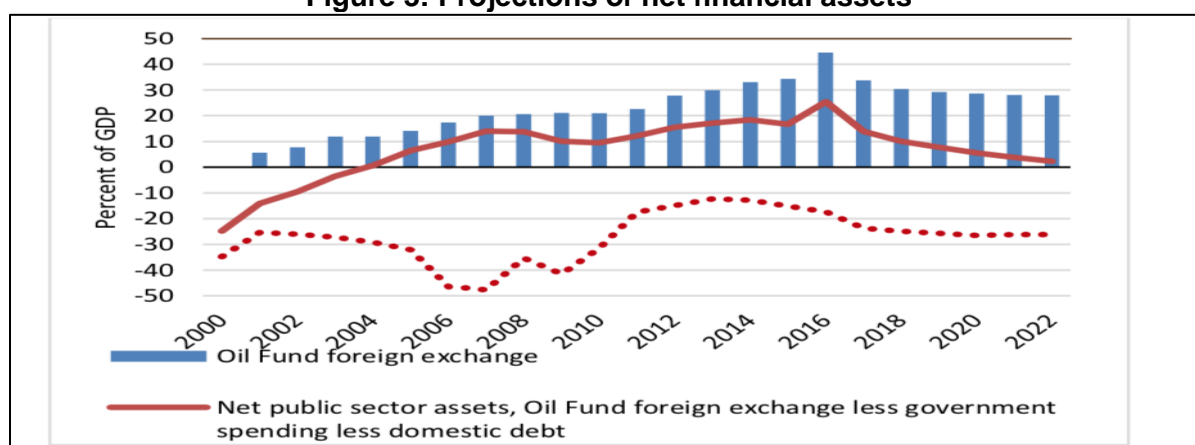
Source: IMF

16. All major development partners share these concerns and advocate very careful use of the NFRK to maintain its long-term mandate. For example, the 2018 Systematic Country

<sup>5</sup> Given recent exchange-rate movements and the fact that these amounts are fixed on tenge terms, the transfers will likely be higher in USD terms.

Diagnostic Study (CDS) for Kazakhstan showed that, as a result of the fiscal deficits over 2010–16 and the devaluation of the tenge in 2015, a stock of government and state-guaranteed debt doubled, leading to a reduction of net financial assets of the government. As the government continued drawing down fiscal reserves from the Oil Fund and the tenge appreciated, net financial assets fell to about 16 percent of GDP in 2017. The SCD estimates suggest that in the absence of fiscal consolidation, net financial assets of the government could be depleted almost completely in 5 to 10 years (Figure 3), hurting the country's ability to borrow at more advantageous rates. Further, NFRK assets may be compared not only against domestic and external public and publicly guaranteed debt but also against Kazakhstan's corporate debt, which is mainly state-owned enterprise (SOE) debt and therefore is a contingent liability for the government. This alternative perspective, again with no policy change, suggests much greater concern over financial sustainability and a sharper need for fiscal consolidation.

**Figure 3: Projections of net financial assets**



Source: Agency of the Republic of Kazakhstan on Statistics.

17. These concerns and need for greater conservatism towards usage of NFRK were also reflected by IMF, focusing, among other issues, on the direct link between NFRK and country's access to global financial markets. In its 2017 country report, IMF noted that while the debt-to-GDP ratio would remain low in the medium-term scenario, market access on favorable terms could come under question with continued drainage of NFRK assets, as markets may expect Kazakhstan to accumulate financial assets, rather than to drain them, given its oil resources. A weaker financial position could also make market access more sensitive to swings in investor sentiment due to external factors (e.g., global or regional developments).<sup>6</sup>

18. Furthermore, in the 2018 analysis of fiscal implications of global green transition, European Bank for Reconstruction and Development (EBRD) noted that renewed oil price shocks and continued high fiscal deficits could erode the country's savings and reduce its fiscal flexibility. EBRD further confirmed that while in 2017 net financial assets were positive, at 16% of GDP, without further fiscal consolidation and a sustainable level of non-oil fiscal deficit of around 5–7 per cent of GDP, net assets could become negative within a decade. In the long run, prevailing market conditions will lead to lower oil and gas revenues, and adversely impact fiscal resources.

<sup>6</sup> IMF. 2017. *Republic of Kazakhstan: Selected Issues, Country Report No. 17/109*. Washington, D.C.

This could affect Kazakhstan's long-term development, given its need for significant and sustained public expenditure.<sup>7</sup>

19. Asian Development Bank (ADB) has been providing policy advice on NFRK that is consistent with the views of the World Bank, IMF and EBRD. ADB's policy advice was focused on the need to (i) develop its own debt management capacity and borrowing plan, (ii) prioritize the challenge of developing a liquid government securities market, and (iii) target net debt objectives in a way that fully takes into account all the financial and institutional trade-offs involved in borrowing vis-a-vis tapping on NFRK, and (iv) fully-incorporate the urgency of ring-fencing the NFRK against foreseeable depletion risks.

20. The non-oil deficit is still significant, which could impact the overall fiscal situation in a context of lower oil prices. The government has set a target for non-oil deficit to be 6% of non-oil GDP by 2025, which was fine at 2018–2019 prices, but is not sufficient at the current prices below \$30 per barrel. The plan to further strengthen the fiscal framework and reduce reliance on transfers from the National Fund is an important reform agenda of the government, as recommended by IMF and World Bank. The challenge is how to deliver fiscal consolidation in a slowing economy when aggregate demand is undermined by the absence of a well-functioning financial sector.

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<sup>7</sup> EBRD. 2018. *The Fiscal Implications for Kazakhstan Of A Worldwide Transition to A Greener Global Economy*. London.