Kazakhstan

Strong prices for oil and gas, rapid growth of domestic consumption, and a rebound in investment continued to propel the economy. But these very strengths carry within them the seeds of future challenges—immediately, keeping rising inflation in check, and improving banks' risk management of their loan portfolios; further out, diversifying the economy, pushing through structural reforms, enhancing competitiveness, and ensuring more equitable development. These measures, plus fiscal and monetary policy coordination, are needed to ensure sustainable growth.

Economic performance

The economy continued to expand at a high and steady rate in 2006. Soaring minerals prices (i.e., oil, gas, and mining), as well as robust private and public consumption and investment, were the main drivers of 10.6% GDP growth (Figure 2.3.1). The oil sector increased at around 5% year on year, after an average rate of about 14% in 2000–2004. Oil and gas play a crucial role in the economy, although growth in the non-oil sector has been faster over the last couple of years.

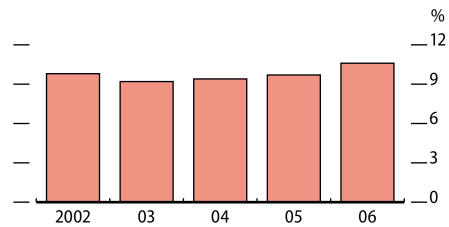
Wage increases and substantial expansion of bank credit fueled private consumption spending. Investment in the resources sector recovered from a recent slowdown and fixed capital investment rose by 18.0% in 2006. Most of this investment consisted of foreign direct investment in minerals, especially in the Kashagan oil and gas field. Fiscal expenditures were augmented to fund increases in minimum wages, pensions, and allowances as well as infrastructure development and social programs. High commodity prices for oil, gas, and metals have significantly raised the value of exports and contributed to raising aggregate demand.

On the supply side, industrial value added rose by 7.0% in 2006 (against 4.6% in 2005), mainly because of mining, industrial processing, and production and distribution of electricity, gas, and water. Construction expanded by 38%, largely in residential dwellings. In manufacturing, real appreciation of the domestic currency, the tenge (T), affected some industries, and capacity constraints in others.

Services, now constituting slightly over 50% of GDP, continued powering ahead at 10.7%, underpinned by a surge in finance (35%), telecommunications (26%), and transport (6.7%). Agricultural production was also buoyant at 8.0%, much higher than the 5-year average of 6%. The sector seems to have benefited from higher productivity arising from investments made in earlier years. Grain and animal husbandry were the two largest contributors to agricultural production growth, picking up by 9.4% and 4.3%, respectively.

Expansionary fiscal policy was another contributor to the surge in demand last year. The budget deficit was T126.2 billion, or 1.3% of GDP (Figure 2.3.2). Rising commodity prices boosted tax revenues from the

2.3.1 GDP growth



Source: Agency of Statistics of the Republic of Kazakhstan.

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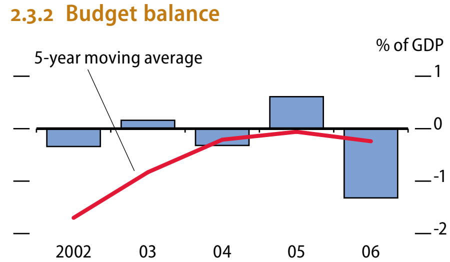
2.3.2 Budget balance



Sources: Agency of Statistics of the Republic of Kazakhstan; Ministry of Finance.

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resources sector. Fiscal revenues amounted to T1.53 billion in 2006, or 16.1% of GDP, while public expenditures came in at T1.66 billion, or 17.4% of GDP. The major expenditure items were public sector wages and pensions, and public investment programs. High oil prices also helped lift the assets of the National Fund of the Republic of Kazakhstan (NFRK), which rose by $6 billion over the year to $14.7 billion.

Inflation intensified in 2006, and the consumer price index was up by 8.6% for the year (Figure 2.3.3). Several major sources stoked inflationary pressure: a substantial influx of oil revenues; greater public spending on wages and pensions and social programs; and excessive domestic demand largely due to a hefty expansion of credits from commercial banks (up 82%). Structural rigidities that limit competition in certain segments of the market for goods and services as well as capacity limits also contributed to rising inflation.

In its quest to control inflationary pressures, the National Bank of Kazakhstan (NBK) took steps to reduce excess liquidity: it raised the refinancing rate in 2 steps from 8% to 9%; strengthened the minimum bank reserve requirements; issued short-term notes to partly sterilize petrodollar inflows; and allowed nominal appreciation of the tenge. These measures have not been effective as reserve money increased by 131% and broad money surged by 80% in 2006 (Figure 2.3.4). Increasing the refinancing rate may have limited impact because most domestic banks borrow from abroad.

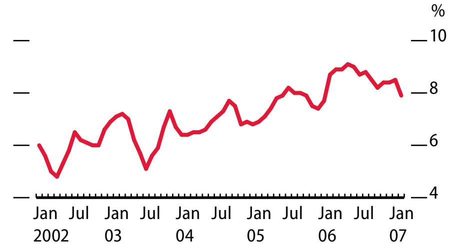
Soaring world commodity prices helped ramp up the value of exports by 35.2% to $38.3 billion in 2006. Crude oil and oil-related products made up just over two thirds of total exports, and metals and metal-related products about one sixth. Imports leaped by 31.7%, largely driven by purchases of machinery and equipment, nonprecious metals, and petrochemical products. The trade surplus increased by 41%. But the deficit on the services, income, and transfers account widened sharply. This stemmed from greater payments for construction, freight, insurance, and information technology services, as well as a near doubling of income payments to foreign direct investors. Nearly all income payments were associated with oil sector development. The current account surplus in 2006 was about $400 million (Figure 2.3.5).

The official reserves at NBK more than doubled to total $19.1 billion at end-2006 (equivalent to 5.4 months of imports of goods and services) while foreign assets of NFRK were $14.1 billion (Figure 2.3.6). The stock of foreign debt stood at $59.6 billion in September 2006 (Figure 2.3.7). Private sector external debt (excluding oil and gas intracompany debt) increased sharply by $11.1 billion to $35.5 billion. The upsurge in private debt in recent years—mainly local bank borrowing for onlending—has largely been in response to the differential between available foreign borrowing rates and domestic lending rates.

The tenge continued to strengthen against the US dollar in 2006, reflecting high export earnings, augmented foreign direct investment, and a surge in private external borrowing. It appreciated by 5.5% over the year, breaking the psychological threshold of T120/$1 in June 2006. It remained below this level in July before NBK intervened and induced a depreciation to around T125–130/$1 (Figure 2.3.8).

Increased credit risk has accompanied the rapid credit growth. Based

2.3.3 Monthly inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 7 March 2007.

Click here for figure data

2.3.4 Money supply (M2) growth

Note: Includes foreign currency deposits.

Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz; both downloaded on 7 March 2007.

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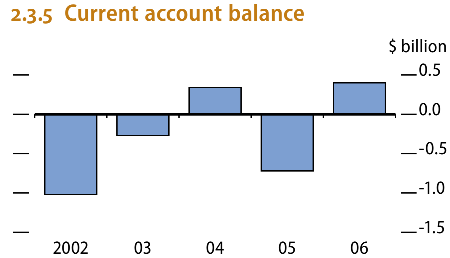
2.3.5 Current account balance



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 28 February 2007.

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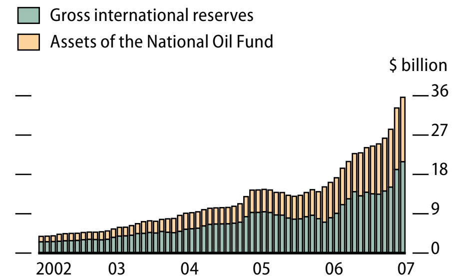
on data from the Agency on Regulation and Supervision of Financial Market and Financial Organizations (AFN), the proportion of bank loans of second-tier banks classified as doubtful loans and bad debts remained extremely high in 2006 at 46%, only down slightly from 48% in 2005. Recognizing the potential problem in the banking sector, NBK and AFN implemented several measures to reduce excessive liquidity and to mitigate risks associated with the deteriorating quality of banks' loan portfolios. The banks' liquidity ratio was increased and asset classification requirement was tightened.

The speed of progress in structural reforms has varied. Robust economic growth seems to have induced some complacency, but new efforts to put Kazakhstan on a more competitive footing and create a favorable environment for business were launched in 2006, including the Kazyna Fund for sustainable development, and Samruk, a new holding company to oversee effective management of state assets (Box 2.3.1). Other measures to improve the business environment included revisions to the law on monopolies and greater powers for the agency regulating them. Substantial progress was made toward joining the World Trade Organization.

2.3.6 Official reserves and assets of the National Oil Fund



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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Economic prospects

The economic outlook remains positive but rests heavily on continued high world commodity prices; a sustained increase in oil and gas and minerals production and export; strong domestic consumption; and continued government commitment to prudent macroeconomic management and market-oriented policy reforms.

GDP is expected to grow at 8.6% and 8.9% in 2007 and 2008, respectively. The major contributors to growth will remain unchanged. The non-oil economy is expected to expand at an average of around 10% a year, driven mainly by key sectors such as construction and services.

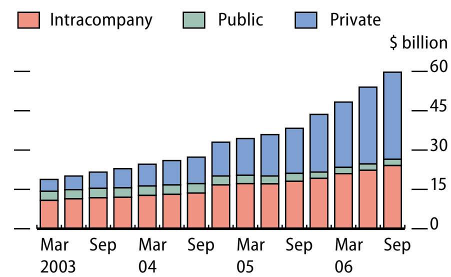
In December 2006, Parliament approved the budget for 2007, and the Government will continue to run an expansionary fiscal policy. Government revenues are expected to be the equivalent of about 17.9% of GDP, and expenditures about 19.2% (the latter an increase of 30%, primarily to fund increases in public sector wages and pensions).

In July 2006, the NFRK was fully integrated into the budgetary system; receipts from all extractive companies will first be accumulated in the NFRK, which will be drawn on as required to fund public investment and government development programs. This will help ensure transparency by demonstrating how the oil fund is being used and separating oil and non-oil transactions.

As part of the Government's initiative to raise the competitiveness of the economy, a variety of tax incentives were introduced to boost the non-oil economy. The VAT rate will be reduced from 15% to 14% in 2007, and a further 1% reduction is scheduled in 2008 and 2009. New tax concessions were introduced to encourage the development of high-value added industries and capital investment. The Government also plans to introduce a flat 10% personal income tax and cut payroll taxes by up to 30% in 2008.

Exports are projected to rise by 15.0% and 9.3% in 2007 and 2008, respectively, largely on higher production from existing oil fields and

2.3.7 External debt



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 22 February 2007.

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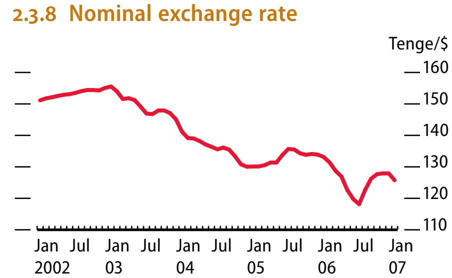
2.3.8 Nominal exchange rate



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of Kazakhstan, available: http://www.nationalbank.kz, both downloaded 17 March 2007.

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new production from the Kashagan oil field in 2008 as well as increased export transport capacity through the Baku-Tbilisi-Ceyhan oil pipeline. Non-oil exports are also expected to increase, mainly on metals and metal-related products, as well as grain.

Rising incomes and excess domestic demand will spill over into imports, projected to rise by 20.4% and 13.3%, largely due to purchases of machinery and equipment for ongoing oil investment projects. Strong exports will keep the trade account in surplus. With the deficit rising in services, income, and current transfers as payment outflows grow, the current account is expected to be in deficit, though it will be readily financed by foreign direct investment and external borrowings. The liberalization of capital account on 1 January 2007—full convertibility of the tenge—will likely take some of the upside pressure off the currency as domestic investors seek out overseas investments.

Inflation is put at 8% in 2007 and 2008, despite NBK's efforts, and the inflationary pressures remain the same.

Over the medium term, the hydrocarbons sector will remain a key locomotive of growth. Its share in GDP will increase as large projects in the Kashagan oil field come on stream in 2008. The Government is likely to continue developing the nonextractive sectors, and construction and services will be key drivers of growth. The Government is also expected to carry on implementing measures to improve competitiveness—including developing Samruk and Kazyna.

In view of large oil-related cash inflows in the coming years, risks are associated mainly with an overheating economy. The focus of monetary policy should be to minimize inflationary pressures. Effective monetary and fiscal policy coordination is also needed to damp excess demand. While the rapid expansion of domestic credit demonstrates confidence in the domestic financial system, it also creates a potential risk in terms of the quality of the loan portfolio of local commercial banks. NBK and AFN recognize this risk, though, and are developing appropriate measures.

Development challenges

Diversifying from oil and mining is a high government priority, though the prospects for developing business services around these industries should not be underestimated. The potential for maturing industries (mostly private but some state owned) to invest in neighboring countries is likely to continue. This will provide a natural incentive for improving competition and productivity of domestic companies.

The private banking sector with major investments in the Kyrgyz Republic and the Russian Federation is leading the way. The efforts to develop Almaty as a regional financial center is praiseworthy but activities need to be carefully thought out. Priority needs to be given not only to the development of laws and regulatory procedures but also, more importantly, to upgrading that city's aging physical infrastructure.

Finally, sustainable and balanced development of the Caspian region represents a major challenge as past significant investment has not translated into efficient utilization of the labor force in the region. Regional cooperation is also important to promote cross-border business activities.

2.3.1 Selected economic indicators

	2007	2008
GDP growth	8.6	8.9
Inflation	8.0	8.0
Current account balance (% of GDP)	-1.6	-2.1

Source: Staff estimates.

2.3.1 Kazyna and Samruk

The Kazyna Fund for sustainable development was established in April 2006. Its objectives are to effectively manage state investments, stimulate investment and innovation activities, and increase the economy's competitiveness. Kazyna identifies and implements investment projects in non-extractive sectors through coordinating various institutions involved in national development. Kazyna identifies investment opportunities and local partners as well as provides administrative support and long-term financing in the form of debt and equity.

Samruk was established in early 2006 to improve the government asset-management efficiency and set a new benchmark for corporate governance. It will act as an active shareholder in the following state corporations: KazMunayGaz, KazakhTelekom, Kazakhstan Temir Zholy (railways), KazPost (post), and KEGOC (electricity). The intention is to expand the coverage to include an additional 17 state companies, including Air Astana and Kazmortransflot (shipping).

Such state-driven industrialization may, though, carry risks in terms of favoring certain firms, unless mechanisms are developed for transparency and accountability for these two entities.