Kazakhstan

High prices for hydrocarbons, ambitious structural changes, foreign investment, and political stability have spurred the economy and improved living standards in recent years. The challenge ahead is to maintain the trend and ensure equitable development. To do this, the economy needs to increase its resilience to adverse external factors and to find sources of growth beyond oil and gas. Expanding non-oil manufacturing, raising productivity in agriculture, and extending the reach of small and medium enterprises offer potential for this. One warning light is flashing though: rising inflation and rapid real exchange rate appreciation have tracked recent robust growth, and sound economic management is needed to prevent overheating and to foment private investment in non-oil activities.

Economic performance

In 2005, the economy remained buoyant, boosted by high world commodity prices, healthy domestic demand, and strong investment. Gross domestic product (GDP) growth continued at a rapid 9.4% (Figure 2.3.1).

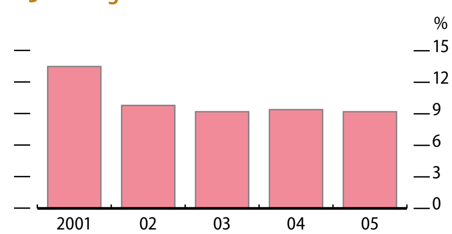
On the aggregate demand side, growth has been increasingly sustained by vigorous private consumption, in turn supported by wage rises and expansion of bank credits. Aided by high oil and gas-related revenues, government spending also grew strongly, above the trend of 23% of GDP. Investment continued to expand rapidly in oil-related activity and in the public sector, while overall fixed capital investment in manufacturing rose by less than the authorities desired, staying at 3% of GDP compared with 15–20% of GDP in the oil sector. This constitutes a major challenge for sustainable non-oil output growth.

On the supply side, industrial expansion dropped to 4.6% in 2005, after 4 years of averaging 11%. In hydrocarbons, transport bottlenecks trimmed growth. In manufacturing, rapid real appreciation of the national currency, the tenge, hit some industries while capacity constraints (investment had not foreseen the high demand levels) affected others, bringing down subsector growth. In contrast, and despite competition pressures from rising imports, the food industry subsector appears to be developing well, picking up from its average growth rate of 9% in 2001–2004 to 13.2% in 2005, reflecting productivity increases from new investment.

Services continued the steady growth that began in 2000 and played a lead role in strengthening overall output. Rising at an average of 10.7% a year, services have been underpinned by a surge in transport, telecommunications, real estate, and retail trade, as oil wealth has filtered through the economy.

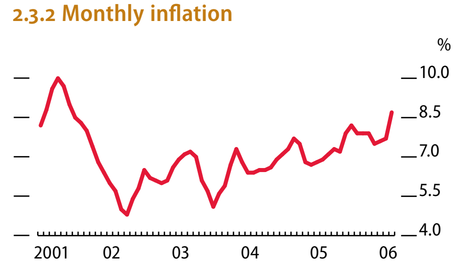
Agricultural growth was impressive at 6.7% in 2005, and much higher than the average of 1.6% seen in recent years. Although performance was driven largely by favorable weather conditions that yielded a bumper

2.3.1 GDP growth



Source: Agency of Statistics of the Republic of Kazakhstan.

2.3.2 Monthly inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz/?docid=170&uid=01F3DE2E-802C-E8FB-36F4BB0112B90882, downloaded 16 March 2006.

harvest, the sector benefited from higher productivity that stemmed from investment made under the aegis of a 3-year state rural revival program.

Though still in single digits (as it has been since 2001), consumer price inflation accelerated to an average of 7.6% in 2005, which is appreciably above the National Bank of Kazakhstan's target of 5–7%. By December, the year-on-year rate had declined by a half percentage point from its 8.2% peak in July, but pushed up again to 8.7% in February 2006 (Figure 2.3.2). Strong growth in public wages (monthly wages up by 25% in nominal terms), buoyant oil-related business incomes, an expansionary fiscal policy, and a credit boom (bank credits up by 75%) all contributed, as did some increases in administered prices. The producer price index rose by 21%, the highest rate in 5 years, partly because the index has a heavy weight for oil and mineral export commodities. Real-estate prices continued to climb, on the back of a decline in mortgage interest rates and gains in household incomes, and are feeding into speculative pressures, reinforcing the circle.

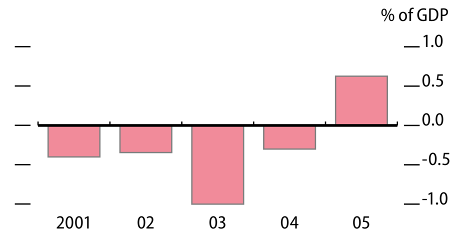
The central bank took several measures to tighten monetary aggregates and slow lending growth during 2005. It raised both the refinancing rate (from 7% to 8%) and the minimum bank reserve requirements. These measures helped bring down broad money growth sharply from over 60% at the start of the year to 25% by the end.

High world oil prices and improvements in tax administration helped lift 2005's general budget revenues by 4.7 percentage points to 28.2% of GDP. This large gain was somewhat offset by the increase in budgetary spending prior to the December presidential election. In the event, the general government budget recorded a surplus of 0.6% of GDP, from a slight deficit of 0.3% in 2004 (Figure 2.3.3). In view of its strong financial position, the Government made early repayments totaling $850 million on its external public debt, reducing the total to about 4% of GDP at end-2005. The 2006 state budget was approved in November 2005. It raised revenues by 2% of GDP from the previous year's level, reflecting government projections for greater receipts from oil. The increase is earmarked for public investment and social programs.

High world commodity prices helped ramp up exports by 40.0% to $28.7 billion; oil and metals accounted for more than two thirds of the increase (Figure 2.3.4). Imports also leaped, by 37%, driven largely by machinery, equipment, and nonprecious metals. The trade surplus improved by about 45% to $9.8 billion, but the deficit on the services, income, and transfers account worsened sharply. The latter 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 associated with oil sector development. Consequently, the current account surplus in 2005 (Figure 2.3.5) improved only marginally from a year earlier to $750 million (about 1.3% of GDP). For the first time in 5 years, official reserves at the National Bank of Kazakhstan declined, though they recovered substantially in the first 2 months of 2006.

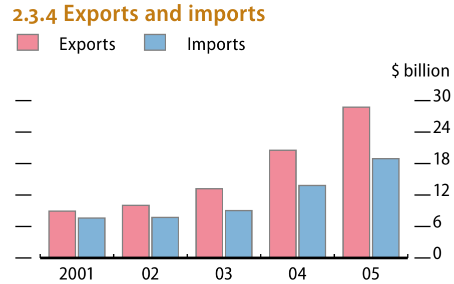
Gross official reserves stood at $7.1 billion at end-2005 (equivalent to 3.7 months of imports of goods and services) while end-year foreign asset holdings of the National Fund of the Republic of Kazakhstan (NFRK), which saves a part of the Government's oil and mineral revenues for

2.3.3 Budget balance



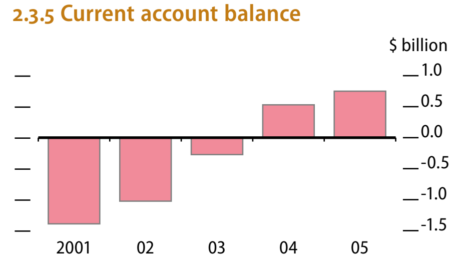
Sources: Agency of Statistics of the Republic of Kazakhstan; Ministry of Finance.

2.3.4 Exports and imports



Source: National Bank of Kazakhstan.

2.3.5 Current account balance



Source: National Bank of Kazakhstan.

future generations, amounted to \$8.0 billion (Figure 2.3.6). During the year, the total of official reserves and fund assets strengthened by about \$684 million (about 1.2% of GDP) to \$15.1 billion. Outstanding public external debt was reduced by about \$1.0 billion to \$2.4 billion (about 4.2% of GDP) in the 9 months to end-September 2005 (Figure 2.3.7). In this period, private sector external debt (excluding oil and gas intracompany debt) increased sharply by \$4.6 billion to \$16.6 billion (about 33% of GDP). The upsurge in private debt in recent years—mainly local bank borrowing for onlending—was largely a response to the differential between available foreign borrowing rates and domestic lending rates of about 15% for tenge loans and 11% for loans denominated in foreign currency.

The tenge continued to appreciate against the US dollar (2.9%) on an average annual basis, reflecting export earnings, foreign direct investment (FDI), and private external borrowing. However, tighter market conditions in the final months of 2005 resulted in a 2.2% depreciation on an end-of-year basis (Figure 2.3.8). As in the previous year, the real effective exchange rate rose by about 6% year on year, due to inflation differentials. Largely because of future substantial oil-related revenues, real appreciation may continue in 2006, further eroding domestic producers' price competitiveness (Figure 2.3.9).

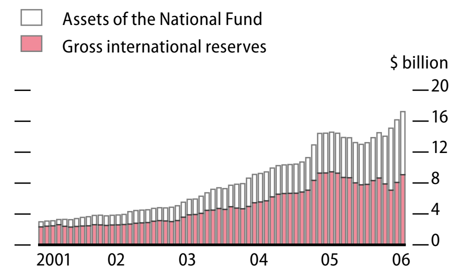
The speed of progress in structural reforms is variable, and the momentum of the late 1990s has slowed. Robust economic growth, driven by high oil prices, seems to have induced complacency. A law on private entrepreneurship was, nevertheless, adopted in November 2005, to simplify the many rules facing small businesses. The capital account has been liberalized, which should help the private sector.

The Government has scheduled liberalization in railroads, power, and telecoms, and, with one eye on economic diversification, is identifying the most suitable sectors for development, including oil and gas engineering, construction materials, food, logistics services, metallurgy, textiles, and tourism. These efforts form part of the Innovative-Industrial Development Strategy to 2015. The Government has also introduced measures to systematize relations and the separation of powers and responsibilities between the central and regional levels. For example, a new budget code brought in significant changes to the budget system in 2005.

Increased credit risk has accompanied the rapid credit growth. The share of bank loans classified as doubtful or bad rose from 44% in 2004 to 49% of total bank loans in 2005. However, about 90% of loans classified as doubtful are actually being serviced on a timely basis. The oversight agency took several steps to mitigate risks associated with the deteriorating quality of banks' loan portfolios. It increased the banks' liquidity ratio and tightened asset classification requirements. Further, concerned by growing risks arising from currency mismatches, it lowered the ceiling on banks' foreign currency-denominated lending from 50% to 30%. The first credit bureau was established during the year, to help banks obtain information on the credit history and creditworthiness of borrowers.

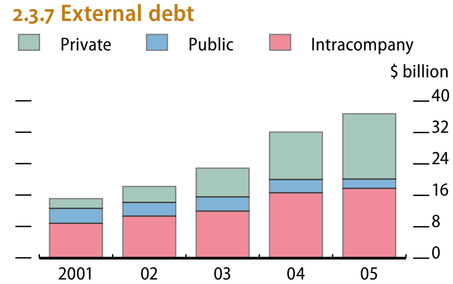
On the governance front, Kazakhstan joined the Extractive Industries Transparency Initiative, an important step toward demonstrating greater openness in the receipt and spending of the nation's mineral wealth. This will be supported by new rules governing the NFRK (established in 2001),

2.3.6 International reserves and assets of the National Fund



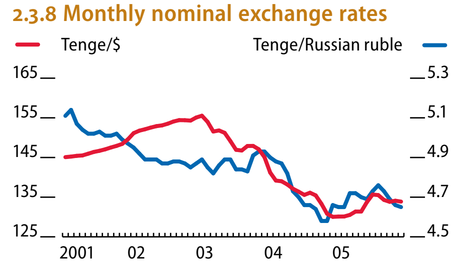
Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz/?docid=180&uid=FDF84D16-802C-E8FB-30C53D87D1E7A74F, downloaded 15 March 2006.

2.3.7 External debt



Note: Data for 2005 are as of end-September.
Sources: Ministry of Finance; National Bank of Kazakhstan.

2.3.8 Monthly nominal exchange rates



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz/?docid=364&uid=0C5C834A-802C-E8FB-3C4C06D57B1A56E1, downloaded 18 March 2006 under which all oil-related revenues will accrue to the NFRK through the budget. Moreover, an anticorruption law has been adopted that should help improve the business environment.

Economic outlook

The country's outlook is positive but rests heavily on a few factors: continued high world oil prices; a sustained increase in oil production and export capacity; strong domestic consumption; continued political stability; and government commitment to prudent macroeconomic management and market-oriented policy reforms.

Prospects for 2006 and 2007

GDP growth is forecast to average 8.5% in 2006–2007. In light of continued high budget revenues from oil, the Government will likely maintain an expansive expenditure policy, especially in the social sectors and infrastructure. Even then, the 2006 fiscal deficit is unlikely to reach the budgeted 2% of GDP, with the likely outcome close to balance.

The continuation of buoyant domestic demand and growing supply constraints in some parts of the economy will keep inflation at the higher end of the central bank's target of 5.7–7.3%. The tight monetary policy, acceptance of some real appreciation in the exchange rate, and less need for domestic oil-price adjustments should help keep inflation just below the upper bound.

Export growth is projected to slow substantially from the rates of the past 3 years but to be sustained at about 8–10% by two main factors: maintenance of high world oil prices (coupled with expansion of oil production from new fields), and new export transport capacity (relieving existing constraints). Exports will expand through diversification of the pipeline network by the opening in late 2005 of a new route to the People's Republic of China and by some shipments through Azerbaijan via the recently opened Baku-Tbilisi-Ceyhan (BTC) oil pipeline. Rising incomes and domestic demand will spill over into imports, including capital goods for three major oil investment projects under construction. Reflecting the projected expansion in the trade and invisibles deficits, the current account surplus is forecast to narrow slightly to 0.5–0.7% of GDP.

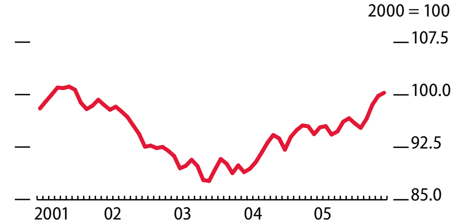
Medium-term outlook

Prospects are encouraging, on the basis of continued oil sector development and expanded economic diversification stemming from implementation of the Innovative-Industrial Development Strategy. GDP is forecast to expand at an annual average of 7% over the medium term.

A decomposition shows that overall growth in 2000–2004 was led by strong contributions from capital and total factor productivity (TFP). The contribution of labor accumulation declined continuously, suggesting that the economy is likely approaching full employment. According to government data, the contributions of capital accumulation, TFP, and labor growth to the average GDP rate of expansion of 10.4% in 2000–2004 were 6%, 3.2%, and 1.2%, respectively.

The hydrocarbons sector has grown at an average of 16% a year since 2000, and will remain the locomotive of growth in the medium term. Its

2.3.9 Monthly real effective exchange rate



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz/?docid=339&uid=E38DD10A-802C-E8FB-309CF4112119C47A, downloaded 10 March 2006.

2.3.1 Selected economic indicators

	2006	2007
GDP growth	8.5	8.5
Inflation	7.3	7.0
Current account balance (% of GDP)	0.7	0.5

Source: Staff estimates.

share in GDP, including production and related services, jumped from 11% in 2000 to almost 25% in 2005, and is expected to continue rising as production capacity increases. Sector growth has been fueled by large capital investments; oil and gas have received 60% of total investment, equivalent to 15% of GDP over the 2000–2005 period. Two thirds of the oil and gas investment came from the private sector. The share of hydrocarbons in GDP will increase over the medium term as large projects come on stream, though investment in the sector is expected to taper off as a share of total fixed investment.

Non-oil output has risen at an average of 7% a year since 2000 and has been sustained at the investment rate of 25% of total investment, representing 6.5% of GDP in 2000–2005. Within the non-oil sector, construction and services have been the most dynamic. Their combined share in GDP and total employment has increased to 65% and 60%, respectively.

In contrast, the share of manufacturing and agriculture in GDP has declined, reflecting low capital investment. Their investment rate stood at 3% of GDP a year on average over the period, with half of that from the public sector. If the investment rate in the non-oil sector keeps to its recent trend, non-oil growth could well stay at 7–8% a year in the medium term—and even higher if the Government manages to diversify the economy and stimulate the private sector. Removing impediments to regional trade and accession to the World Trade Organization would advance development of both the non-oil and private sectors (Box 2.3.1).

With the start of oil production from Kashagan oil field—one of the world's largest—scheduled for 2008, prospects for exports are good. As construction of large-scale oil projects winds down, demand for imports of capital goods will decline, though profit remittances will rise. Present projections indicate that the current account would from 2008 move to a surplus of about 1% of GDP at current world oil price levels. While projected oil revenues are expected to keep the overall budget balance comfortable, greater price stability will be a key macroeconomic ingredient. If inflation targeting is adopted in 2007 as planned, inflation should be brought within the targeted level of 4–6% over 2008–2010.

In view of large oil-related cash inflows in the coming years, risks are associated mainly with an overheating economy. The quality of spending is also an issue, because escalating pressures to spend the greater resources come up against current limited capacity. Difficulties in banking may arise if rapid credit expansion continues. Also, the Government needs to ensure that the Innovative-Industrial Development Strategy is implemented along lines consistent with its objective of maintaining both a market-driven economy and long-term competitiveness.

2.3.1 Behind-the-border barriers to trade

Trade has contributed significantly to economic development by improving the balance of payments, attracting FDI, and promoting competition—but the country trades very little with the rest of Central Asia. For example, exports to the rest of the subregion amount to only 3% of the total, while imports are even lower, at 2%. The major limiting factors for the subregion's economies include a similar commodity-based structure, restrictive trade policies, high tariffs, heavy transport costs, underdeveloped infrastructure, and cross-border barriers. Mitigate these, and Kazakhstan has the potential to be an engine of growth in Central Asia. But to do so, all governments will have to make the necessary political commitment, invest adequately in infrastructure, and enforce liberal trade and transit policies. Kazakhstan's neighbors can benefit from its investment, energy exports, and relatively advanced financial sector. Greater cooperation among the countries in the subregion would provide all of them with significant opportunities for enhanced, sustainable, economic growth.

From a wider perspective, greater access to non-subregional markets remains important. Consequently, the Government has been pursuing accession to the World Trade Organization since 1996. Membership should improve exports, enhance competition, promote enterprises' cost-competitiveness, and increase FDI.