KAZAKHSTAN

Highlights

- **The economy has been hit by collapsing oil prices and a difficult external environment.** Economic growth is expected to decelerate to 1.2 per cent in 2015 after 4.3 per cent growth in 2014, but fiscal buffers against external shocks remain strong, supported by sizeable National Fund reserves.
- **Kazakhstan has made advances on its ambitious reform agenda to promote investment and growth**. The country's accession to the World Trade Organization (WTO), together with other structural reforms, is helping to improve investment attractiveness.
- **A floating exchange rate regime with inflation targeting has been introduced**, replacing a fixed exchange rate regime which was pegged to the US dollar. This is a significant policy shift which was inevitable and necessary for Kazakhstan in the long run; in the short run, while having a significant effect on some sectors and consumers, it can be expected to have a neutral overall effect on growth.

Key priorities for 2016

- **Adjustment of this oil-dependent economy to lower oil prices is a key priority.** A successful and timely implementation of the government's structural reform agenda and effective management of fiscal stimulus programmes are important for improving the business environment and achieving better growth in light of lower oil prices.
- **Monetary policy framework needs to be strengthened**. Following the shift in the exchange rate regime, it is important to take steps to create confidence in the tenge, which will allow the volatility to subside and the exchange rate to stabilise at an economically optimal level. As part of this, it is critical to continue to enhance the monetary policy framework and operations, with a rate-setting mechanism and other instruments, required for effective inflation targeting.
- **Implementation of the broad privatisation programme announced in 2014 needs to be accelerated.** Progress to date has been slow and it is important to continue with this process in order to attract fresh investment into key sectors and reduce the role of the state in the economy.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	7.5	5.0	6.0	4.3	1.2
Inflation (average)	8.3	5.1	5.8	6.7	6.8
Government balance/GDP	6.0	4.5	5.0	1.8	-3.0
Current account balance/GDP	5.4	0.5	0.4	2.1	-3.0
Net FDI/GDP [neg. sign = inflows]	-4.6	-5.8	-3.5	-2.2	-2.8
External debt/GDP	66.7	67.4	64.8	72.4	n.a.
Gross reserves/GDP	15.6	13.9	10.7	13.4	n.a.
Credit to private sector/GDP	31.1	32.8	32.0	31.0	n.a.

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Macroeconomic performance

Economic growth has been decelerating as a result of external shocks. Real GDP growth dropped to 1.7 per cent in the first half of 2015 year-on-year (after reaching 4.3 per cent in 2014) as a result of the plunge in oil prices, the recession in Russia, the slow-down of key trading partners and weaker domestic demand. The drop in the Russian rouble resulted in an influx of cheap imports from Russia, putting pressure on domestic industries and leading to weaker exports. Lower oil prices have led to a sharp drop in export earnings, with exports down by 44 per cent in the first half of 2015 year-on-year and imports down by 17 per cent in the same period, reflecting weaker domestic demand. Inflation stood at 4.4 per cent in September 2015 year-on-year, significantly lower compared with 7.5 per cent in January 2015.

The National Bank of Kazakhstan (NBK) moved to a floating exchange rate regime (with inflation targeting) on 20 August 2015. As a result the tenge depreciated by more than 26 per cent against the US dollar to around USD/KZT 255 and subsequently stabilised at around USD/KZT 270-275 in the second half of September, implying depreciation of around 30 per cent compared with the previous level. The NBK continues to have sufficient buffers to prevent abrupt fluctuations in the exchange rate, with foreign exchange/gold reserves at US$ 35.9 billion and National Fund assets standing at US$ 67.9 billion at the end of September 2015.

In light of lower oil revenues, the government had to revise the budget. The 2015 budget is based on an oil price of US$ 50 per barrel and a target deficit of 3 per cent of GDP in 2015 and a level of overall spending slightly higher compared with 2014. The budget has been increased by adding spending under the *Nurly Zhol* programme (around US$ 3 billion a year), financed by the National Fund and mainly focusing on infrastructure investments. At the same time, some spending has been reduced mainly by delaying or terminating new projects; all social expenditure has been kept unchanged. The deficit will be financed by budgetary support loans from the World Bank and Asian Development Bank; proceeds from the US$ 4 billion in Eurobonds successfully placed in July 2015; and bonds issued in domestic markets. The government plans to prepare its 2016 budget based on an oil price of US$ 40 per barrel, with a slightly higher budget deficit of 3.3 per cent.

GDP growth is projected to slow to 1.2 per cent in 2015 and remain subdued at 1.5 per cent in 2016, reflecting the difficult external environment with continued recession and rouble weakening in Russia, flat oil prices, and stagnant oil production as a result of delays in the Kashagan oilfield. Weaker investor sentiment as a result of the geopolitical crisis is also affecting growth. On the positive side the announced fiscal stimulus programme and ambitious reform agenda are expected to provide a boost for growth.

Major structural reform developments

The *Nurly Zhol* stimulus programme and Enhanced Partnership with international financial institutions (IFIs) are supporting growth and reform. *Nurly Zhol* is a US$ 3 billion a year counter-cyclical stimulus programme for 2015-17, which was unveiled in November 2014. The programme, which is financed from the National Fund, is designed to primarily support infrastructure development, small and medium-sized enterprises (SMEs), and the resolution of non-performing loans (NPLs) in the banking sector. Kazakhstan has also made good progress under an Enhanced Partnership with the EBRD and other IFIs, signed in 2014, whereby the government set aside US$ 2.7 billion from the National Fund, to finance and support structural reforms in key sectors of the economy. In May 2015 the Law on Natural Monopolies was amended to increase the transparency of tariff calculation and the activities of natural monopolies, streamline tariff procedures, ensure consumer protection and facilitate processing of bids and the elimination of unnecessary costs.

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Other structural reforms are also being implemented. President Nazarbayev, re-elected in April 2015, has introduced Kazakhstan's "100 Concrete Steps" programme, which aims to boost transparency and accountability using structural reforms by: creating a professional government apparatus; ensuring rule of law; improving industrialisation policy and promoting growth and creating a transparent, accountable state. As part of the programme, the capital city, Astana, will be developed as a new international financial centre (AIFC) created on the site of the Astana Expo 2017. The AIFC is to become a regional financial hub, by adopting international standards and establishing an independent judicial system based on the British common law. The government has also introduced reforms to support a favourable investment climate: in particular the rules on the organisation of a one-stop shop activity for investors were adopted in February 2015, and the law on investments was amended in December 2014 to help improve the investment climate and, as announced in July 2015, the visa-free regime was extended for developed countries until the end of 2017. The country improved its score in the World Bank *Doing Business 2016* report and ranked 41st among 189 countries (compared with 53rd in the 2015 report). The main improvements were achieved in the areas of starting business, protecting minority investors and resolving insolvency.

In April 2015 NBK adopted the monetary policy guidelines to 2020, setting out the reforms that will be implemented as part of the shift to a floating exchange rate with inflation targeting (which has now taken place). The monetary and institutional reforms will include: strengthening the governance structure, establishment of a monetary policy committee, greater independence in decision-making, establishment of a money market committee for implementation of monetary policy, including an assessment of banking sector liquidity and interbank market developments.

Kazakhstan has joined the WTO and is actively progressing with the process of joining the OECD. Kazakhstan's WTO accession protocol was signed on 23 July 2015, with the accession agreement ratified in October 2015. The country will formally become a full member of the WTO 30 days after it notifies the WTO Director-General of such ratification. As part of the accession, Kazakhstan's external tariffs will drop to around 6.0 to 6.5 per cent, returning back to the level that the country had before joining the Eurasian Economic Union (which resulted in an increase in Kazakhstan's common external tariffs to around 10.6 per cent). WTO accession may cause some short-term disruptions to the economy as a result of lower tariffs and the lifting of import restrictions, but the institutional changes and greater transparency will improve the country's business and investment climate in the longer term. Also, in January 2015 Kazakhstan signed a Memorandum of Understanding with the OECD, relating to a cooperation programme for 2015-16. Kazakhstan plans to introduce a visa-free regime for OECD countries from January 2017.

Efforts to improve cross-border trade, transport and logistics infrastructure have advanced. The government and other stakeholders are showing increasing commitment to improve the ability to trade across borders and transport infrastructure. The 900 km railway linking Kazakhstan, Turkmenistan and Iran, launched in late 2014, gives Kazakhstan access to Iranian ports in the Persian Gulf. The country is also targeting completion of the Kazakhstan section of the Western Europe-Western China road by the end of 2015. More broadly, the country is actively engaging in implementation of the Chinese Silk Road Economic Belt initiative. Significant challenges, however, remain: the World Bank's Logistics Performance Index ranks Kazakhstan 88th (out of 160 countries), identifying weaknesses in customs clearance process, trade and transport-related infrastructure, the quality of logistics services and the ability to track and trace consignments and deliver in a timely manner.

Kazakhstan has deepened its economic ties with China. A Kazakh-Chinese investment fund was established with the participation of the China-Eurasia Economic Cooperation Fund (50 per cent) and Kazakhstan's National Holding Baiterek (50 per cent). The Fund, which has initial capital of US$ 500 million, will invest in Kazakhstan's economy. In March 2015 the two countries also signed 33 bilateral deals worth US$ 23.6 billion to finance investments in sectors such as steel, non-ferrous metals, sheet glass, oil refining, hydropower and automobiles. Kazakhstan has become one of the founding members of the Asian Infrastructure Investment Bank.

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The NBK has taken steps towards resolution of the legacy NPL problem. The legal framework has been strengthened, the Distressed Asset Fund recapitalised and its remit and procedures are being refined, and BTA-Kazkommertsbank, the bank with the highest level of NPLs, has been split into “good” (Kazkommertsbank) and “bad” (BTA) banks, with the banking licence of the BTA bank rescinded. The Tenge 500 billion (or around US$ 2.7 billion) provided for the banking sector bail-out is being used primarily to support the work-out of the NPLs of the BTA-Kazkommertsbank that now reside in the BTA bank. While reported NPLs have fallen to 9.98 per cent of total loans as of July 2015 (down from 30 per cent in December 2013), some of the NPLs that have been taken off the balance sheets of banks, contributing to the reduction in reported NPLs, continue to have recourse back to the banks that originally granted the loans.

The NBK has developed a de-dollarisation plan for 2015-16. The level of dollarisation in the banking sector, particularly on the deposit side, remains very high. In response, the new plan was approved by the government in February 2015. It focuses on improving macroeconomic stability, development of non-cash payment systems, reduction of the shadow economy and achieving priority of the national currency over foreign currencies.

The privatisation programme is progressing slowly. The original plan envisaged the sale of stakes in 106 state companies during 2014-16. However, between 2014 and July 2015 only 28 companies have been privatised under this programme. The National Welfare Fund Samruk-Kazyna plans to offer a further 14 assets for sale in 2015.