

Kazakhstan

Economic Update
No.3 | Summer 2016



A Long Road to Recovery



Kazakhstan: A Long Road to Recovery

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Summer 2016



Government Fiscal Year: January 1– December 31
Currency Equivalents: Exchange Rate Effective as of July 1, 2016
Currency Unit: Kazakhstani Tenge (KZT)
US\$1 = 338.04 KZT
Weights and Measures: Metric System

Abbreviations and Acronyms

FX	Foreign Exchange
NBK	National Bank of Kazakhstan
NPL	Nonperforming Loan
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprise
SPV	Special-Purpose Vehicle
GDP	Gross Domestic Product

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Foreword

This edition of the Kazakhstan Economic Update is part of a biannual series designed to monitor economic developments in Kazakhstan. It presents a concise analysis of macroeconomic and structural conditions from late 2015 through the first five months of 2016. The authors are Dorsati Madani and Ilyas Sarsenov, Senior Country Economists for Kazakhstan. The report benefited from the valuable inputs provided by Colleen Mascenik (Financial Economist) and Alma Nurshaikhova (Public Sector Management Specialist). The focus section on employment dynamics was developed in collaboration with Thomas Farole (Lead Economist). The authors are grateful for the guidance and comments provided by Ato Brown (Country Manager for Kazakhstan), Christos Kostopoulos (Lead Economist for Central Asia), Anton Dobronogov (Senior Economist, Africa Region), and Aurelien Kruse (Senior Economist, Europe and Central Asia Region). Gulmira Akshatyrova (Program Assistant in Astana) and Sarah Nankya Babirye (Program Assistant in Washington, D.C.) provided administrative support. Shynar Jetpissova (Communications Associate) and Kubat Sydykov (Online Communications Associate) helped with report dissemination.

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Overview

Kazakhstan's challenging external environment caused a broad-based economic slowdown and an adjustment in income and domestic prices. GDP growth slowed from 4.1 percent in 2014 to 1.2 percent in 2015, and the economy contracted by an estimated 0.2 percent during the first five months of 2016. Falling export oil prices led to a large terms-of-trade shock, while China's growth slowed further and Russia's recession continued, weakening both external and domestic demand. The move to a floating exchange-rate regime in August 2015 led to a sharp depreciation of the Kazakhstani tenge (KZT) and a steep increase in the inflation rate, which rose from 3.8 percent, year-on-year, in August 2015 to 16.7 percent in May 2016, eroding real wages and consumer purchasing power. Low-income households are particularly vulnerable to increasing prices, declining real wages and dampened employment opportunities. Progress in poverty reduction has stalled, and the national poverty headcount rate (measured at US\$5 per day in purchasing-power parity terms) remained at an estimated 14 percent during 2014-15.

The government's macroeconomic policy stance was mixed in 2015, though in 2016 it became more consistent with lower medium term oil prices. In 2015 the authorities adopted a proactive fiscal policy stance, but a fiscal consolidation is planned for 2016. The government adjusted on-budget spending in March 2015 to reflect the expectation of lower oil prices over a longer period of time. The authorities also balanced earlier countercyclical spending commitments under the Nurly Zhol infrastructure development program with reductions or delays in other non-priority capital expenditures. However, off-budget support to the national oil company increased the nonoil deficit, counteracting consolidation efforts. The 2016 budget calls for a reduction in overall spending and the nonoil deficit consistent with the goal of medium-term consolidation. Monetary and exchange-rate policies were slow to adjust in 2015, with the central bank announcing a shift to a floating exchange rate and an inflation-targeting regime in mid-August 2015. The transition was difficult, as the newly introduced base rate was initially ineffective and was suspended in November 2015, leading to large money-market rate fluctuations that continued into early 2016. The 2016 monetary policy measures indicate progress toward the full adoption of the new monetary regime. The reintroduction of the policy rate in early February 2016 stabilized the money market, while exchange rates also steadied and began to appreciate as oil prices rose. The authorities are moving ahead with further measures to enhance the effectiveness of the new monetary policy framework.

The authorities plan to continue implementing structural reforms designed to promote diversified development. The government has reiterated the importance of institutional and structural reforms to diversify the economy and reduce its dependence on oil exports. In May 2015 it launched a large-scale institutional reform program "One Hundred Concrete Steps, a Modern State for All", which encompasses reforms in public administration, the regulatory framework, public financial management and accountability, the management of state-owned enterprises (SOEs), and various sector-specific reforms, which aim to strengthen governance and reduce the role of the state in the economy. The legislation underpinning these reforms was passed in December 2015, and a privatization program has also been introduced. Accelerating the implementation of planned macroeconomic, institutional and structural reforms would have a substantial impact on the drivers of medium-term growth. In turn, higher (and higher quality) growth of the non-oil economy will help create productive and high quality jobs for the large cohort entering the labor market starting in 2020 (further discussed in Focus Section).

Growth is projected to recover gradually over the medium term, but the economy will continue to face substantial headwinds. The baseline scenario presented in this edition of the Kazakhstan Economic Update rests on the assumption that oil prices will average around US\$41 per

barrel in 2016, then rise to US\$50 in 2017 and reach US\$53.3 in 2018. Under the baseline scenario, GDP growth is expected to remain near zero in 2016 before rising to 1.9 percent in 2017 and 3.7 percent in 2018 as production commences at the Kashagan oilfield, global oil prices rebound, renewed consumer and investor confidence supports the recovery of the nonoil sectors, and inflation eases to an average of 6-8 percent per year. Meanwhile, both fiscal and external conditions are expected to improve. However, this medium-term outlook is subject to significant downside risks, including risks to the health of the financial sector, sluggish global growth, and the potential for a deeper or more protracted recession in Russia, a further slowdown in China, continued instability in global oil markets or production delays at the Kashagan oilfield.

A. Recent Political Developments

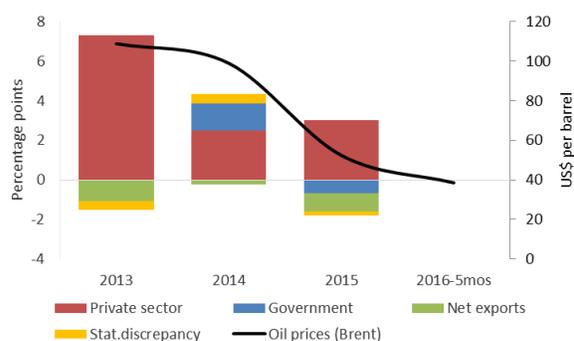
Kazakhstan's government is consolidating its political mandate in the wake of recent elections, and the authorities are taking steps to operationalize the agenda announced in early 2015. Elections for the lower house of parliament were held in March 2016, one year after President Nursultan Nazarbayev was reelected to a new five-year term. The governing Nur Otan Party secured 82 percent of the vote, winning 74 of the 98 seats in the lower house. Meanwhile, the Ak Zhol Party and the Communist People's Party each received about 7 percent of the vote. The Nur Otan Party's large majority in the lower house is expected to ensure continued support for the president's development strategy and the reform agenda outlined in the "One Hundred Concrete Steps, a Modern State for All" program launched in the spring of 2015. The authorities are now implementing the reform program, and President Nazarbayev has been spearheading its privatization component since November 2015. In recent months, the Minister of National Economy and the Minister of Agriculture changed in the aftermath of the public discontent expressed about the land reform agenda. The Minister of Investment and Development was also changed apparently to further strengthen the implementation of the infrastructure investment program Nurly Zhol (bright path).

B. Recent Economic Developments

A difficult external environment continues to affect the economy

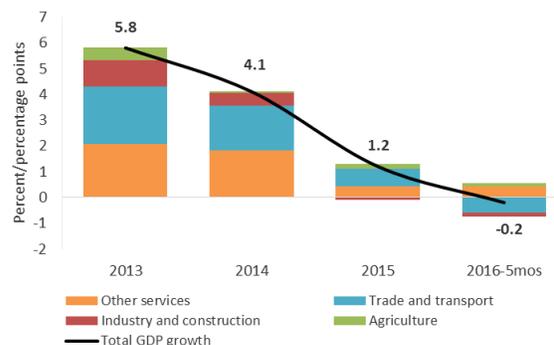
In 2015 and early 2016 adverse external conditions contributed to an abrupt drop in the GDP growth rate. Output growth continued to slow across all economic sectors as oil prices fell and both domestic and external demand weakened (Figure 1 and 2). The GDP growth rate fell from 4.1 percent in 2014 to 1.2 percent in 2015. Preliminary data suggest that GDP contracted by 0.2 percent, year-on-year, during the first five months of 2016, continuing the broad-based growth slowdown that marked the previous year. Private sector demand weakened due to lower consumer and investor confidence as the pass-through effect of the depreciation eroded domestic purchasing power after an inevitable adjustment to the exchange rate. Although the government provided additional fiscal support to the private sector (on-budget in 2014 and off-budget in 2015-16), the private sector's contribution to GDP growth was half of what it was in 2013. Meanwhile, a slowing Chinese economy and a protracted recession in Russia undermined external demand for oil, mineral and industrial products, which comprise Kazakhstan's major exports.

Figure 1. GDP Growth by Demand Component
(In percentage points and US\$ per barrel)



Source: World Bank staff calculations based on official data published by the authorities.

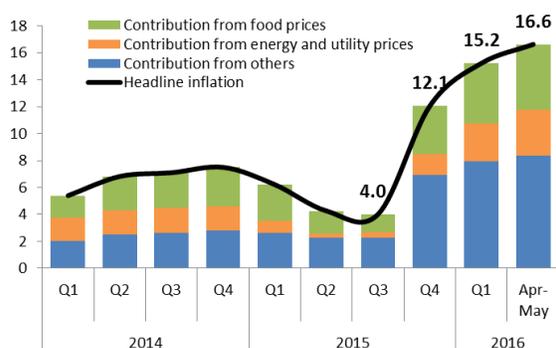
Figure 2. Sectoral Contribution to GDP Growth
(In percent and percentage points)



Source: World Bank staff calculations based on official data published by the authorities.

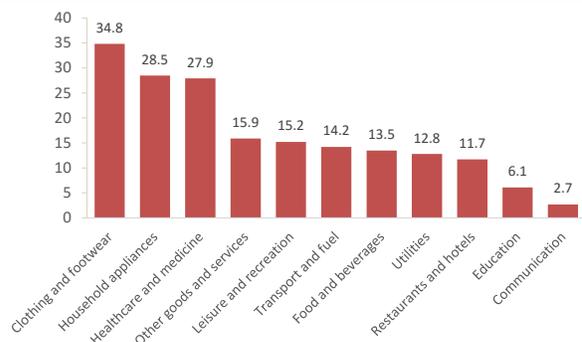
Lower external demand led to a decline in the output of the extractive industries, while weaker domestic demand negatively affected the non-resource economy. Consistent with the trends observed in 2015, industrial output declined by 2.2 percent, year-on-year, during the first five months of 2016, primarily due to a contraction in the extractive industries, as weaker external demand caused oil output to drop by 4.4 percent and iron ore production to plunge by 23.1 percent. Although the decline in the extractive industries was partly offset by the growth of the manufacturing and construction sectors—which expanded by 0.5 and 6.8 percent, year-on-year, respectively—the combined contribution of industry and construction to growth remained negative during the first five months of 2016, as in 2015 (Figure 2). While the non-resource service sector was the main contributor to growth in 2015, there are early indications that it contracted during the first five months of 2016, as the diminished purchasing power of households caused domestic trade activity to contract by 5.1 percent and the communication sector to shrink by 4.6 percent. Agricultural production grew by 4.1 percent in 2015 and by an estimated 2.7 percent in 2016, though the sector’s contribution to GDP growth remains relatively minor.

Figure 3. Headline Inflation and Its Components
(In percent, year-on-year)



Source: World Bank staff calculations based on official data published by the authorities.

Figure 4. Consumer Price Inflation, May 2016
(In percent, year-on-year)



Source: World Bank staff calculations based on official data published by the authorities.

Despite weak domestic demand, the pass-through effect of the tenge’s depreciation led to a sharp increase in the inflation rate and a drop in real wages. Following the exchange rate adjustment that started in August 2015, prices for imported goods surged and contributed to higher domestic inflation. Headline inflation jumped from a low of 4 percent, year-on-year, in Q3 2015 to

over 12 percent in Q4 2015 and over 15 percent in January-May 2016 (Figure 3). Higher prices for imported apparel, durable goods and medicine drove the increase in inflation (Figure 4). Prices for other domestically produced goods and services also increased, spurred by higher fuel prices and more expensive imported inputs. As a result, the official average annual index of real wages and salaries fell from 103.9 in 2014 (2013=100) to 97.6 in 2015 and 97.3 in Q1 2016, a decline of 2.7 percent, year-on-year.

The shift to a floating exchange-rate regime in August 2015 led to large adjustments in the nominal and real exchange rates, potentially enhancing the price competitiveness of nonoil exports. After depreciating from 188 KZT/US\$ in mid-August 2015 to 384 KZT/US\$ in mid-January 2016, following the adoption of the floating exchange rate in a context of substantial market uncertainty, the nominal exchange rate rebounded, rising to 330 KZT/US\$ at the end of April 2016 as oil prices stabilized. These swings are reflected in the adjustment of the nonoil real effective exchange rate, which proxies Kazakhstan's real prices relative to those of its external trading partners. The nonoil real effective exchange rate fell from 116.4 in January 2015 (December 2013=100) to 110.3 in July, due largely to bilateral ruble-tenge adjustments. It reached a nadir of 72.9 in January 2016 as the tenge hit its lowest value against the US dollar, but rose to 75.3 in April, signaling a potential price advantage in nonoil exports. Trade data for 2016 are not yet available to verify whether this apparent price advantage has generated a supply response.

The external balance adjusted sharply in late 2015 and early 2016

Following the shift to a floating exchange rate, the external balance improved from a deficit in 2015 to a balanced position in Q1 2016. Preliminary data suggest that while the current account remained in deficit, as the terms-of-trade shock and the tenge's depreciation continued to negatively impact the trade balance, the capital and financial account significantly improved, almost offsetting the current-account deficit in Q1 2016 (Table 1). Although the Q1 2016 trade balance deteriorated compared to Q1 2015, it improved compared to Q4 2015 due to a substantial import compression following the tenge depreciation and relative price adjustments. As a result, the current-account deficit fell from US\$1.6 billion in Q4 2015 to US\$0.9 billion in Q1 2016, contributing to narrow the external deficit. Increased foreign direct investment inflows and a reversal in capital flight financed the remaining deficit. Short-term investment experienced a particularly sharp reversal, with substantial outflows in 2014 and 2015 shifting to a net inflow of US\$1.1 billion in Q1 2016. The developments in capital and financial account balance are expected adjustments after the floating of the tenge.

An improved external position allowed the central bank, the National Bank of Kazakhstan (NBK), to replenish its official international reserves and improve their quality. The country's official foreign-exchange (FX) reserves comprise FX assets in the Oil Fund and FX reserves at the NBK. Total FX reserves declined by a modest 0.3 billion between end-2015 and Q1 2016, and preliminary data suggest that they then increased by about US\$1.6 billion during April-May 2016. This increase was driven by US\$2 billion in fiscal savings in the Oil Fund during the first five months of 2016, while FX reserves at the NBK declined by \$0.7 billion. During this period the NBK bought US\$3.2 billion on the FX market to repay FX swaps to commercial banks (Figure 5). The country's stock of total official international reserves, including gold, increased between end-2015 and May 2016, and the repayment of FX swaps improved the quality of those reserves (Figure 6).

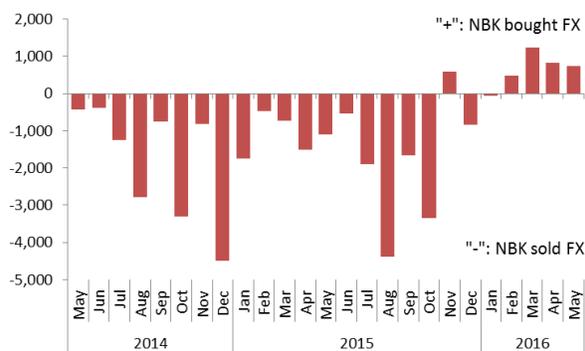
Table 1. Balance of Payments and Official Reserves, 2014-16 (Q1)
(In US\$ billions)

	2014	2015	2015-Q1	2016-Q1
Current account balance	6.4	-5.8	-0.1	-0.9
Merchandise trade	36.7	12.6	4.2	2.7
Exports f.o.b.	80.2	46.3	12.1	8.4
Imports f.o.b.	43.5	33.6	7.9	5.7
Services	-6.3	-5.4	-1.1	-1.0
Primary income, of which:	-22.7	-11.5	-3.0	-2.5
Income of direct investors, net	-19.6	-8.5	-2.4	-2.0
Secondary income/transfers	-1.3	-1.6	-0.3	-0.1
Capital and financial account balance ^{/1/2}	0.3	-4.7	-2.9	0.6
Foreign direct investment	4.8	3.4	1.4	2.6
Portfolio investments ^{/1}	5.8	-2.6	-2.7	-1.4
Medium- and long-term investments	2.3	4.2	1.4	-0.5
Other short-term investments	-3.5	-4.0	-1.1	1.1
Estimated amount of NBK interventions	-18.0	-17.7	-2.9	1.7
FX liabilities of the NBK to residents	10.3	5.5	3.3	-2.6
Other short-term flows	4.2	8.2	-1.4	2.1
Errors and omissions	-9.0	-5.7	-1.9	-1.2
Overall external balance ^{/3}	6.7	-10.5	-3.0	-0.3
Change in FX assets in the Oil Fund	2.5	-9.7	-3.5	0.8
Change in FX reserves at the NBK	4.3	-0.8	0.5	-1.1
<i>Memorandum items:</i>				
Total official reserves (stock)	102.5	91.4	98.9	92.7
FX assets in the Oil Fund	73.2	63.5	69.7	64.3
FX reserves at the NBK	21.8	20.3	21.6	19.3
Gold reserves at the NBK	7.4	7.6	7.5	9.1

Source: World Bank staff calculations based on data published by the National Bank of Kazakhstan (NBK).

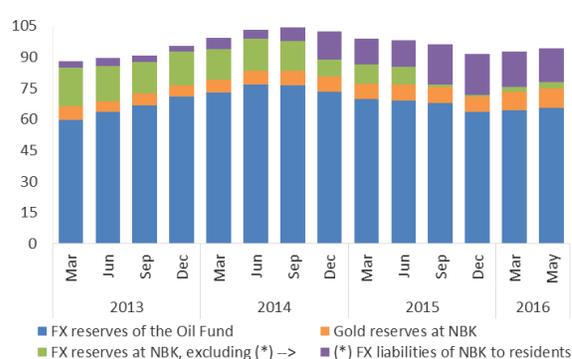
Note: Some sums may not add up exactly due to rounding. ^{1/}Excluding investments of the Oil Fund. ^{2/} Including errors and omissions. ^{3/} "+" = reserve accumulation.

Figure 5. Central Bank FX Interventions
(In US\$ millions)



Source: World Bank staff calculations based on publicly available data.

Figure 6. Total Official International Reserves
(In US\$ billions)



Source: World Bank staff calculations based on official data published by the authorities.

Kazakhstan's improved external position also contributed to the de-dollarization of deposits in the banking sector. The ratio of FX deposits to total deposits in the banking sector rose steadily from June 2015 to a peak of almost 70 percent at the end of January 2016, due to plunging oil prices and uncertainty regarding the course of monetary and exchange-rate policies. The trend reversed in February 2016, as oil prices began to recover and interest rates on deposits changed in favor of tenge denominated deposits. Beginning on February 1st, interest rates on tenge deposits were increased from 10 to 14 percent, while rates for FX deposits were lowered from 3 to 2 percent. As a result, during January-May 2016 the stock of FX deposits dropped by about US\$3.2 billion, a decline of almost 10 percent, year-on-year, while tenge deposits increased by nearly 35 percent.

The currency depreciation affected the banking sector

Although the banking system was not as exposed to FX lending in August 2015 as it had been in August 2009, the depreciation significantly impacted certain banks. While FX lending represented nearly 50 percent of total bank lending in August 2009, by August 2015 this share had fallen to 23 percent. And whereas FX loans to individuals represented 10 percent of total lending in August 2009, they represented 3.7 percent in August 2015. However, the depreciation increased banks' relative exposure to FX lending, exacerbating deposit dollarization – at least initially, and discouraging dollar-denominated borrowing. As a result, by February 2016 the share of FX lending in bank portfolios had risen to 35.4 percent of total lending, while FX lending to individuals had fallen to 5 percent. At the same time, banks' short-open currency position widened, and FX-denominated liabilities rose from 65 percent in January 2015 to 80 percent in February 2016.

The NBK has taken steps to mitigate the impact of the depreciation on bank capital. An increase in the authorized capital ratio scheduled for January 2016 was postponed. In addition, new prudential regulations that would have required consolidated bank reporting according to international financial reporting standards, including reports on special-purpose vehicles (SPVs), were suspended, enabling some of the largest financial institutions to conceal substantial amounts of nonperforming loans (NPLs) in SPVs. These SPVs represent a considerable portion of some banks' exposures, and consolidated reporting is critical to sectoral oversight. The decision to postpone an increase in the capital ratio may be prudent given its potentially pro-cyclical impact during a time of stress on the banking system. Six of the top ten banks by assets have Tier-1 capital ratios under 11 percent, and the trend has been declining in recent months. This suggests, however, that more proactive measures are needed to stress-test the largest banks, revisit and improve the calculation of banks' liquidity ratios to adequately capture liquidity risk, and set time-bound reporting expectations for banks in order to reveal capital shortfalls and formulate recovery plans.

The economic slowdown is influencing labor-market and poverty indicators

Labor-market trends are beginning to reflect the impact of the economic slowdown. Real wages declined by 2.4 percent, year-on-year, between 2014 and 2015 and by 2.7 percent during Q1 2016, while the official unemployment rate remained stable at around 5 percent during 2015 and Q1 2016. The stability of the official unemployment rate may be due in part to a local practice of putting workers on administrative leave rather than laying them off, as a result of which they continue to be counted as part of the employed labor force. Declining labor-force participation may also be absorbing the impact of the downturn. The number of economically active individuals exceeded 9.1 million in 2014 and mid-2015, but then fell below 9 million in Q4 2015 and Q1 2016, suggesting that about 100,000 workers exited the labor market as the economic crisis unfolded.

Progress in poverty reduction has stalled, and the poverty rate (measured at US\$5 per day in purchasing-power parity terms) is estimated to remain stable at 14 percent over 2014-16.¹ In recent years a combination of employment growth, especially in the service sector, and rising real wages has driven poverty reduction in Kazakhstan. Conversely, slowing rates of GDP growth and job creation would imply a slowdown (or stagnation) in the pace of poverty reduction. Rising inflation in Q4 2015 and in the first half of 2016 is expected to compound the effects of slowing growth by eroding real wages and consumer purchasing power. Sharp price increases for basic consumer goods and services (footwear and clothing, furnishing and household equipment, and health care) in Q4 2015 present particular cause for concern. Low-income households are especially vulnerable to consumer price increases, falling real wages and diminished employment opportunities. The government has taken steps to soften the impact of the slowing economy by protecting social spending. The authorities also increased pension payments in 2015 and raised public sector nominal wages in early 2016. However, pro-poor transfer programs are still relatively limited, and accelerating poverty reduction and promoting shared prosperity will require a greater focus on the rural and regional dimensions of poverty.

C. Macroeconomic Policies

The transition to a new monetary-policy regime has been challenging, but the reform process is on track

The launch of the new monetary-policy regime was followed by a period of uncertainty in the market, which appears to have subsided in Q1 2016. International experience suggests that a well-organized and orderly shift from a fixed or tightly managed exchange rate to a floating exchange rate based on inflation targeting will take about a year to become fully operational. Kazakhstan's policy change took place during a time of crisis and with insufficient advance preparation, which intensified its inherent uncertainty and destabilized financial markets for several months. A new base rate was launched in early September 2015, but it did not appear to function as intended. The average overnight interbank interest rate, or tenge overnight index average (TONIA), shot from 2 percent to 318 percent during 2015, driven by policy uncertainty and tight tenge liquidity.² In early November 2015 the new NBK governor effectively suspended the base rate and announced that there would be no further interventions to manage the exchange rate unless the financial system's integrity was at risk. Interbank interest rates fell in mid-January 2016, and in February they began to stabilize within the range of the newly announced base rate. The TONIA and the tenge weekly index average (TWINA) fell from highs of about 80 percent in early January to about 25 percent by the end of the month. In early February the NBK reintroduced a 17 percent base policy rate with a +/-2 percentage-point band, which helped stabilize the interbank rates at 15 percent (Figure 7). In May 2016 the NBK reduced the policy rate to 15 percent and tightened the band to +/-1 percentage points as exchange-rate volatility diminished and inflationary pressures eased. The central bank also resumed its monthly policy announcements.

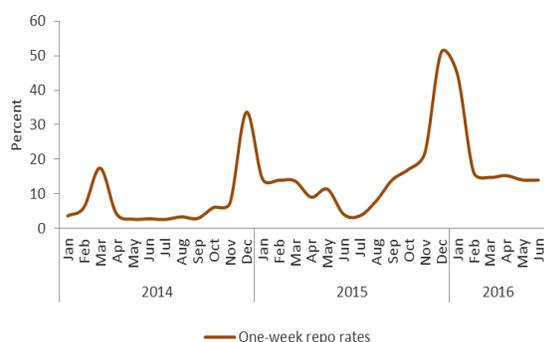
Since mid-January 2016, the tenge has steadily regained ground as oil prices have increased. There are at least three nonexclusive explanations for the tenge's recent movements. The first is that the currency tracks Brent oil prices (Figure 8). The second is that the move from a fixed or tightly managed exchange rate regime to a floating exchange rate regime was followed by a temporary adjustment period, during which investors' unfamiliarity with the "rules" of the new regime

¹ World Bank staff estimate based on household budget surveys.

² The TONIA is a weighted average interest rate for automatic one-business-day repo opening deals for government securities. By contrast, the tenge weekly index average (TWINA) is a weighted average interest rate for seven-business-day repo opening deals.

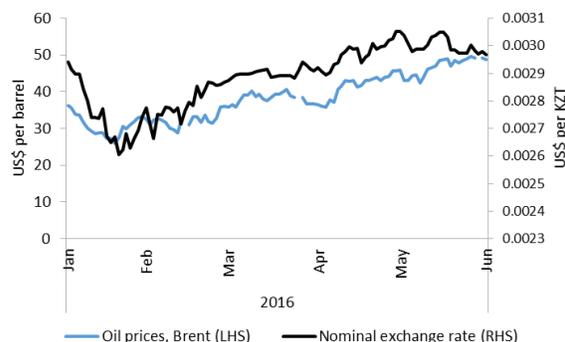
increased uncertainty and intensified depreciation pressures. In this case, the international experience indicates that the tenge would tend to overshoot its equilibrium before eventually stabilizing and then moving based on normal market forces, and indeed the tenge's performance since mid-August 2015 appears to broadly fit this pattern. The third explanation is that the tenge's appreciation in February can be attributed in part to the tax cycle for exporters seeking to convert dollars into tenge. This explanation implies that the NBK's replenishment of its FX reserves supported the continued appreciation through March and April.

Figure 7. Market Interest Rates
(In percent)



Source: World Bank staff calculations based on official data published by the authorities.

Figure 8. Oil Prices and the Exchange Rate
(In US\$ per barrel and US\$ per KZT)



Source: World Bank staff calculations based on official data published by the authorities.

The central bank is working to develop a credible inflation-targeting regime. This requires an effective interest-rate transmission channel to signal changes in monetary aggregates to market participants, influencing economic activity and thereby altering the inflation rate. The NBK launched a new base rate in September in an effort to establish a new transmission channel. However, this rate and the standing facilities were effectively suspended in early November 2015 and a new rate of 17 percent +/-2 percent was reestablished in February 2016, reflecting the difficulty of abruptly switching monetary regimes in the midst of an economic crisis. This also suggests that FX market expectations were driving liquidity constraints in the banking system. The FX and inter-bank markets appear to have stabilized in early February 2016; interbank interest rates are within the range of the newly announced base rate, and exchange-rate movements appear to be more closely aligned with market fundamentals than they were in late 2015.

Managing the new base rate will require the NBK to effectively utilize its monetary-policy instruments and communicate more openly with the public. The authorities will need to use models to assess liquidity needs and project inflation dynamics, as well as monetary instruments such as repo and reverse-repo auctions to affect markets. Regular communications between the central bank and the public will be essential to the efficacy of inflation targeting. Further developing the country's shallow financial and bond markets would also support the effectiveness of the new monetary regime and expand the range of investment options. Developing a functional yield curve and facilitating interbank liquidity flows would help improve monetary policy management. Regular publication of detailed progress reports on the NBK's objectives and the implementation of its policies would enhance transparency and build confidence in the new monetary-policy regime. The NBK's recent decision to publish records of its interventions on a monthly basis is a positive step.

Box 1. Exchange-Rate Regimes in Oil-Producing Countries

The international experience suggests that oil-producing countries should opt for a flexible exchange-rate regime, which enables the authorities to more effectively manage the impact of external shocks. Flexible exchange-rate regimes are also consistent with the independence of the central bank and monetary policy in general. Monetary-policy independence allows central banks to focus on keeping inflation low and predictable. During a recession, when unemployment is temporarily high and real growth is temporarily low, the central bank can accelerate the growth of the money supply, cut interest rates, influence the currency depreciation, and/or raise asset prices in order to mitigate the downturn. Flexible exchange-rate regimes help economies adapt to external shocks through relative price adjustments, usually mitigating negative production and employment effects in the medium term. Depending on the responsiveness of producers and consumers, the production stimulus caused by a relative price adjustment could mitigate the effect of the downturn even without any deliberate action by the government. Australia emerged from 1997-98 Asian crisis in relatively good shape because its currency was free to depreciate automatically in response to the deterioration of its export markets. Canada and New Zealand, like Australia, are commodity exporters with floating currencies that automatically adjust to reflect changes in external demand. The principal argument against a flexible exchange-rate regime is that central banks may not have adequate knowledge or experience to use discretionary monetary policy effectively.

Fixed or pegged exchange rate regimes usually provide credibility to a stable monetary policy, with central bank commitment to price stability helping anchor expectations related to wage, price and international capital flow. Managing the growth of the money supply and preventing high or volatile inflation rates are the major arguments for adopting a nominal anchor. However, rigid nominal anchors, such as a fixed or pegged nominal exchange rate, can prevent monetary policy from changing in response to the evolving needs of the economy. A lack of consistency between a rigid nominal anchor and the needs of the economy can result in the loss of monetary independence, an inability to automatically adjust to export shocks and unnecessary volatility.

Source: Jeffrey Frankel, 2003; Mohsin S. Khan, 2009.

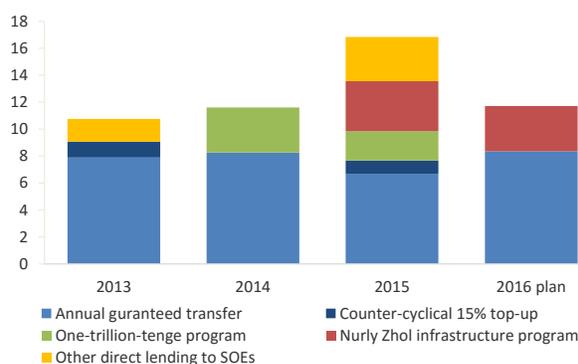
The government provided short-term fiscal stimulus, while envisaging a medium-term consolidation

During 2015 the government adopted a countercyclical fiscal stance combined with a fiscal adjustment to the capital budget. The government continued implementing two fiscal stimulus programs launched in 2014 in an effort to offset what appeared to be a temporary drop in oil prices. The first was a short-term KZT 1 trillion economic support program to be implemented in 2014-15, and the second was the Nurly Zhol infrastructure development program, which is planned for 2015-20. Both programs were financed with resources from the Oil Fund.³ These resources rose from US\$11 billion in 2013 to US\$12.2 billion in 2014 and more than US\$18 billion in 2015, far exceeding the annual guaranteed transfer of US\$8 billion (Figure 9). As it became clear that oil prices would remain low over the medium-to-long term, the government launched a medium-term fiscal adjustment in March 2015 by cutting some lower priority capital expenditures for 2015. However, off-budget support to the ailing national oil company⁴ caused the nonoil deficit to widen from 10.1 percent of GDP in 2014 to 12.5 percent in 2015, though it is expected to narrow again in 2016 (Figure 10).

³ The short-term program was financed exclusively from the Oil Fund, while Nurly Zhol is financed in part by the Oil Fund (US\$9 billion to be disbursed during 2015-17) and in part by Kazakhstan's multilateral development partners (US\$6.5 billion to be disbursed during 2015-20).

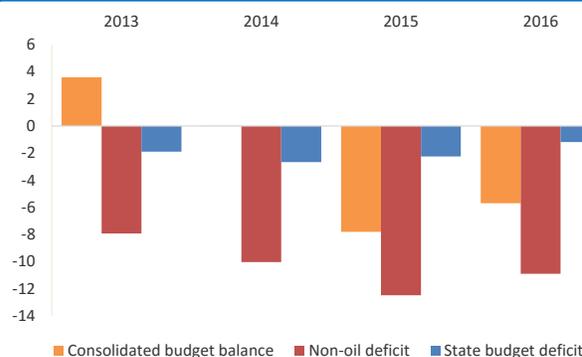
⁴ In 2015 KazMunayGas, the National Oil And Gas Company, received US\$2.7 billion in public funds to refinance its foreign debt.

Figure 9. The Use of the Oil Fund
(In US\$ billions)



Source: World Bank staff calculations based on official data published and provided by the authorities.

Figure 10. The Fiscal Balances
(In percent of GDP)



Source: World Bank staff calculations based on official data published and provided by the authorities.

Box 2. Oil Fund Transparency and Governance

The National Fund of the Republic of Kazakhstan (NFRK) 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 reduce volatility from oil revenue inflows; and (ii) a savings function to address inter-generational equity from the oil windfall. As part of the stabilization function, the government appropriates \$8-15 billion annually, while the rest of an annual fiscal gap (implicitly capped at 3 percent of GDP up to 2015) is financed through domestic and external borrowing. As part of the savings function, most of oil revenue inflows (net of annual appropriations/transfers to the consolidated budget) are invested abroad, while about 10 percent of total NFRK assets are invested domestically into bonds issued by four state-owned enterprises and development institutions. The NBK is in charge of implementation of the NFRK 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.

The current features of Kazakhstan's fiscal rule is based on a variation of the permanent income hypothesis that provides range of potential annuity. It is defined as fixed nominal transfer from the oil fund to the budget, with allowance for cyclicity, targeted investment spending and off-budget expenditures, and debt control features:

- Fixed annual guaranteed transfer of \$8 billion to the budget (starting in 2011)
- Counter-cyclical provision of +/- 15 percent of guaranteed transfer amount
- Minimum oil fund balance of 30 percent of GDP
- Non-oil deficit to reach 2.8 percent by 2020
- No-off budget financing – that is no guarantees or lending for domestic activities including to Samruk-Kazyna, KazAgro and Baiterek. This rule has been waived on an annual basis.
- Features to control borrowing and indebtedness:
 - Annual expenditures on debt services, however defined, not to exceed 4.5 percent of imputed fixed investment return on the fund.
 - Average of cost of service and repayment of public debt over 10 years not to exceed 15 percent of total budget receipts including cash transfers from the fund.

Source: World bank staff, based on World Bank "Oil Rules: Policy Options in a Downturn", 2013.

The government is attempting to rebuild its fiscal buffers by consolidating the fiscal accounts over the medium term. The recently approved budget for 2016-18 envisages a significant decrease in government spending, including a substantial reduction in the net acquisition of nonfinancial assets, which in practice are primarily cash transfers to SOEs. Meanwhile, off-budget lending from the Oil Fund to SOEs is supposed to cease after 2016, when the last approved allocation of KZT 351.5 billion will be disbursed to Baiterek, a joint-stock national management holding company, and Samruk-Kazyna, the sovereign wealth fund, as part of the Nurly Zhol program. There are plans to discontinue subsidized direct lending from the Oil Fund to SOEs and instead invest Oil Fund assets in liquid financial instruments at market rates, including bonds issued by SOEs in the domestic market. As a result, the nonoil deficit is expected to narrow from 12.5 percent of GDP in 2015 to about 12 percent in 2016 and to less than 9 percent in 2017 (Table 2 and Figure 10). Moreover, following a 30 percent nominal increase in public sector salaries in 2016, current expenditures are expected to gradually decline as a share of GDP, and capital spending should normalize after a brief contraction in the wake of the completion of the EXPO-2017 project. The authorities are reviewing potential tax-policy reforms and administration options to enhance nonoil revenues over the medium term. The government plans to merge the Tax Code and the Customs Code into a single Revenue Code and has launched a review of certain tax policies, such as the corporate income tax and its numerous exemptions, as well as the tax framework for SMEs. However, these reviews and revisions are still in their early stages, and it is not yet possible to gauge their prospective impact on nonoil revenue.

Table 2. Consolidated Fiscal Accounts: Government Fiscal Framework, 2014-17*
(In percent of GDP)

	2014 actual	2015 actual	2016		2017 indicative plan of Nov 17, 2015
			approved plan of Nov 30, 2015	revised plan of Mar 5, 2016	
Revenue and grants	21.3	15.7	14.8	14.3	14.3
Oil revenue, total	10.1	4.7	4.7	4.4	4.1
Oil revenue saved in the Oil Fund	2.7	-5.5	-3.2	-5.6	-3.6
Oil revenue consumed, on-budget and off-budget	7.4	10.2	7.9	10.0	7.7
<i>of which: Oil Fund allocations for Nurly Zhol</i>	..	1.6	1.4	2.6	1.8
Nonoil revenue	11.2	10.9	10.1	9.8	10.1
Expenditure and net lending	21.3	23.5	19.6	21.9	19.1
General government expenditures	20.6	20.9	19.5	21.1	19.1
Current expenses	15.0	16.6	16.6	17.6	..
Capital expenses and net lending	4.2	3.4	2.7	3.2	..
Transfers to SOEs	1.4	0.9	0.2	0.4	0.1
Oil Fund direct lending to SOEs	0.7	2.5	0.1	0.8	0.0
Overall fiscal deficit	0.0	-7.8	-4.8	-7.7	-4.8
Republican Budget non-oil deficit	-9.4	-9.9	-9.4	-11.3	-8.9
Consolidated Budget non-oil deficit	-10.1	-12.5	-9.6	-12.1	-8.9
Consolidated Budget non-oil deficit financing	10.1	12.5	9.6	12.1	8.9
Oil revenue consumed, on-budget and off-budget	7.4	10.2	7.9	10.0	7.7
State Budget deficit financing	2.7	2.2	1.6	2.0	1.2
Domestic borrowing, net	1.5	-0.2	0.8	1.2	1.2
Foreign borrowing, net	1.1	2.4	0.7	0.8	0.0
Privatization	0.1	0.1	0.0	0.0	0.0

Source: Government of Kazakhstan.

Note: * The fiscal data (as percent of GDP) presented in this table differ from those in Annex Table 1 due to differences in the GDP and oil-price assumptions used by the government and the World Bank.

D. Structural Reforms

The authorities have launched a major reform effort designed to reduce the size of the public sector and strengthen the competition policy framework

The authorities have launched a major privatization effort, but its implementation will likely prove challenging. President Nazarbayev announced a new privatization initiative in November 2015, and in December the government approved a comprehensive 2016-20 privatization plan. The plan's main objectives are to reduce the state's role in the economy, attract increased foreign direct investment to promote diversification, improve the efficiency of public asset management and secure financing for the budget deficit. The program's targets include a reduction in the number of quasi-public organizations by 15 percent and the privatization of 5 percent of municipal organizations. At the national level, the privatization list includes the 65 largest companies owned directly by the state or indirectly via state-owned conglomerates, Samruk-Kazyna, Baiterek and KazAgro. The national air carrier Air Astana, the state gas company KazMunayGas and the mining firm Kazzinc are also on the list, along with 173 companies that are subsidiaries and affiliates of Samruk-Kazyna. In addition, 545 state assets are to be liquidated, privatized or managed through public-private partnerships.

Attracting the right investors will be critical to the success of the privatization effort. The uncertain global economic environment in general, and the collapse of global oil prices in particular, have reduced the attractiveness of many middle-income countries to international investors, and Kazakhstan is no exception. The challenges of privatization may be exacerbated by the specific terms of the privatization process. For instance, a number of important SOEs are slated for partial privatization, with the government retaining an ownership share of 75 percent or more, which may diminish their appeal to investors. Moreover, the initial public offering approach has not proven successful in Kazakhstan in the past. In addition, slowing economic growth rates have negatively affected the value of the firms and assets that are being privatized, which may deter high-quality investors. The economic deceleration also appears to have dampened the enthusiasm of domestic investors, at least in the short term. Finally, a successful privatization effort will require a transparent, technically sound and fair process for screening investors and evaluating bids.

The authorities are implementing reforms designed to increase competitiveness, with a focus on anti-monopoly policies. Private sector competition is among the government's top institutional reform priorities. Kazakhstan ranked 42nd out of 144 countries in the 2015 global competitiveness index; however, it ranked 68th on the effectiveness of anti-monopoly policies and 94th on the intensity of local competition.⁵ Representatives of the business community perceive competition in local markets to be weak by the standards of comparable countries.⁶ In Kazakhstan, 10 percent of all markets have either monopolistic or duopolistic characteristics, and only 44 percent of surveyed firms face a large number of competitors.⁷ SOEs play an important role in the concentration of Kazakhstan's markets and may require special attention from regulatory authorities, particularly in areas where the private sector could deliver products or services more efficiently.

The authorities have already taken important steps to strengthen the regulatory framework for private sector competition. Recently adopted "Yellow Page Rule" legislation amended the existing anti-cartel enforcement provisions of the Entrepreneurship Code and the State Property Law by introducing the "subsidiarity principle," an innovative approach to competition policy designed to help evaluate and rationalize direct government participation in markets. The Natural Monopoly and

⁵ Global Competitiveness Report 2015.

⁶ World Bank Business Environment and Enterprise Performance Survey (BEEPS), 2015.

⁷ World Bank staff calculation based on BEEPS data.

Regulation and Competition Protection Committee is now mandated to assess whether a particular SOE complies with the subsidiarity principle, and it is developing a pro-competition analytical framework to identify SOEs that do not fulfill a subsidiary role. However, more could be done to enhance market competition. For instance, the government could guarantee a policy of competitive neutrality to ensure a level playing field between the public and private sectors. Broadening the mandate of the Natural Monopoly and Regulation and Competition Protection Committee to include reviewing and approving the creation of SOEs would strengthen the use of subsidiarity as a lens for analyzing state participation in economic activities.

The legislative framework for the “One Hundred Concrete Steps” program is being put in place, but the success of the reform agenda will hinge on the quality of its implementation over the medium term. As of end-2015 parliament had passed 59 legislative acts supporting the implementation of the “One Hundred Concrete Steps” initiative, including measures to modernize and professionalize the civil service, strengthen the rule of law, and enhance public sector transparency and accountability. One new law aims to modernize and professionalize the civil service by providing the legislative basis for a career-oriented, competency-based civil service. Some of these reforms, including changes to recruitment requirements and processes, are already in place, and the newly created Ministry of the Civil Service has been tasked with implementing the remaining reforms. An Anticorruption Bureau within the Ministry of the Civil Service will focus on developing policy and preventive measures, while the creation of a new code of ethics and the introduction of Ethics Commissioners are expected to bolster public integrity. To strengthen the rule of law, a new Civil Procedures Code and a new Law on the High Judicial Council were adopted. In an effort to enhance judicial professionalism, the Law on Judicial System and the Status of Judges was amended to include higher qualification requirements for judges and introduce strict selection mechanisms. The judicial system was restructured into three tiers, with courts of first instance, appeals and cassation. This reform was intended to enhance the efficiency of the court system and to reduce the case backlog in courts of cassation by increasing the responsibility of the courts of first instance and appeals. A new Law on Access to Information came into force in 2016, which is expected to ensure online access to up to 70 percent of public documents. The newly adopted Law on Public Councils is meant to increase public participation in decision-making processes, including the formulation, revision and monitoring of strategic plans and the budget programs of line ministries and local governments. While the legislative effort is commendable, the success of the institutional reform agenda will depend on how effectively it is implemented over the next few years.

E. Outlook

Low oil prices and a fragile global recovery will affect Kazakhstan’s medium-term outlook

Global economic growth is expected to remain modest and uneven over the medium term. The global growth rate reached just 3.1 percent in 2015 and is projected to remain subdued at 3.2 percent in 2016 and 3.5 percent in 2017. Major developed economies, China, India and the ASEAN-5 countries are expected to drive worldwide growth.⁸ However, weaknesses are apparent even within this group. The US growth rate slowed in the last quarter of 2015 and is expected average 2.4-2.5 percent over the next two years. The aggregate EU economy is projected to grow at just 1.8-1.9 percent in 2016-17, while China’s growth will continue to slow (Table 3). The uncertain global recovery has increased the volatility of financial markets and undermined business and consumer confidence. In addition, while the global oil supply has recently contracted, it is still expected to outpace demand over the

⁸ IMF WEO, April 2016. The ASEAN-5 includes Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

medium term, and oil prices are projected to recover gradually.⁹ Global oil demand continues to strengthen, reaching 1.6 million barrels per day in 2015, but years of excess supply have led to the accumulation of large inventories in OECD countries.

Table 3. Projected Global Economic Growth Rates and Oil Prices, 2014-17

(In percentage change, unless otherwise indicated)

Countries	2014	2015	2016 (est.)	2017 (proj.)
World, of which:	3.4	3.1	3.2	3.5
United States	3.4	2.4	2.4	2.5
European Union	1.5	2.0	1.8	1.9
China	7.3	6.9	6.5	6.2
Russia	-1.4	-3.7	-1.9	1.1
Oil price, Brent-Dubai-WTI average (US\$ per barrel)	96.2	50.8	41.0	50.0

Sources: IMF, WEO April 2016; WBG Russia projections and Commodities Prices, April 2016.

Growth prospects among Kazakhstan’s major trading partners remain uneven and could negatively affect its exports. Growth in the EU, Kazakhstan’s largest oil export market, was slower than anticipated at just 2 percent in 2015 and is expected to remain modest through 2017. Meanwhile, the growth of the Chinese economy, a major export market for Kazakhstan’s oil and metal products, is expected to slow from 6.9 percent in 2015 to 6.5 percent in 2016 and 6.2 percent in 2017, as the economy transitions to a new development model. The Russian economy, a major destination for Kazakhstan’s metal exports, contracted by 3.7 percent in 2015 and is expected to contract by another 1.9 percent in 2016 due to a combination of international sanctions, falling oil prices and the depreciation of the ruble, with its attendant pass-through effects on inflation and domestic demand.

Figure 11. Oil Price and Output Outlook

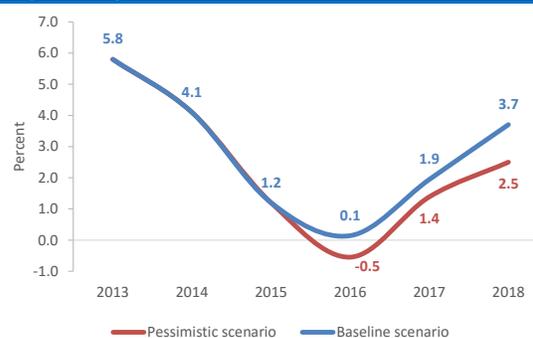
(In US\$ per barrel and million metric tons)



Source: World Bank staff estimates.

Figure 12. GDP Growth Outlook

(In percent)



Source: World Bank staff estimates.

The analysis of Kazakhstan’s medium-term economic outlook presented below is based on two scenarios. The baseline scenario reflects the World Bank’s current oil-price forecast, which projects that average crude oil prices will fall to US\$41 per barrel in 2016, then rebound to US\$50 in 2017 and US\$53.3 in 2018 (Figure 11). A second, more pessimistic scenario assumes that oil prices

⁹ Despite falling US shale-oil output, the decline in the global oil supply is believed to have run its course, given continuing robust OPEC and Russian production and the return of Iran to the market. The World Bank estimates that, *ceteris paribus*, an increase in Iranian oil exports by 1 million barrels per year to pre-sanction levels would cause global oil prices to fall by about 14 percent, or about US\$10 per barrel, in 2016. See: MENA QEB, 2015.

will be 15 percent lower than in the baseline. Under this scenario oil prices would hit US\$33 per barrel in 2016 before recovering modestly to US\$42 in 2017 and US\$45 in 2018.

Under the baseline scenario Kazakhstan’s GDP growth rate is projected to remain at close to zero in 2016 due to low oil prices, a continuing recession in Russia and slowing growth in China. As expected in an economy dealing with a large and persistent terms of trade shock, an uncertain economic outlook would damage investor confidence and undermine domestic demand, while the inflationary pass-through effect of the tenge’s depreciation will continue to erode household purchasing power. The ongoing fiscal adjustment is expected to keep public sector consumption subdued. Weak domestic demand will slow the recovery of production and retail trade, while low oil prices will continue to inhibit the growth of ancillary subsectors such as transportation and wholesale trade. Both the fiscal and current-account deficits are expected to narrow somewhat from their 2015 levels, but will remain negative in 2016.

Over the medium term, the projected recovery of oil prices is expected to boost domestic demand. Under the baseline scenario, GDP growth is projected to rise to 1.9 percent in 2017, while rising oil revenues and continued fiscal consolidation would improve the overall fiscal balance. The current-account deficit is expected to narrow significantly as oil prices increase and the Kashagan oilfield begins production in 2017. In 2018, GDP growth is projected to accelerate to 3.9 percent as rising oil output bolsters consumer and investor confidence, and further improvements are expected in the fiscal and current-account balances. Barring any new external shocks, inflation is projected to remain modest over the medium term (Table 4).

Table 4. Baseline Scenario: Selected Macro-Fiscal Indicators, 2014-18
(In percentage change, unless otherwise indicated)

	2014	2015	2016	2017	2018
			Projections		
Oil price, Brent-Dubai-WTI spot average (US\$ per barrel)	96.2	50.8	41.0	50.0	53.3
Oil production (million metric tons)	80.8	79.5	77.0	78.4	79.8
GDP at constant market prices	4.1	1.2	0.1	1.9	3.7
Private consumption	1.8	1.0	0.0	1.5	4.5
Government consumption	9.8	3.0	-10.5	1.6	1.6
Gross fixed capital investment	4.4	4.1	6.8	4.7	5.3
Exports of goods and services	-3.2	-3.6	-2.1	2.1	2.5
Imports of goods and services	-4.0	-0.6	-1.0	3.0	4.0
GDP at constant factor prices	3.9	1.7	0.3	2.1	3.9
Oil sector	-1.0	1.1	-1.9	2.3	3.5
Nonoil sector	5.4	1.6	0.8	1.9	3.8
Consumer price inflation, year-end (percent)	7.4	13.6	6.9	4.3	4.5
Consumer price inflation, period average (percent)	6.7	6.6	14.2	4.8	4.4
Nominal exchange rate, period average (KZT/USD)	179	222	330	315	305
Current-account balance (percent of GDP)	2.8	-3.2	-2.9	-0.2	0.3
Overall fiscal balance (percent of GDP)	0.0	-7.8	-5.1	-2.2	-1.2
Non-oil fiscal balance (percent of GDP)	-10.1	-12.5	-10.3	-8.9	-8.7
Official FX reserves, stock (percent of GDP)	41.8	45.5	56.5	50.7	49.5
Central Bank FX reserves	9.6	11.0	15.0	15.8	17.7
Oil Fund FX reserves	32.2	34.4	41.5	34.9	31.8
Government debt and guarantees (percent of GDP)	14.1	21.9	21.4	20.9	20.7

Source: World Bank staff calculations and estimates.

The public debt stock is expected to remain low under the baseline scenario, though reserves in the Oil Fund will decline. As part of its fiscal adjustment the government plans to reduce annual net borrowing from 2.2 percent of GDP in 2015 to about 1 percent by 2018. This should keep the total stock of public and publicly guaranteed debt stable at about 21 percent of GDP over the medium term. From 2015 onward an anticipated US\$6.5 billion in multilateral borrowing to finance the implementation of the Nurly Zhol program will increase the debt stock, though favorable borrowing terms should mitigate the impact on the debt profile. Meanwhile, net foreign-exchange savings in the Oil Fund are projected to stop growing, as oil prices will remain well below a breakeven point of about US\$80 per barrel, suggesting that the government will draw on oil revenue to finance the nonoil deficit.

Table 5. Pessimistic Scenario: Selected Macro-Fiscal Indicators, 2014-18
(In percentage change, unless otherwise indicated)

	2014	2015	2016	2017	2018
			Projections		
Oil price, Brent-Dubai-WTI spot average (US\$ per barrel)	96.2	50.8	33.0	42.0	45.0
Oil production (million metric tons)	80.8	79.5	77.0	78.4	79.8
GDP at constant market prices	4.1	1.2	-0.5	1.4	2.5
Private consumption	1.8	1.0	-1.0	0.0	2.0
Government consumption	9.8	3.0	-10.6	3.0	3.0
Gross fixed capital investment	4.4	4.1	6.8	3.0	3.9
Exports of goods and services	-3.2	-3.6	-2.1	2.1	2.5
Imports of goods and services	-4.0	-0.6	-3.0	1.0	3.5
GDP at constant factor prices	3.9	1.7	-0.4	1.5	2.6
Oil sector	-1.0	1.1	-1.9	2.3	3.5
Nonoil sector	5.4	1.6	-0.1	1.2	2.2
Consumer price inflation, year-end (percent)	7.4	13.6	6.8	4.6	4.9
Consumer price inflation, period average (percent)	6.7	6.6	14.0	5.0	4.8
Nominal exchange rate, period average (KZT/USD)	179	222	345	345	335
Current-account balance (percent of GDP)	2.8	-3.2	-6.1	-2.6	-2.7
Overall fiscal balance (percent of GDP)	0.0	-7.8	-5.7	-3.5	-3.1
Non-oil fiscal balance (percent of GDP)	-10.1	-12.5	-10.6	-9.5	-9.5
Official FX reserves, stock (percent of GDP)	41.8	45.5	59.2	53.4	49.9
Central Bank FX reserves	9.6	11.0	14.5	14.1	14.1
Oil Fund FX reserves	32.2	34.4	44.7	39.3	35.9
Government debt and guarantees (percent of GDP)	14.1	21.9	22.9	22.4	23.9

Source: World Bank staff calculations and estimates.

Under the pessimistic scenario, Kazakhstan's growth performance would be weaker than in the baseline, though it would be driven by the same dynamics described above. In a context of lower oil prices GDP would contract by 0.5 percent in 2016 before expanding by 1.4 percent in 2017 and 2.5 percent in 2018, as the Kashagan oilfield comes online (Table 5 and Figure 12). However, it should be noted that low oil prices could themselves cause a delay in Kashagan oil production, compounding the downside risk of low prices. Both export revenues and the growth of oil-related subsectors, such as technical services and transportation, would be lower and would recover more slowly than in the baseline. Domestic demand, both in terms of consumption and investment, would recover more gradually than in the baseline, slowing the improvement of Kazakhstan's fiscal and external positions. Total government debt would be higher than in the baseline scenario, though it would remain stable and sustainable and would ultimately decline over the long term. In a context of

low growth, and barring any new negative food- or fuel-price shocks, the consumer price inflation would fall below 5 percent in 2017.

The downside risks suggest that the recovery may take a while, affecting job creation and poverty reduction, and the authorities may need to take an action. Longer recovery time and lower growth rates would likely impact employment and poverty dynamics, which could prompt the authorities to expand targeted social protection programs and increase infrastructure investment to support economic activity and promote social welfare. Accelerating the implementation of planned macroeconomic, institutional and structural reforms would have a substantial impact on the drivers of medium-term growth. In turn, higher (and higher quality) growth of the non-oil economy will help create productive and high quality jobs, including for the large cohort entering the labor market starting in 2020 (further discussed in Focus Section).

F. Focus Section: How to Promote Job Creation in a Difficult Economic Context?¹⁰

Kazakhstan created over 1.5 million jobs between 2004 and 2014 in the context of a favorable global environment, high oil prices and robust economic growth. However, the quality and productivity of many jobs remain relatively low. Moreover, about 30 percent of the employed are self-employed, and many self-employed workers are classified as “unproductive.” In order to create high-quality jobs Kazakhstan will need to overcome three key challenges. First, as oil prices are expected to recover slowly, and modest growth rates are projected over the medium term, policymakers cannot rely on a favorable macroeconomic environment to drive job creation. Second, the authorities will need to design policies to address the needs of the large share of self-employed workers who are underemployed or suffer from low productivity. Finally, starting around 2020 the job-creation rate will need to increase significantly, as a large cohort of young people will begin entering the labor force.

Between 2004 and 2014 Kazakhstan’s economy grew at an annual average rate of 6.5 percent and created over 1.5 million jobs, but a large segment of the workforce remains engaged in relatively unproductive forms of self-employment. While structural economic changes led to a reduction in the number of agricultural sector jobs, the share of agricultural employment remains high. Moreover, most new jobs were created in relatively low-productivity service sectors, while industrial job creation was stagnant. Although the labor force increased by about 130,000 workers per year, the job-creation rate for wage employment was substantially higher, at about 170,000 jobs per year.¹¹ The official unemployment rate fell from 8.4 percent in 2004 to 5 percent by end-2014, and the self-employment rate fell from 40 percent of the employed workforce in 2003 to about 30 percent in 2014. However, the self-employment rate remains close to 30 percent, dramatically higher than in most OECD countries. Indeed, self-employment dynamics may more accurately reflect the challenges facing Kazakhstan’s labor market than unemployment indicators. A large share of the self-employed population does not earn sufficient income to keep their households above the poverty line (Figure 13). As of 2015, about 25 percent of self-employed workers, or around 500,000 people, were classified as “unproductive.”¹²

¹⁰ This focus section was developed in collaboration with Thomas Farole, Lead Economist, World Bank Group, as part of a larger study on jobs and job creation in Kazakhstan by the World Bank Group. It is designed to complement and deepen the analysis presented in the focus section of the May 2015 edition of the Kazakhstan Biannual Economic Update.

¹¹ Job numbers are in gross term.

¹² The government measures the degree to which self-employment is ‘productive’ or ‘unproductive’, where ‘unproductive self-employment’ is defined to be employment that delivers earnings below a national subsistence minimum. As of April 2015, this level is set at 19,036 tenge per month per person. Even at this low level, 30 percent of the self-employed in Kazakhstan (around 700,000 workers) are classified as ‘unproductively self-employed’, and therefore are likely to be in

Unproductive self-employment is concentrated in the agricultural sector. Most unproductive self-employed workers live in rural areas, and their average education level is lower than that of other workers. Agriculture accounts for half of all self-employment in Kazakhstan, and self-employed workers hold two-thirds of all agricultural jobs (Figure 14). Trade is the second most common sector for self-employment, accounting for 26 percent of self-employed workers, who hold more than half of all service jobs. Transportation and construction are the only other sectors where self-employment plays a significant role, accounting for 31 percent and 27 percent of jobs, respectively. Self-employment in Kazakhstan is concentrated in rural areas and outside of the country’s oil-producing and metropolitan regions. Self-employment accounts for fewer than 5 percent of jobs in Astana and fewer than 10 percent in Almaty City and Mangistau. By contrast, almost half of all employment in Zhambyl is self-employment, as is 45 percent of employment in South Kazakhstan. Low-productivity self-employment is concentrated among the least educated segments of the population. While around 75 percent of all wage workers have specialized vocational or tertiary education, the same is true for only half of nonagricultural self-employed workers and less than 36 percent of farmworkers.

Figure 13. Estimated Distribution of Low-Wage Workers by Employment Type, 2013

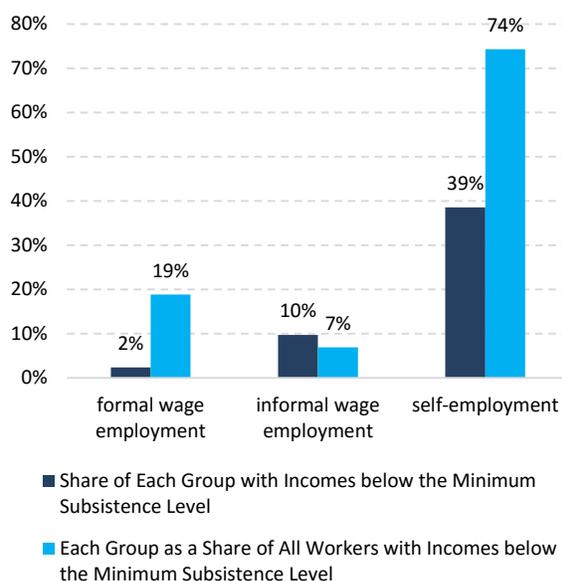
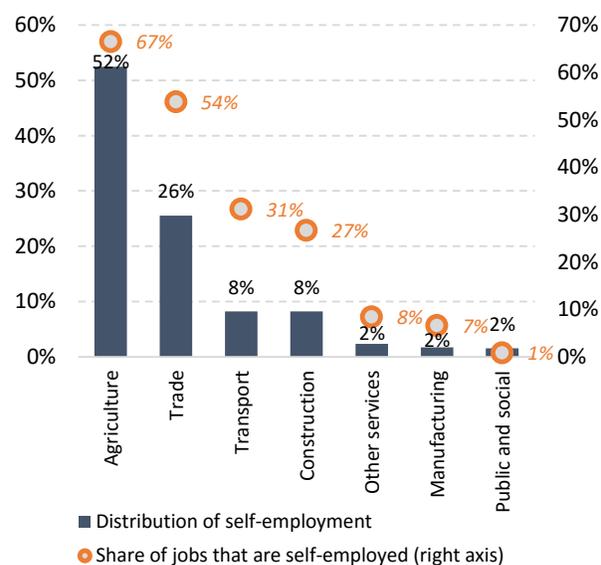


Figure 14. Sectoral Distribution and Concentration of Self-Employed Workers, 2014



Source: World Bank staff calculations based on official data.

While robust growth and a favorable external environment drove employment dynamics in the past, positive external conditions and high growth rates cannot be expected to sustain future job creation. Oil prices are expected to recover slowly and to remain below their pre-crash level, while the GDP growth rate is expected to remain modest over the medium-to-long term. In this context an analysis of several alternative scenarios for maintaining a steady-state outcome in the labor market over different time periods can shed light on the options available to policymakers.

The scenarios presented below reflect two key macroeconomic variables: the GDP growth rate and the employment elasticity of growth. The current employment elasticity of growth is estimated at 0.23; i.e., one percent GDP growth yields a 0.23 percent increase in employment. Given

households that are either poor or vulnerable. Using an alternative, relative poverty rate of 25 percent of average earnings, which would be 50 percent higher than the current threshold, would define a much larger share of the self-employed as “unproductive.”

the current rate of employment elasticity, an annual GDP growth rate of around 3.5 percent would be required to keep employment indicators stable over 2015-2020, and higher growth rates would be needed to reduce the rate of self-employment. However, if Kazakhstan were able to shift to a more employment-intensive growth pattern, which would most likely entail diversifying away from the natural resource sector, steady-state labor market outcomes could be achieved with lower annual growth rates. Under an alternative scenario in which the employment elasticity of growth rises from 0.23 to 0.45, a 2 percent average GDP growth rate would be sufficient to keep employment indicators constant through 2020 (Figure 16). Between 2023 and 2030, however, substantially higher growth rates would be necessary under both scenarios to offset an anticipated influx of new workers into the labor market. Under the baseline scenario the GDP growth rate would have to accelerate to at least 5.7 percent per year. These projections underscore the critical importance of diversifying into more labor-intensive activities and sectors.

Figure 15. The Projected Growth of the Labor Force, 2010-50
(Year-on-year and cumulative increase in the labor force)

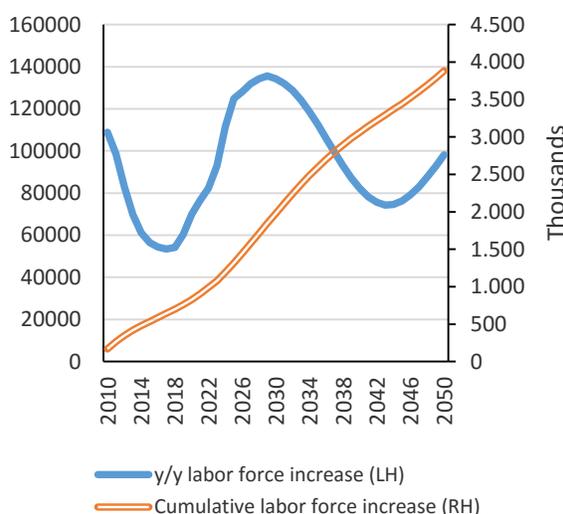
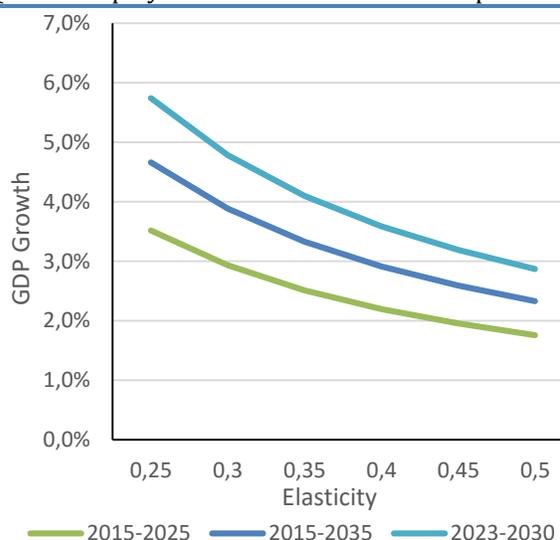


Figure 16. Growth Rates Required to Maintain Stable Employment Indicators
(Three employment elasticities over three periods)



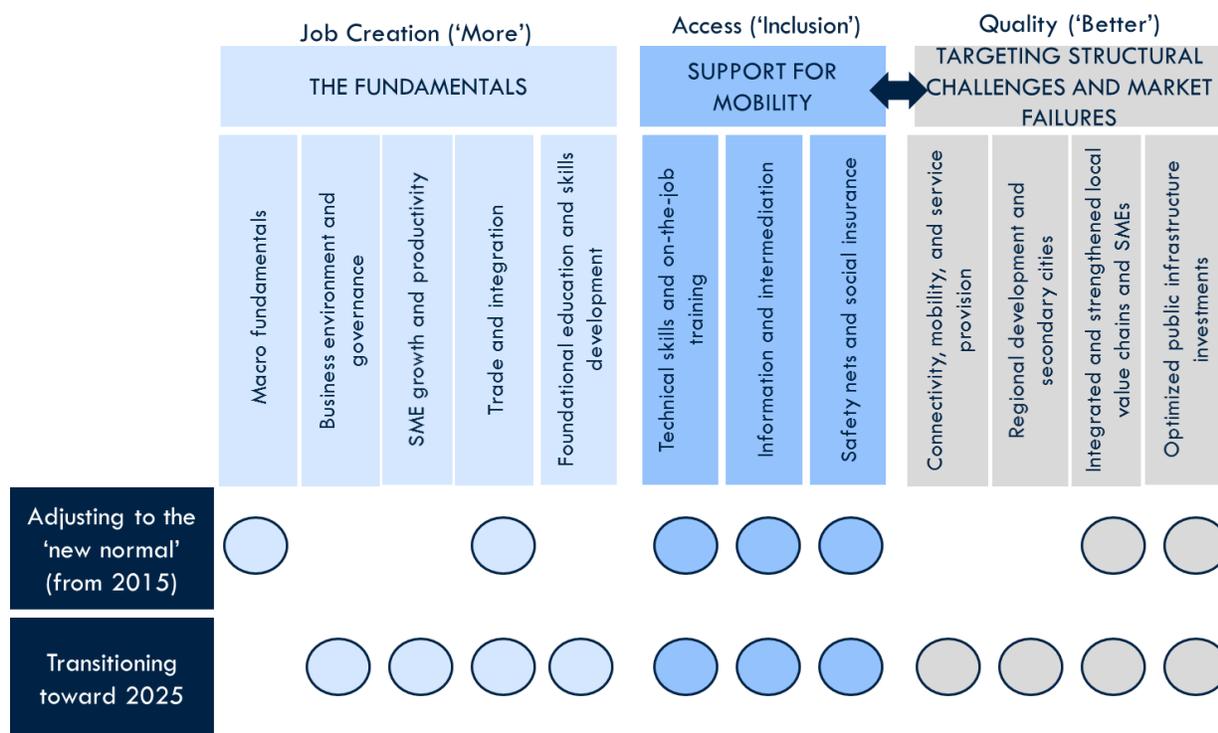
Source: World Bank staff calculations and estimates.

The government has formulated a large number of strategies and initiatives designed to address various elements of high-quality job creation. Kazakhstan’s diversification programs tend to focus primarily on the business environment, especially access to finance and firm-level productivity. Meanwhile, employment programs often concentrate on technical training, job-search assistance and relocation support, and are generally targeted to vulnerable groups. Many programs include cross-cutting interventions, such as support for entrepreneurship and overall private sector development. However, the link between the diversification and jobs agendas is not strong enough to fully leverage programmatic synergies. Most economic and social development strategies and large infrastructure projects do not include greater employment and labor productivity as explicit objectives. As a result, the program components that address different aspects of employment are disjointed and in some cases may even be working at cross purposes.

A comprehensive strategy to create more and higher quality jobs must incorporate both short- and long-term objectives and actions. Short-term policies will need to focus on adjusting to a context of persistently lower economic growth rates by adopting an appropriate set of macro-fiscal policies to control economic volatility and maintain adequate fiscal space to invest in stimulus programs and protect vulnerable workers. Medium-term policies should concentrate on advancing

the economy’s structural transformation to create high-quality jobs and establish the necessary conditions to absorb the larger number of new workers entering the labor market over the coming decade (Figure 17).

Figure 17. A Strategic Framework for Employment Creation in Kazakhstan



Source: World Bank Group staff.

Maintaining macroeconomic stability and ensuring the prudent management of natural resource revenues will be critical for Kazakhstan to sustain the gains achieved over the past decade. Adopting a more balanced approach to budget management, including efforts to strengthen control over non-resource revenues and ensure expenditure discipline—as well as increased attention to the quality and efficiency of expenditures—would help reinforce macroeconomic stability. Prudent management of the natural resource earnings would entail strengthening the institutional and governance framework to support transparency and fiscal discipline, enabling the Oil Fund to achieve its core objectives of development of Kazakhstan’s endowments while avoiding Dutch disease and savings for the future.

An agenda for supporting overall private sector growth will be necessary but not sufficient to promote high-quality employment creation. In order to generate sustainable, high-quality jobs Kazakhstan must develop a more diversified and competitive private sector. However, firms guided only by their private economic incentives may choose to invest in sectors with low employment intensity, such as the extractive industries. Building competitive advantages based on productivity growth may involve a shift from labor-intensive to capital-intensive activities and could boost demand for a more sophisticated mix of workforce skills. The development of agglomeration economies may further encourage the concentration of employment growth in major urban centers.

Facilitating the growth of SMEs will be crucial to promote diversification and job creation. Kazakhstan’s SME sector is responsible for just 28 percent of total job creation, far below the global average of 63 percent. Although Kazakhstan’s economy includes more than 300,000 SMEs, just over

half of all registered SMEs are active. Moreover, SMEs in Kazakhstan grow more slowly than both larger firms in Kazakhstan and SMEs in comparable countries. While Kazakhstan is believed to have a large number of “latent entrepreneurs,” the share of startup firms remains relatively low,¹³ and few firms transition from small to medium size, or from medium to large. Barriers such as geography, local market size, informality, corruption and clientelism, high administrative costs, inadequate access to finance, and a lack of professional and managerial skills all inhibit the formation and growth of SMEs.¹⁴ The dominant role of SOEs in a number of markets is also a major barrier to the entry and growth of smaller firms and to the overall development of the private sector (Figure 18).

Figure 18. SOEs as a Share of Registered Firms by Firm Size and Location

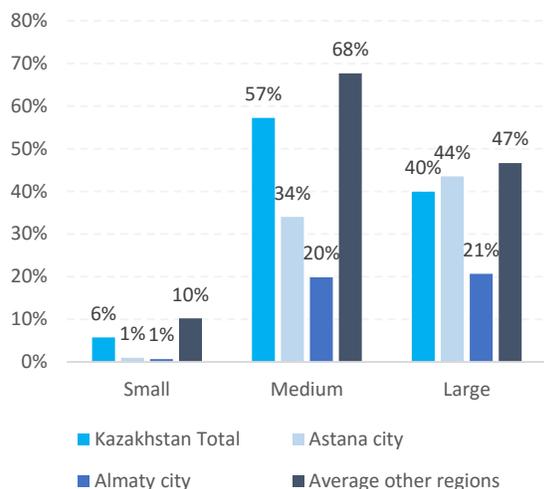
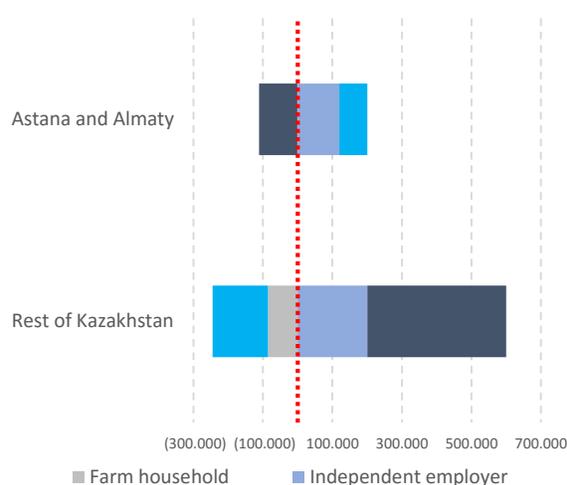


Figure 19. Employment Gains and Losses by Employer Type and Location, 2010-13



Source: World Bank staff calculations based on official data.

Addressing low-productivity self-employment will require dealing with important spatial challenges in the distribution of jobs. Employment policies should focus on rural workers with lower levels of educational attainment and include support to facilitate mobility as well as targeted sectoral interventions designed to promote the creation of high-quality jobs outside of metropolitan areas. Successful employment programs will support the development of technical skills and promote on-the-job training to ensure the cultivation of relevant skills. Employment information and intermediation services would help link workers to jobs and promote labor mobility, and providing adequate social insurance would facilitate the adjustment of the labor market.

These measures should be complemented by interventions designed to address structural challenges and market failures. Employment initiatives should explicitly try to expand employment access among vulnerable groups and marginalized communities by improving economic connectivity, promoting agglomeration, strengthening and integrating local value chains, and implementing complementary public works. A well-designed jobs agenda should not focus exclusively on cyclical employment needs, but should reflect a comprehensive approach to maximizing the economy’s short- and long-term employment potential.

¹³ World Bank, 2013.

¹⁴ ADB, 2014.

Annex Table 1. Selected Macroeconomic and Social Indicators, 2013-18

	2013	2014	2015	2016	2017	2018
				Projections		
(In percent, unless otherwise indicated)						
National Accounts and Prices						
GDP growth	5.8	4.1	1.2	0.1	1.9	3.7
Oil sector growth	-4.8	-1.0	1.1	-1.9	2.3	3.5
Non-oil sector growth	9.6	5.4	1.6	0.8	1.9	3.8
GDP per capita growth	4.3	2.6	-0.3	-1.2	0.6	2.5
GDP per capita (US\$)	14,310	13,155	10,508	7,765	8,625	9,442
Private consumption growth	12.6	1.8	1.0	0.0	1.5	4.5
Gross investment (percent of GDP)	22.8	24.1	26.4	27.0	27.3	27.2
Consumer price inflation, year-end	4.8	7.4	13.6	6.9	4.3	4.5
Consumer price inflation, period average	5.8	6.7	6.6	14.2	4.8	4.4
GDP deflator	8.9	5.6	-0.9	11.3	5.4	3.4
(In percent of GDP, unless otherwise indicated)						
Consolidated Fiscal Accounts						
Revenues	23.4	21.3	15.7	16.2	17.5	18.6
Oil revenue	11.6	10.1	4.7	5.2	6.7	7.5
Non-oil revenue	11.8	11.2	10.9	11.0	10.9	11.1
Expenditures	19.8	21.3	23.5	21.3	19.8	19.8
Current expenditures	14.7	15.0	16.6	17.0	16.6	16.5
Capital expenditures and net lending	5.1	6.3	6.9	4.2	3.2	3.3
Overall fiscal balance	3.6	0.0	-7.8	-5.1	-2.2	-1.2
Non-oil fiscal deficit	-8.0	-10.1	-12.5	-10.3	-8.9	-8.7
(In current US\$ billions, unless otherwise indicated)						
External Accounts						
Merchandise exports, <i>of which:</i>	85.6	80.2	46.3	40.5	47.1	50.3
Oil exports	57.2	53.6	28.0	22.0	27.6	30.2
Merchandise imports	-50.8	-43.5	-33.6	-28.3	-29.6	-31.2
Current-account balance	1.2	6.4	-5.8	-4.0	-0.3	0.5
as percent of GDP	0.5	2.8	-3.2	-2.9	-0.2	0.3
Foreign direct investment, net	8.0	4.8	3.4	3.2	3.5	3.6
Total official international reserves	95.5	102.5	91.4	86.3	86.2	92.5
FX reserves in the Oil Fund	70.8	73.2	63.5	57.3	54.3	54.8
FX reserves at the Central Bank	19.2	21.8	20.3	20.7	24.5	30.5
Gold reserves	5.6	7.4	7.6	8.3	7.4	7.2
External debt, total	150.0	157.4	153.5	162.4	168.1	173.6
External debt, excl. intra-company loans	75.9	78.0	71.6	76.5	78.7	81.7
as percent of GDP	31.1	34.3	38.8	55.3	50.6	47.4
Multilateral debt (percent of external debt)	2.8	2.9	3.6	5.0	5.5	6.4
Social Indicators						
Population, total (millions)	17.0	17.3	17.5	17.8	18.0	18.2
Population growth (percent)	1.5	1.5	1.5	1.4	1.3	1.2
Unemployment rate (percent of labor force)	5.2	5.0	5.0
Poverty rate, national (percent of population)	2.9	2.8	2.7

Sources: World Bank staff calculations and estimates based on official data published and provided by the authorities.



Kazakhstan

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