

Kazakhstan

Economic Update
No.2 | Fall 2015



Adjusting to Lower Oil Prices; Challenging Times Ahead



Kazakhstan:

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Fall 2015

Government Fiscal Year: January 1st – December 31st
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Currency Equivalents: (Exchange Rate Effective as of November 30, 2015)
US\$1 = 307.2 KZT
Weights and Measures: Metric System

Abbreviations and Acronyms

EaCU Eurasian Customs Union
EaEU Eurasian Economic Union
ECA Europe and Central Asia
FDI Foreign direct investment
FX Foreign exchange
NBK National Bank of Kazakhstan
NPL Non-performing loan
SOEs State-owned enterprises
SPIID State Program for Industrial and Innovative Development
WTO World Trade Organization

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Foreword

This edition of the Kazakhstan Economic Update is part of biannual series designed to monitor economic developments in Kazakhstan. It presents a concise analysis of macroeconomic and structural conditions during the first nine months of 2015, plus preliminary data for October. The authors are Dorsati Madani and Ilyas Sarsenov, Senior Country Economists for Kazakhstan. The focus section was developed in collaboration with Sara Rebollo Ramirez (Investment Promotion Officer), Robert Whyte (Senior Investment Promotion Officer), Harald Jedlicka (Senior Investment Policy Officer), Persephone Economou (Research Officer), and Ekaterina Kniga (Consultant). The authors are grateful for the guidance and comments provided by Ludmilla Butenko (Country Manager for Kazakhstan), Christos Kostopoulos (Lead Economist for Central Asia), and Faruk Khan (Lead Economist for Afghanistan, as well as Sarah Babirye and Zakia Nowrouz (Team Assistants), who helped format the report.

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Overview

Kazakhstan's economy faces the challenge of adjusting to a large terms-of-trade shock in a context of declining domestic and external demand. After a substantial drop during the second half of 2014, oil prices remained low in 2015, averaging about US\$53 per barrel during January-October 2015, with negative implications for both domestic consumption and investor confidence. Meanwhile, China's GDP growth rate is estimated to have slowed to less than 7 percent, and Russia's economy is estimated to contract by 3.8 percent in 2015, affecting demand for Kazakhstan's exports and, thus, translating into lower economic growth and inflation for Kazakhstan. Kazakhstan's GDP growth slowed from 4.1 percent (year-on-year) during the first nine months of 2014 to an estimated 1 percent during the same period in 2015. Oil prices dropped by more than 50 percent between June 2014 and October 2015, cutting export revenues by almost a half and creating a twin deficit in the fiscal and current-account balances in 2015. In addition, foreign direct investment (FDI) inflows declined and the overall external balance deteriorated, putting downward pressure on the tenge. Inflation decreased from 7.5 percent (year-on-year) in the beginning of 2015 to a historical low of 3.8 percent in August due to weaker domestic demand and lower fuel prices. However, inflation appears to be rising once again in the wake of the recent exchange-rate adjustment.

The authorities responded to the collapse of global oil prices through a rapid fiscal adjustment followed by corresponding monetary and exchange-rate policy adjustments. In March 2015, the government balanced out the earlier allocated spending for the infrastructure development program *Nurly Zhol* with reductions or delays in other non-priority capital expenditures, allowing it to keep the state budget deficit (or a debt accumulation) within 3 percent of GDP in 2015. Meanwhile, the central bank tightened its monetary policy stance in support of the pegged exchange-rate regime to ensure price and exchange rate stability. Tighter monetary policy reduced credit to the economy despite the government's provision of subsidized loans to specific sectors. The defense of the pegged exchange rate regime affected official international reserves. It also contributed to the real appreciation of the tenge and dollarization of deposits in the banking system. In August 2015, the authorities decided to move to a floating exchange rate and shift the country's monetary policy to an inflation-targeting regime. By end-October 2014, the tenge had lost about a third of its value against the US dollar. These policy measures and the adjustment of the relative prices were necessary to safeguard fiscal and external accounts sustainability in the medium term and help adjust national income in a context of lower oil prices.

A difficult external environment will continue to affect Kazakhstan's medium-term outlook; over the longer term diversification of the economy will increase its resilience to external shocks. Under our baseline scenario, oil prices are expected to remain low through 2016 before gradually recovering in 2017, supporting increased consumption and stronger investor confidence over the medium term. GDP growth will remain at about 1 percent in 2015 and 2016, but may increase to 3.3 percent in 2017. The lower-case scenario assumes that in 2016 oil prices will fall further than in the baseline, worsening Kazakhstan's fiscal and external positions and further depressing domestic demand and GDP growth. Under both scenarios, domestic oil production is expected to begin increasing in 2017 due to oil production in the Kashagan, boosting GDP growth and improving the fiscal and current account balances. Nevertheless, the economy continues to face significant downside risks, including the possibility of delays in Kashagan oil production or a protracted recession in Russia and a further slowdown in China. Going forward, the successful implementation of the government's ambitious structural reform agenda, including full implementation of World Trade Organization (WTO) agreements, along with institutional reforms and capacity building, human capital formation and continued investment in infrastructure should

boost productivity and competitiveness in the non-oil economy. Over time, this is expected to lay the foundation for a more sustainable and diversified development path in Kazakhstan.

A. Recent Political Developments

During the first ten months of 2015, Kazakhstan reaffirmed its political stability and the government launched a new wave of structural reforms. President Nursultan Nazarbayev was re-elected in April 2015 to a new five-year term with a solid margin of support. He promptly re-nominated the government led by Prime Minister Karim Massimov, confirming the continuity of political leadership and continued support for the structural reform agenda in the face of an uncertain global economic climate and subdued Kazakhstan's economic growth. In May 2015, the government launched a new wave of institutional, social and economic reforms designed to support nation building and economic development. The "One Hundred Concrete Steps, a Modern State for All" program is focused on five priority areas for institutional reform: (i) professionalizing the public administration, (ii) enforcing the rule of law, (iii) increasing public transparency and accountability of the state, (iv) fostering economic diversification and growth, and (v) uniting the nation. Strengthening institutions via the *One Hundred Concrete Steps* program, improving investments in physical infrastructure via the *Nurly Zhol* program, and efforts to build human capital and enhance workforce skills all represent key pillars of the country's long-term development strategy, *Kazakhstan 2050*, the objective of which is to develop a more diversified, knowledge-based economy led by the private sector.

B. Recent Economic Developments

Worsening external conditions led to slower growth in Kazakhstan

In 2015, the ongoing slump in global oil prices and weak domestic and external demand adversely impacted Kazakhstan's GDP growth. Growth slowed from 3.9 percent, year-on-year (y/y), in the first half (H1) of 2014 to 1.7 percent in H1 2015 (Table 1). Preliminary estimates indicate that GDP growth slowed to about 1 percent (y/y) in the first nine months of 2015, compared to 4.1 percent during the corresponding period in 2014. The precipitous drop in oil prices during H2 2014 influenced negatively domestic demand, while slowing growth in China (below 7 percent) and the contraction of the Russian economy (-3.7 percent during the first nine months of 2015) diminished external demand. Household consumption contracted by 2.3 percent (y/y) in 2014, then rebounded by 1.4 percent in H1 2015 as households presumably began drawing down their savings. Government consumption slowed as a result of the fiscal adjustment undertaken in response to the oil-price shock. The growth rate of fixed capital investment fell from 5.1 percent (y/y) in H1 2014 to 2.8 percent in H1 2015 as devaluation expectations, competition from Russian imports, and uncertain global economic prospects weakened investor confidence.

Industrial output continued to contract, while growth in the service sector slowed sharply. Industrial production contracted by 1.3 percent (y/y) in the first ten months of 2015, mainly due to a contraction in mining. Mining output fell by 2.2 percent in the first ten months of 2015 due to reduced demand for oil and metals from China and Russia. Manufacturing growth accelerated from 0.3 percent in the first ten months of 2014 to 0.5 percent during the same period in 2015, as a 15.3 percent expansion in the metallurgical subsector offset declines in food and beverages (-0.6 percent), oil refining (-5.3 percent), and an especially sharp drop in auto assembly (-55 percent). Oil refining and auto assembly were negatively affected by the appreciation of the tenge against the Russian

ruble, which led to a surge in merchandise imports from Russia.¹ Growth in services halved from 5.7 percent (y/y) in the first nine months of 2014 to 2.4 percent in same period of 2015. Preliminary data suggest that the growth of domestic trade, a major component of the service sector, has been slowing sharply due to weaker domestic demand. Agriculture grew by about 1.9 percent in the first ten months of 2015, marginally higher than in the previous year (Figure 1).

Table 1. Contribution to Real GDP Growth, 2012-15

(Percentage points)

	2012 H1	2012 H2	2013 H1	2013 H2	2014 H1	2014 H2	2015 H1
GDP growth	5.6	4.4	5.1	6.9	3.9	4.7	1.7
<i>of which contribution from:</i>							
Domestic demand	7.7	10.3	13.3	2.0	0.3	3.2	1.8
Consumption	6.9	5.4	7.1	5.2	0.3	-0.2	1.0
Government	1.4	1.4	0.2	0.2	1.4	0.7	0.3
Households	5.3	4.0	6.9	4.9	-1.1	-1.2	0.7
Gross capital formation	0.8	4.9	6.1	-3.2	0.0	3.4	0.9
Fixed capital investment	0.5	3.4	1.2	0.9	0.8	-0.8	0.5
Net exports	-5.1	-2.9	-7.7	5.5	3.5	2.6	0.4
Exports of goods and services	-1.1	4.9	-5.2	6.9	-0.7	-3.3	-1.8
Imports of goods and services	-4.0	-7.8	-2.5	-1.5	4.2	5.9	2.2
Statistical discrepancy	-3.0	3.1	0.4	0.6	-0.1	1.1	0.5

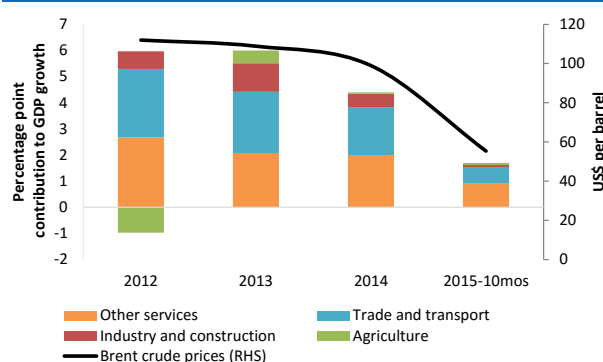
Source: World Bank staff calculations based on data from the Statistical Office of Kazakhstan.

Note: Some totals may not add up exactly due to rounding.

Weaker domestic demand and lower fuel prices reduced inflation in the first eight months of 2015, but the pass-through effect of the tenge depreciation since August appears to have reversed this trend. Headline inflation fell from 7.5 percent (y/y) in the beginning of 2015 to a historical low of 3.8 percent in August, but by September a combination of the exchange-rate adjustment and the related removal of price controls on gasoline had begun pushing up consumer prices. As a result, headline inflation averaged 4 percent (y/y) in Q3 2015 but jumped to 9.4 percent in October (Figure 2). Food-price inflation that initially dropped from 8.7 percent (y/y) in January 2015 to 3.5 percent in August, then increased to 3.8 percent in September and 8.0 percent in October. Non-food price inflation also initially fell from 7.4 percent (y/y) in January 2015 to 2.9 percent in August, due in large part to fall in the prices for imported cars and both domestic and imported fuel. However, it rebounded to 4.5 percent in September as gasoline prices adjusted and further up to 14.5 percent in October due to the pass-through effect of the tenge depreciation.

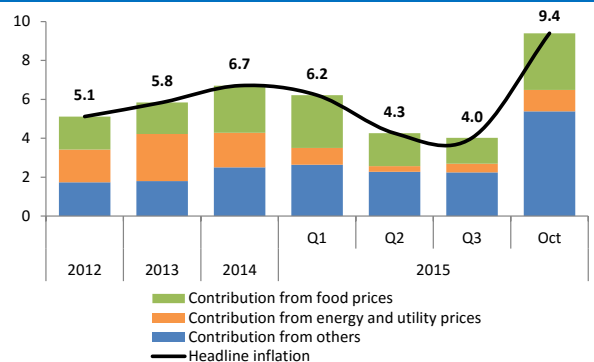
¹ As a result of the oil price shock, the Russian ruble has lost a half of its value vis-à-vis the U.S. dollar since mid-October 2014 when the Central Bank of Russia switched to a floating exchange rate regime, while the Kazakhstan's tenge remained relatively stable, leading to an appreciation of the tenge vis-à-vis the ruble (until August 2015, when Kazakhstan also moved to a floating regime).

Figure 1. GDP Growth and Oil Prices
(Percentage points; US\$ per barrel)



Source: World Bank staff calculations based on data published by the Statistical Office of Kazakhstan.

Figure 2. Consumer Price Inflation
(Percentage points)



Source: World Bank staff calculations based on data published by the Statistical Office of Kazakhstan.

A weakening external position has put pressure on the tenge

The trade surplus narrowed substantially in 2015, and the current account went into deficit. As oil prices fell and external demand from China and Russia weakened (for metal and metal products, in particular), total export revenues plunged from US\$62.7 billion in first nine months of 2014 to US\$36.4 billion in the first nine months of 2015 (Table 2). Total imports also fell during the same period due to weaker domestic demand but not as sharply as exports. Russian imports, which increased during the past twelve months due to relatively lower prices, partially offset a potentially higher decline in import volumes. Consequently, the merchandise trade surplus narrowed by two-thirds in 2015, compared to 2014, and the current account dropped from a surplus of US\$6.1 billion in the first half of 2014 to a deficit of US\$4.0 billion in the same period of 2015.

The capital and financial accounts present a more complex picture, as foreign direct investment declined and short-term capital outflows increased. While net investment inflows (excluding investments of the national oil fund) declined in 2015, mainly due to an increased outflow of short-term capital, they were partially offset by foreign direct investment (FDI) inflows and external borrowing by residents of Kazakhstan. According to World Bank estimates based on official data, net short-term capital and other FX outflows included in errors and omissions, increased from US\$7.8 billion during 2014 to US\$9.0 billion in the first nine months of 2015. Estimates by Halyk Bank indicate that in 2014 about US\$11 billion in short-term FX outflows represented an increased spending by Kazakhstani citizens on goods and services in Russia due to the appreciation of the tenge vis-à-vis the ruble.² Moreover, as net FDI inflows halved from US\$7.6 billion in the first nine months of 2014 to US\$3.6 billion in the same period of 2015, they only partially offset the outflow in short-term capital, leading to a deficit in the capital and financial accounts. As a result, the overall external balance-of-payments (excluding investments of the oil fund) worsened substantially from a surplus of US\$8.4 billion in the first nine months of 2014 to a deficit of US\$6.1 billion in the same period of 2015, putting pressure on official reserves and the tenge.

² http://tengrinews.kz/private_finance/kazahstantsyi-profinansirovali-rossiyskuyu-ekonomiku-11-280248/

Table 2. Balance of Payments and Official Reserves, 2012-15
(Billions of US\$)

	2012	2013	2014	2014 9mos	2015 9mos
Current account balance	1.1	0.9	6.0	6.1	-4.0
Merchandise trade	38.1	34.8	36.7	30.6	10.7
Exports f.o.b.	86.9	85.6	80.3	62.7	36.4
Imports f.o.b.	48.8	50.8	43.6	32.1	25.7
Services	-7.9	-7.2	-6.4	-4.7	-3.8
Primary income, <i>of which:</i>	-28.1	-25.1	-22.7	-18.8	-9.6
Income of direct investors (net)	-24.6	-22.2	-19.6	-16.5	-7.2
Secondary income/transfers	-1.0	-1.6	-1.7	-1.1	-1.4
Capital and financial account balance /1/2	9.0	9.6	0.7	2.3	-2.1
Foreign direct investments	11.9	8.0	4.7	7.6	3.6
Portfolio investments /1	-2.9	1.7	5.7	2.3	2.1
Medium- and long-term investments	4.1	5.1	2.3	1.6	1.2
Other short-term investments /2	-4.0	-10.3	-7.8	-5.9	-9.0
FX liabilities of the NBK to residents	-0.3	0.7	10.3	5.5	6.0
Estimated amount of NBK interventions	-3.7	-11.0	-18.1	-11.4	-15.0
Statistical discrepancy	-0.2	5.1	-4.3	-3.3	0.0
Overall balance /3	10.0	10.5	6.7	8.4	-6.1
Change in FX assets in the Oil Fund	14.3	12.9	2.5	5.4	-5.3
Change in FX reserves at the NBK	-4.3	-2.4	4.3	3.0	-0.8
<i>Memorandum items:</i>					
Total official reserves (stock)	86.2	95.5	102.5	104.2	96.1
FX assets in the oil fund	57.9	70.8	73.2	76.2	67.9
FX reserves at the NBK	22.1	19.2	21.8	20.8	20.5
Gold reserves at the NBK	6.1	5.6	7.4	7.2	7.7

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.

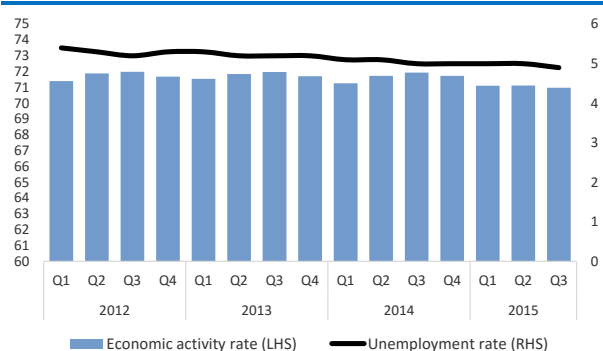
Labor market and poverty indicators continued to improve despite the economic slowdown

The unemployment rate fell even as growth slowed. The official unemployment rate slid from 5 percent in Q2 2015 to 4.9 percent in Q3 2015 (Figure 3). A World Bank analysis suggests that the elasticity of employment to growth in Kazakhstan is about 0.23 percent; i.e., a 1 percent increase in GDP leads to a 0.23 percent increase in the number of jobs. As growth slowed employment creation would have been expected to decline accordingly, and given an estimated annual inflow of 150 thousand new job seekers, unemployment should have increased during this period. However, this was not the case, and the official unemployment rate continued to fall. This may be due to the existence of local programs to contain the shedding of labor during economic downturns, through which workers are put on administrative leave, but are not registered as unemployed. Also, the decrease in the labor force participation rate may exceed what is recorded in the official data. The size of the economically active population shrank by about 58 thousand workers (y/y) in Q3 2015,

while the number of employed workers fell by 44 thousand, including self-employed, yet the number of economically inactive population increased by 40 thousand.³

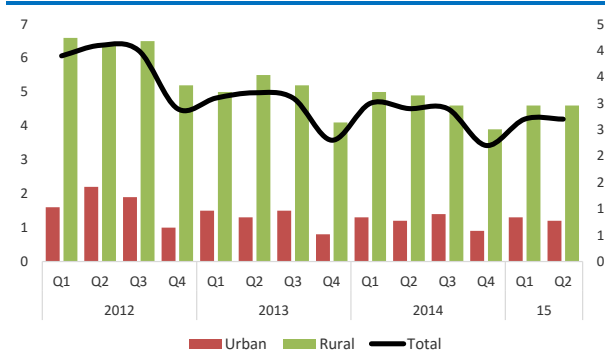
The poverty rate also continued to decline despite the slowing growth. The national poverty rate dropped from 3.8 percent (at the national poverty rate) in 2012 to 2.9 percent in 2013 and 2.8 percent in 2014, reaching 2.7 percent in Q2 2015 (Figure 4). However, this may be due in part to measurement issues involving the national poverty line. Since 2003 average annual adjustments to the nominal national poverty line has not fully reflected nominal wage growth in all years except 2008 and 2011. In addition, a combination of rising public sector wages, greater social spending and price controls is mitigating the impact of slower growth on poverty. Yet given that poverty reduction in Kazakhstan has been largely driven by employment creation, especially in the service sector, and real wage increases, a slowdown in GDP growth and job creation would suggest a slowdown in the pace of poverty reduction. Accelerating poverty reduction and promoting shared prosperity will require a greater focus on the rural and regional dimensions of poverty.

Figure 3. Labor Force Participation and Unemployment
(% of the population)



Source: World Bank staff calculations based on data published by the Statistical Office of Kazakhstan.

Figure 4. The National Poverty Rate
(% of the population)



Source: World Bank staff calculations based on data published by the Statistical Office of Kazakhstan.

C. Macroeconomic Policies

The government has launched a fiscal adjustment plan in response to persistently low oil prices

In response to the oil price shock the government has adjusted its on-budget expenditures promptly and initiated a fiscal consolidation for the medium term, but off-budget spending caused the estimated nonoil deficit to widen between 2014 and 2015. As oil prices were forecast to remain low over the near term the government revised its planned 2015 budget in March, with total budget cuts estimated at about 8 percent of the initial budget (Box 1). The 2015 GDP growth estimate was revised to reflect a new baseline oil price of US\$50 per barrel, down from the US\$80 per barrel used in the original budget. Increases in some public sector salaries were delayed—though social expenditures and the vulnerable groups protected—and on-budget transfers to state-owned enterprises (SOEs) were reduced. Finally, the new budget eliminated or delayed low-priority capital expenditures, offsetting the investment spending under the *Nurly Zhol* program. As a result, on-

³ i.e. students, persons occupied solely in domestic duties in their own households, members of collective households, inmates of institutions, retired persons, persons living entirely on their own means, and persons wholly dependent upon others.

budget spending is expected to fall from 21.5 percent of GDP in 2014 to 20.9 percent in 2015. However, an off-budget transaction to support the state oil-and-gas company Kazmunaygaz widened the nonoil deficit. Low oil prices affected Kazmunaygaz's ability to meet its debt-repayment schedule, and in June 2015 the government allocated US\$2.7 billion from the national oil fund to finance the SOE's external debt payments.⁴ As total revenue is expected to drop by about 6.4 percent of GDP and total expenditure is planned to increase by about 1.3 percent, overall fiscal balance will deteriorate from a surplus of 0.9 percent of GDP in 2014 to a deficit of about 7 percent in 2015. The nonoil deficit will increase from 10.5 percent of GDP in 2014 to 13 percent in 2015. Assuming the medium-term fiscal consolidation continues as planned, public spending could fall from 23.5 percent of GDP estimated in 2015 to about 20 percent by 2017, narrowing the nonoil deficit to 9 percent of GDP.

Box 1. The Composition of the Expenditure Cuts

The Government is pursuing fiscal consolidation in line with the medium-term objective of reaching sustainable non-oil deficit levels. While the fiscal adjustment effort has cut or delayed elements of both current and capital expenditures, it is also focusing on efficiency of expenditures. Current spending represents 45 percent of Kazakhstan's budget, and capital investment comprises 55 percent. Capital expenditures have borne the brunt of recent cuts, but this is tempered by the investment demands of the *Nurly Zhol* program. The table below summarizes key budget revisions. Principal areas of adjustment and reprioritization are as follows. First, the budgets of the Ministry of National Economy (MNE) and Ministry of Investment and Development (MID) are being cut substantially. The cuts will come from a variety of sources: suspension of projects that are not close to initiation, new projects delayed or transferred to SOEs for implementation, some current expenditure cuts, and in the case of MID, streamlining some of the industrial support and subsidy programs. Second, scheduled civil servants salary increases and the launch of the piloting the per-capita financing in education have been delayed. Third, the authorities are also revising the "Employment Roadmap 2020" in an effort to increase its efficiency within a smaller budget envelop. Fourth, the security sector—including the Ministry of the Interior, the Ministry of Defense and the National Security Committee—will have their capital budgets for 2015 and 2016 revised downward. Fifth, other line agencies will be subject to more modest budget cuts.

National budget, 2015-2016	2015 Initial Budget	2015 Revision	2016 Initial Budget	2016 Revision
(In billions of tenge or % change)				
Total, of which:	7,855	-8%	8,042	-9%
Cuts in MNE and MID expenditures:				
MID budget	695	-10%	689	-18%
MNE budget	909	-14%	863	-32%
Other cuts in current expenditures:				
Delaying salary increases	119	-100%	298	2%
Delaying piloting per-capita financing in education	13	-91%	15	-87%
Healthcare services	615	-4%	639	-1%
Reforming Employment Road-Map 2020	90	-59%	101	-63%
Other cuts in capital expenditures:				
Ministry of Interior	67	-69%	59	-73%
Ministry of defense				-19%
National Security Committee		-8%		-20%

Source: World Bank staff calculations based on data provided by the Government of Kazakhstan.

⁴ Moreover, in July 2015, the central bank announced it would arrange a US\$4 billion debt swap with Samruk-Kazyna for a 10 percent stake in Kazmunaygaz. This does not affect the consolidated budget, as it reflects a change in financing instruments.

As oil prices are expected to remain low, the authorities are considering strategies for sustaining the fiscal consolidation. The current adjustment plan relies heavily on cuts to on-budget investment spending, which were reduced by about 2 percent of GDP between 2014 and 2015 and are expected to decline further to about 3.7 percent of GDP in 2017. The authorities are working to enhance the efficiency of the public investment program through various reforms such as adoption of new cost norms and revising the law on private-public partnerships in an effort to leverage the impact of limited public resources for increased development impact. The authorities are also implementing customs and tax administration reforms designed to boost nonoil revenues. At the same time they are considering tax policy measures to enhance non-oil tax revenues. Eliminating loopholes and tax incentives provided under the various public programs could yield significant revenue gains. Finally, to ensure sustainability of the consolidation the administration has pledged, and per President Nazarbayev's mandate, to keeping withdrawals from the oil fund to the guaranteed amount, foregoing any additional "targeted" withdrawals until 2018. This commitment encompasses both on- and off-budget expenditures.

Table 3. The Consolidated Fiscal Accounts, 2012-17, Estimated and Projected
(% of GDP)

	2012	2013	2014	2015e	2016p	2017p
Total revenue	26.4	24.2	23.1	16.7	17.9	18.1
Oil revenue	13.8	11.8	11.4	6.1	6.6	6.9
Oil revenue saved in the Oil Fund	7.3	6.2	4.4	-1.6	-2.0	-1.9
Oil revenue spent in the State Budget	6.6	5.6	7.0	7.7	8.6	8.8
o/w: Oil Fund transfer for Nurly Zhol				1.1	0.8	0.8
Non-oil revenue of the State Budget	12.6	12.4	11.7	10.6	11.3	11.2
Total expenditure and net lending	22.3	20.8	22.2	23.5	21.2	20.1
Budget expenditures	22.1	20.1	21.5	20.9	21.1	20.1
Current expenditure	16.1	15.5	15.7	16.9	17.3	16.4
Capital expenditure and net lending	6.0	4.6	5.9	4.0	3.8	3.7
Budget investment and net lending	4.7	4.0	4.4	3.5	3.6	3.7
Budget transfers to SOEs	1.3	0.6	1.5	0.5	0.2	0.0
Off-budget direct lending to SOEs	0.2	0.7	0.7	2.6	0.1	0.0
o/w: Oil Fund transfer for Nurly Zhol				0.7	0.1	0.0
Overall fiscal balance	4.0	3.4	0.9	-6.8	-3.3	-2.1
State Budget deficit	-3.0	-2.1	-2.8	-2.6	-1.2	-0.2
Non-oil deficit	-9.8	-8.4	-10.5	-12.9	-9.9	-8.9
Oil revenue spent in the State Budget	6.6	5.6	7.0	7.7	8.6	8.8
Off-budget direct lending to SOEs	0.2	0.7	0.7	2.6	0.1	0.0
Oil revenue saved in the Oil Fund	7.0	5.4	3.7	-4.2	-2.1	-1.9
<i>Memorandum items:</i>						
Net government financial assets	16.1	17.7	19.1	19.0	24.4	19.7
Oil Fund FX reserves	28.5	30.5	33.8	36.1	39.8	34.2
Total government debt	12.3	12.8	14.7	17.0	15.4	14.5

Sources: World Bank staff calculations based on data published by the Ministry of Finance.

Note: Some sums may not add up exactly due to rounding; e=estimate; p=projection.

The government's net debt position is expected to remain solid. Total government debt rose from 14.7 percent of GDP in 2014 to 17.0 percent in 2015. This increase was due in part to a US\$4 billion Eurobond issue combined with multilateral borrowing in the context of the 2015-17 Partnership Framework Arrangement (PFA) program supporting the "Kazakhstan 2050" development strategy.⁵ However, the fiscal consolidation should help to reduce overall government

⁵ Partnership Framework Arrangement (PFA) is a new instrument guided by the Country Partnership Strategy and designed to support the government's efforts to promote sustainable development and inclusive, pro poor growth.

debt in the medium term. Also, despite lower oil prices the net foreign-exchange savings in the oil fund are projected to increase from 33.8 percent of GDP in 2014 to 36.1 percent in 2015, partly reflecting the valuation effect resulting from the move to a free float.⁶ The government's net financial asset position (i.e. oil fund foreign-exchange reserves minus total government debt) is expected to remain flat at about 19 percent of GDP in 2014 and 2015.

A floating exchange rate regime was introduced in August 2015

Despite the fall in oil prices and weakened external position, the authorities maintained the nominal exchange rate as monetary anchor until mid-August 2015, when they announced a shift to a floating regime. In 2014, the authorities indicated that maintaining stability of the nominal exchange rate peg was a part of the economic support program aimed at mitigating the effects of the external oil price shock on the national economy. In the Joint government and NBK's Annual Statement of Economic Policy for 2015, the authorities announced a plan to transition to an inflation-targeting regime over the medium term, implying a shift to a float, and the central bank began establishing the necessary legal and technical groundwork. From February 2014 to June 2015 the tenge depreciated against the US dollar by about 2-3 percent in nominal terms (Figure 5). In June, the crawling depreciation of the tenge accelerated, possibly fed by the increased availability of tenge liquidity and low money market interest rates that started in late May. On July 15 the central bank announced a widening of the band around the central parity 185 KZT/US\$ from +3/-15 to +13/-15 in preparation for the transition to inflation targeting. However, in the aftermath of the unexpected 4.4 percent devaluation of the Chinese yuan on August 17th-18th, and the subsequent collapse of global oil prices, the authorities opted to float the tenge on August 20th. The tenge immediately lost about 26 percent of its value, falling from 188.4 KZT/US\$ to 254 KZT/US\$. It continued to slide to about 280 KZT/US\$ by end October 2015, with the central bank intervening to address episodes of volatility.

The defense of the nominal anchor until August 2015 affected official international reserves, contributed to the appreciation of the real exchange rate and the dollarization of deposits. According to the authorities, defending the exchange rate cost about US\$28 billion between early 2014 and mid-2015.⁷ This also led to a significant change in the quality of international reserves held at the central bank marked by an increase of short-term contingent foreign-exchange liabilities to residents of Kazakhstan. The defense of the nominal anchor also led to the appreciation of the real effective exchange rate (REER). The REER index stood at 122.2 in July 2015, up from 100 in July 2014.⁸ The tenge began to appreciate against the ruble in real terms in October 2014, when the latter shifted to a floating regime. As a result, the bilateral real exchange rate index rose from 83.4 to a peak of 125 in January 2015, then eased to 102.9 by July 2015. The appreciation of the bilateral real exchange rate led to a temporary surge in merchandise imports from Russia. Meanwhile, the expectation of an eventual exchange-rate adjustment led to dollarization of deposits. The share of dollar-denominated deposits rose from about 39 percent in January 2014 to about 55 percent in January 2015, before moderating to 52 percent in July 2015. The share of dollar-denominated time deposits held by individuals rose from 49 percent in January 2014 to 73 percent in July 2015.

The switch to the floating exchange rate is helping relative prices to adjust to the new reality of lower oil prices, with the tenge depreciation expected to impact domestic demand. The REER index fell from 122.2 in July 2015 to 109.9 in September.⁹ Since then the tenge has continued

⁶ In 2015 the increase in the oil fund's foreign-exchange reserves (as a share of GDP) was due to exchange-rate effects; while in nominal dollars terms the reserves declined from US\$73 billion at the end-2014 to below US\$64 billion by October 2015.

⁷ http://forbes.kz/finances/exchange/nazarbaev_myi_soigli_28_mlrda_2_goda_na_podderjanie_kursa_tenge/

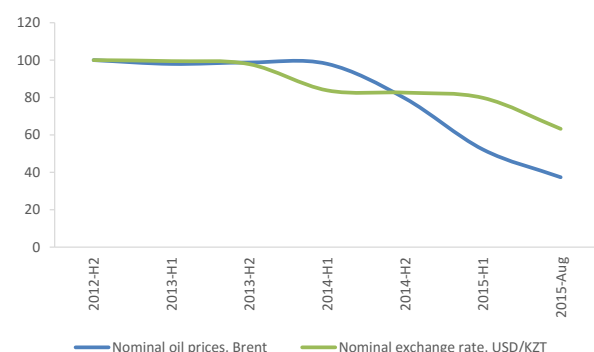
⁸ The REER index is 2000 = 100 for all exchange-rate figures presented in this section.

⁹ Ibid 8.

to adjust, depreciating by 35 percent to reach about KZT 280/US\$ by end-October 2015. The depreciation of the tenge is expected to affect aggregate demand through both wealth and price effects. The wealth effect is expected to be relatively small and stems from the loss in value of tenge-denominated holdings, which may lead households to reduce consumption and cause businesses to defer planned investments. The dollarization of deposits may mitigate this effect, and the government has announced a program to compensate holders of tenge-denominated deposits valued at up to one million tenge (about US\$3,800). The authorities have also launched income-support programs for selected groups. As only 3.7 percent of bank lending is in the form of foreign-exchange loans to individuals, a relatively small number of households are expected to face a larger repayment burden. However, this may be alleviated somewhat by the government's new mortgage-refinancing program. Depreciation may also affect aggregate demand through rising import prices. Private demand is projected to weaken further as household purchasing power erodes and businesses face higher prices for imported intermediate and capital goods. The authorities have announced price controls on 33 basic food products to mitigate the pass-through effects of the depreciation, and the significant degree of economic slack should also buffer the price effect. Nevertheless, domestic consumer prices had already risen by September and are expected to increase further in the next few months.

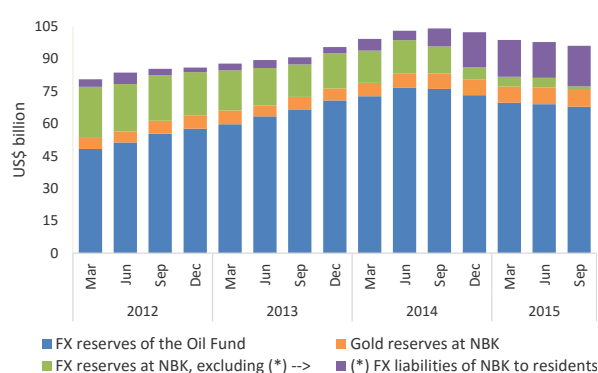
The depreciation will impact the financial sector by undermining certain bank assets, but its impact is not expected to be nearly as large as it was during the global financial crisis. In Q3 2009, just before the crisis unfolded, foreign exchange represented about 50 percent of total bank lending. Yet foreign-exchange lending has steadily declined over the past few years, falling from 42.3 percent of total lending in 2010 to 23.3 percent in July 2015. This should reduce the impact of the depreciation on bank assets. Foreign-currency lending to physical persons also declined during the same period, dropping from 10.1 percent to 3.7 percent of total lending. Bank balance sheets do not yet reflect asset deterioration; indeed, the system-wide share of nonperforming loans (NPLs) declined from 23.5 percent in January to 9.4 percent in August following Kazkommertsbank/BTA purchase-and-assumption agreement in June. Nevertheless, financial sector risk needs to be monitored closely by the government and the central bank. Already, in September Moody's downgraded four top banks based on their substantial foreign-exchange exposure and/or limited capital buffers. The negative effects of the depreciation should be viewed as tradeoffs against expected medium-term benefits in terms of improved tenge liquidity and access to hedging instruments to mitigate asset-liability mismatches. It is expected that further resolution of NPLs in the BTA Special Purpose Vehicle (SPV) and across the banking sector will free up bank resources to finance domestic economic activity. Strengthening the corporate insolvency framework and creating the basis for a personal insolvency framework will also be critical to enable the sustainable growth of credit to the economy.

Figure 5. Oil Prices and the Exchange Rate
(Index 2012=100)



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

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



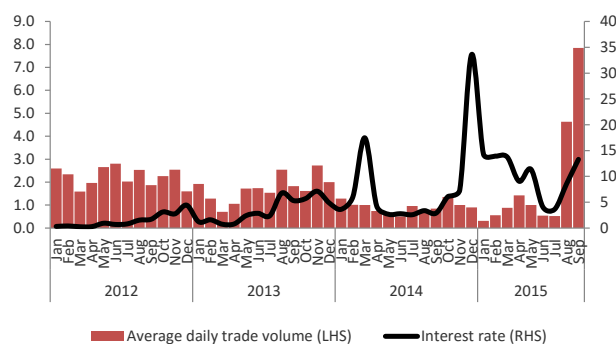
Source: World Bank staff calculations based on data published by the National Bank of Kazakhstan.

Monetary policy remained tight in early 2015 to support the nominal exchange rate anchor, but started relaxing in late spring

An evolving monetary policy stance influenced money market interest rates during the first nine months of 2015. The authorities tightened monetary policy in support of the nominal exchange-rate anchor during the first five months of the year. Consequently, money market interest rates were relatively high and volatile, ranging from 7 to 15 percent (Figure 7). From June to mid-August the rates declined to about 4 percent as the central bank began providing short-term tenge liquidity through money market interventions in addition to ongoing long-term subsidized funding from the national pension fund and foreign-exchange swaps from its own reserves. Additionally, at end-June 2015 Kazkommertzbank signed an agreement with the central bank's Problem Loans Fund, securing a ten-year 250 billion tenge deposit.

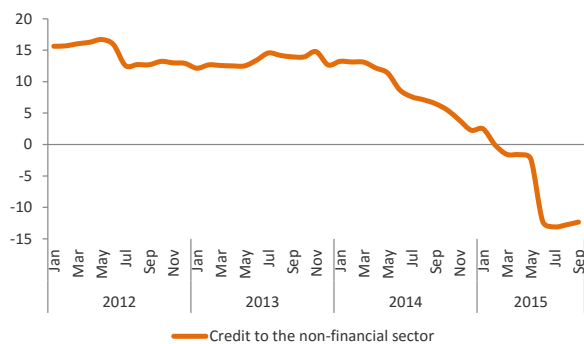
Tight monetary policy caused credit to the economy to contract, prompting selective interventions by the authorities. Credit contracted by about 12 percent between January and August 2015, as bank funding costs increased and deposits were converted into foreign exchange (Figure 8). Credit to businesses contracted by about 19 percent between January and July before beginning to expand in August. Credit to individual borrowers remained flat in July and grew by 3.3 percent in August due to the increasing value of dollar-denominated loans associated with the tenge depreciation. To address the tight credit environment the authorities extended subsidized credit programs (capped at a nominal 6 percent) for small and medium enterprises and launched two subsidy programs for mortgage refinancing and the purchase of cars assembled domestically. This intervention spurred a partial recovery of credit growth in targeted sectors.

Figure 7. Repo Market Volumes and Rates
(US\$ billions; %)



Source: World Bank staff calculations based on data published by the Kazakhstan Stock Exchange.

Figure 8. The Growth of Credit to the Economy
(% change, year-on-year)



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

The implementation of the new monetary policy takes time and an effective monetary transmission channel

While the move to inflation targeting will facilitate the economy's adjustment to lower oil prices, the central bank faces a key challenge in developing a functional and credible inflation-targeting regime. Since the shift to a floating regime, the tenge has experienced episodes of volatility, and the central bank has intervened to stabilize its value. It will take time for the new inflation-targeting regime to become fully functional and for market participants to understand its risks and benefits. A functional inflation-targeting regime requires an effective interest-rate transmission channel that can signal changes in monetary aggregates to market participants, influencing economic activity and thereby altering the inflation rate.

The central bank must ensure that its interest-rate transmission channel is effective. In the past, Kazakhstan's interest-rate transmission system has not always functioned properly. The central bank launched a new base rate—the 12 percent overnight repo rate—in early September in an effort to reestablish the interest-rate transmission system. Managing the new base rate will require the central bank to use monetary policy instruments, including repo and reverse repo auctions, to adjust liquidity in the banking system. The challenge will be to ensure that interest-rate signals are transmitted through the banking system to consumers and businesses. "The Monetary Policy of the Republic of Kazakhstan through 2020," provides a transparent and predictable roadmap to implement the new monetary policy. The frequent publication of detailed progress reports on its implementation would help to ensure a smooth transition to the inflation-targeting regime.

D. Structural Reforms

The authorities continue to implement an ambitious reform agenda

Kazakhstan will become the 162nd member of WTO in December 2015 and is expected to benefit from liberalizing its economy going forward. Negotiations concluded in June 2015 and President Nazarbayev signed the protocol of accession in July. The Parliament approved the accession in October. The process is expected to be finalized in December at the WTO's annual ministerial conference. Within the framework of the Eurasia Customs Union (EaCU) and the Eurasian Economic Union (EEU) Kazakhstan adopted fifty new laws and introduced amendments to ten international agreements to align its legal framework with WTO rules and regulations. Further

adjustments are being made based on the commitments made in the WTO protocol. WTO accession is expected to encourage international integration and bolster competitiveness. Over the next few years Kazakhstan is expected to lower its average trade weighted tariff to about 5.5 percent, similar to the average rate that prevailed in 2009, before it joined the EaCU and then the EEU. Lower tariffs will reduce costs to consumers and domestic producers, improving price and quality, and promoting more robust competition in the domestic market. The accession reforms will also liberalize important segments of the service sector, which represents over half of the national economy. Opening the financial and telecommunications subsectors, increasing labor mobility and expanding access to foreign technical and managerial experts will promote FDI. Kazakhstan has also committed to phasing out trade-related investment measures and local content requirements included in its investment regime, which is expected to increase the quality and efficiency of production and services in key sector, including in mining and petroleum production. Finally, Kazakhstan will benefit from access to the WTO dispute-settlement mechanism.

The authorities are recasting their approach to industrial development to better promote industrialization and diversification of the economy. The first State Program for Industrial and Innovative Development (SPIID) for 2010-14 was not as successful as the authorities hoped, as economic diversification remained elusive. A recent review suggested that the SPIID could have benefitted from greater private sector participation and improved interagency coordination. A more “SMART” (specific, measurable, attainable, realistic, and time-bound) design would have most likely resulted in better results. Moreover, subsidies provided through the program distorted competition between firms. The authorities are revising the subsequent SPIID II program for 2015-19 to reflect these lessons, broadening the focus to encompass multidimensional business climate reform as well as support to specific sectors. The program will also include a more market-driven incentive framework. The government plans to allocate KZT 600 billion (approximately US\$2 billion) from the national budget to implement the SPIID II, with additional funding for specific investments in 14 targeted subsectors. The “territorial clusters” program is one of the main tools under the SPIID II.

The authorities’ ambitious institutional reform agenda was bolstered by the launch of the “One Hundred Concrete Steps, a Modern State for All” program in May 2015. The program is one of the pillars of the Kazakhstan 2050 vision, which acts as the overarching development strategy of the country, and complements the Nurly Zhol economic support program – announced in fall 2014 and focused on infrastructure, private sector support and financial sector reforms – and the authorities’ ongoing reform agenda on industrialization and diversification (the SPIID II). The program is designed to reduce the regulatory and economic imprint of the public sector and develop a more professional, efficient and transparent modern state, imbued with a regulatory mandate with a much lighter touch. The program includes measures to create a more effective and professional public service through open recruitment, better training and the linking of pay and promotion to performance. To make the rule of law more transparent, trials by jury will be expanded and the rights of defendants will be increased. Judges will serve a probationary period before full confirmation while police recruitment and training are to improve, as is their accountability to local communities. To increase accountability to the population, the program includes devolution of decisions to the local level – as the authorities are pursuing devolution of budget expenditures to the local authorities in parallel. The expanded use of e-government systems is also expected to accelerate administrative processes and decrease corruption, and agencies at various administrative levels will be required to publish regular performance information. The success of the reform agenda, however, will depend on its effective and comprehensive implementation.

E. Outlook

Continued Low oil prices and global economic uncertainty will affect Kazakhstan's medium term outlook

The global oil supply is expected to outpace demand over the medium term, maintaining downward pressure on oil prices. Oil prices briefly rallied early in the summer of 2015, but then dropped again after the announcement of a multilateral nuclear deal with Iran. Brent Oil prices edged up from a low of US\$47 per barrel in January 2015 to US\$66 per barrel in mid-May, then fell back to about US\$48 in August due to the anticipated removal of sanctions on Iranian oil exports. Following the deal Iran immediately began selling off its reserves, and the Minister of Oil announced that Iran intended to regain its market share regardless of international prices. While Iranian oil production will not reach capacity for another year, the formal reentry of Iran into the global oil market, along with the expectation of increased production in Iraq and OPEC's refusal to cut production are expected to keep oil prices low over the short-to-medium term, despite a decline in US oil output as the shale oil subsector is consolidated.¹⁰ Meanwhile, a slow and uneven global economic recovery is expected to keep demand for oil subdued. Global GDP growth is projected to slow from 3.4 percent in 2014 to 3.1 percent in 2015 before rising to 3.6 percent in 2016. Aggregate GDP growth in advanced economies is projected to accelerate slightly from 1.8 percent in 2014 to 2 percent in 2015 and 2.2 percent in 2016, driven by the US recovery. However, growth in emerging markets and developing economies is expected to slow from 4.6 percent in 2014 to an estimated 4 percent in 2015, then rebound to a projected 4.5 percent in 2016.¹¹ Given these expected developments, World Bank projects average oil prices (Brent-Dubai-WTI) at US\$52.5 per barrel in 2015, US\$51.4 in 2016, and US\$54.6 per barrel in 2017 in the baseline scenario.

Table 4. Projected Global Growth Rates and Oil Prices, 2014-17
(% change unless otherwise indicated)

Countries:	2014	2015e	2016p
United States	3.4	3.1	3.6
European Union	1.5	1.9	1.9
Emerging and developing countries	4.6	4.0	4.5
of which : China	7.3	6.8	6.3
of which : Russia	0.6	-3.8	-0.6
 Oil price, Brent-Dubai-WTI average (US\$ per barrel)	 96.2	 52.5	 51.4

Sources: IMF, WEO October 2015. World Bank Group Commodities Prices, October 2015.

Note: e=estimate; p=projection.

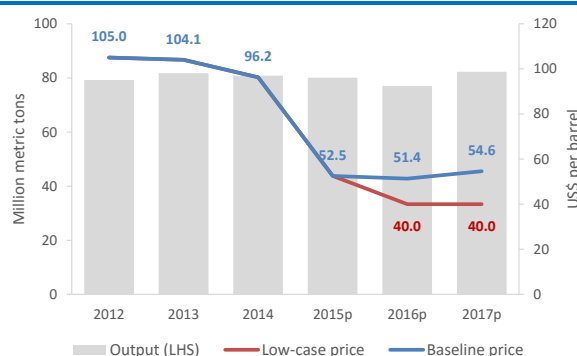
Growth among Kazakhstan's main trade partners is expected to remain uneven over the medium term, negatively impacting demand for both oil and nonoil exports. The euro zone, Kazakhstan's largest oil export market, is still grappling with the uncertainty of the Greek debt crisis, and growth is expected to reach a modest 1.9 percent in 2015 and 2016. China is another major export market for Kazakhstan's oil and metals products, and Chinese growth is expected to slide from 6.8 percent in 2015 to 6.3 percent in 2016 as the country continues as the economy transitions to a new development model and the government attempts to implement structural reforms and

¹⁰ 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 (MENA QEB July 2015).

¹¹ IMF, WEO, October 2015.

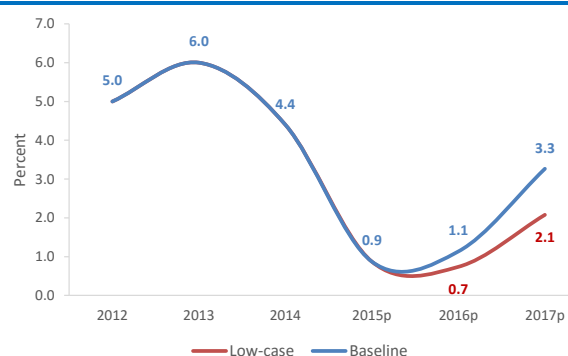
deleverage the internal debt burden.¹² The Russian economy, a major destination for Kazakhstan's metal exports, is expected to contract by 3.8 percent in 2015 and by 0.6 percent in 2016, also due in large part to falling oil prices and the impact of the depreciation of the Ruble and related inflation on domestic demand.¹³ In the first half of 2015 the appreciation of the tenge against the ruble led to a surge in Russian exports to Kazakhstan, heightening price competition with domestic producers. The shift to a floating regime in mid-August is expected to slow the influx of imports, but exports are expected to remain subdued due to the Russian recession

Figure 9. Oil Output and Price Outlook
(million metric tons; US\$ per barrel)



Source: World Bank staff estimates.

Figure 10. Kazakhstan's GDP Growth Outlook
(%)



Source: World Bank staff estimates.

In this context, the current baseline scenario assumes that Kazakhstan's GDP growth rate will slow unless oil prices rise and output increases. The growth rate is projected to drop substantially from 4.4 percent in 2014 to about 1 percent in 2015 as oil prices remain low leading to contraction of domestic demand (Table 5). The uncertain external outlook will dampen private investment, while the pass-through effect of the tenge depreciation will reduce household consumption and public consumption will remain modest due to the ongoing fiscal adjustment. Weak domestic demand will in turn negatively affect production and retail trade, while low oil prices continue to slow the growth of ancillary subsectors such as transportation and wholesale trade. Both the fiscal and current-account balances are expected to turn negative in 2015.

The projected recovery of oil prices over the medium term is expected to boost domestic demand. Under the baseline scenario GDP growth is projected to be about 1 percent in 2016. While the overall fiscal balance improves due to the consolidation effort, the current-account balance is expected to worsen as oil production is expected to fall from 80.1 million metric tons in 2015 to 77.0 in 2016. If the Kashagan oilfield begins production in 2017 as planned, increased oil output may improve consumer and investor confidence, boosting economic growth to 3.3 percent in 2017, and improving fiscal and current account balances. However, if oil prices remain low, there is an additional downside risk that production at Kashagan may be postponed. Consumer price inflation (as defined by the official year-end consumer price index) in 2015 will be affected by the depreciation of the tenge, while the low domestic demand is expected to attenuate some of the inflationary pressures in 2016. Import prices and producer prices more fully reflect the pass-through effect of the tenge depreciation, and both are likely to experience higher rates of inflation in 2016.

¹² IMF, October 2015.

¹³ World Bank, Russia Economic Report, September 2015.

Table 5. Key Macro-Fiscal Indicators, 2012-17, Baseline Scenario
(% change unless otherwise indicated)

	2012	2013	2014	2015e	2016p	2017p
Oil price, Brent-Dubai-WTI average (US\$ per barrel)	105.0	104.1	96.2	52.5	51.4	54.6
Oil production (million metric tons)	79.2	81.8	80.8	80.1	77.0	82.3
GDP at constant market prices	5.0	6.0	4.4	0.9	1.1	3.3
Private consumption	11.0	12.6	-2.0	-2.0	0.0	2.0
Government consumption	13.2	1.7	10.3	-3.2	4.3	0.0
Gross fixed capital investment	9.1	4.9	0.2	-7.3	1.2	3.2
Exports of goods and services	4.7	-0.2	-4.6	-1.9	-2.6	6.7
Imports of goods and services	20.9	5.2	-15.7	-13.0	-5.0	2.1
GDP at constant factor prices	5.4	5.6	3.9	1.2	1.2	3.3
Oil sector	0.0	-4.8	-1.0	-1.0	-1.7	4.7
Nonoil sector	6.0	7.9	5.3	1.2	1.5	3.1
Consumer price inflation, year-end	6.0	4.8	7.4	12.5	7.0	4.8
Consumer price inflation, period average	5.1	5.8	6.7	6.4	13.3	5.3
Current account balance (% of GDP)	0.5	0.4	2.8	-3.8	-4.6	-2.9
Overall fiscal balance (% of GDP)	4.0	3.4	0.9	-6.8	-3.3	-2.1
Non-oil fiscal balance (% of GDP)	-9.8	-8.4	-10.5	-12.9	-9.9	-8.9

Sources: World Bank staff calculations and estimates based on data published by the Statistical Office of Kazakhstan, the National Bank of Kazakhstan, and the Ministry of Finance of Kazakhstan.

Note: e=estimate; p=projection.

Under the baseline scenario, government debt is expected to remain low while fiscal reserves in the oil fund will stop rising. As part of the fiscal adjustment, the government plans to reduce annual net borrowing from the planned level of 3 percent of GDP in 2015 to about 1 percent by 2018. This should keep the public debt stock stable at about 14-16 percent of GDP over the medium term. While external public debt and state guarantees are expected to rise from about 4 percent of GDP in 2014 to between 6 and 7 percent in 2015-17, domestic public debt is expected to drop from about 11 percent of GDP to about 7-9 percent during the same period. The increase in external debt is driven by a US\$4 billion Eurobond issue in 2015 (in addition to a US\$2.5 billion bond issue in 2014) coupled with an anticipated commitment of about US\$7 billion in multilateral borrowing in the context of the implementation of the 2015-17 Partnership Framework Arrangement. Meanwhile, net foreign-exchange savings in the oil fund are projected to stop growing, because low oil prices (below a breakeven of US\$80-90 per barrel) suggest that the government draw on oil revenue to finance the nonoil deficit. As a result, the government's net financial asset position (i.e. Oil Fund FX reserves minus Total government debt) is expected to stabilize around 19 percent of GDP over the medium term.

The low case scenario assumes that oil prices will remain low over the medium term, leading to a slower economic recovery than in the baseline. A further excess of supply over demand could cause oil prices to fall below expectations. In this scenario both export revenues and growth in ancillary subsectors to oil, such as technical services and transport, would be lower and recover more slowly than in the baseline. Kazakhstan's growth performance would be weaker than in the baseline scenario, though driven by the same economic dynamics described above. Recovery of domestic demand, both consumption and investment, will be slower than in the baseline. Under the low case scenario GDP growth would slow to about 1 percent in 2015 and 0.7 percent in 2016, before rising to 2.1 percent as production at the Kashagan oilfield commences. This outcome would translate into slower improvement in external and fiscal positions. In such a case, the government may wish to consider using the anti-cyclical and targeted rules of the oil fund to provide economic support to the economy through expansion of targeted social protection as well as investment in critical infrastructure. Total government debt would remain higher in the medium term than in the baseline,

though it would remain stable and sustainable and ultimately decline over the longer term. Assuming oil price of US\$40 per barrel would magnify the downside risk that Kashagan production could be postponed, slowing the economic recovery. In a context of low growth, and barring any new negative external shocks (global food- or further oil-price shocks), price inflation would slow to an average of about 4 percent in 2017.

Table 6. Key Macro-Fiscal Indicators, 2012-17, Low Case Scenario

(% change unless otherwise indicated)

	2012	2013	2014	2015e	2016p	2017p
Oil price, Brent-Dubai-WTI average (US\$ per barrel)	105.0	104.1	96.2	52.5	40.0	40.0
Oil production (million metric tons)	79.2	81.8	80.8	80.1	77.0	82.3
GDP at constant market prices	5.0	6.0	4.4	0.9	0.7	2.1
Private consumption	11.0	12.6	-2.0	-2.0	-2.0	1.0
Government consumption	13.2	1.7	10.3	-3.2	4.3	0.0
Gross fixed capital investment	9.1	4.9	0.2	-7.3	1.2	2.2
Exports of goods and services	4.7	-0.2	-4.6	-1.9	-2.6	6.4
Imports of goods and services	20.9	5.2	-15.7	-13.0	-8.0	1.5
GDP at constant factor prices	5.4	5.6	3.9	1.2	1.0	2.3
Oil sector	0.0	-4.8	-1.0	-1.0	-1.7	4.7
Non-oil sector	6.0	7.9	5.3	1.2	1.1	1.7
Consumer price inflation, year-end	6.0	4.8	7.4	12.5	6.1	3.9
Consumer price inflation, period average	5.1	5.8	6.7	6.4	9.6	4.1
Current account balance (percent of GDP)	0.5	0.4	2.8	-3.8	-5.9	-5.5
Overall fiscal balance (percent of GDP)	4.0	3.4	0.9	-6.8	-5.0	-3.5
Non-oil fiscal balance (percent of GDP)	-9.8	-8.4	-10.5	-12.9	-10.2	-9.2

Sources: World Bank staff calculations and estimates based on data published by the Statistical Office of Kazakhstan, the National Bank of Kazakhstan, and the Ministry of Finance of Kazakhstan.

Note: e=estimate; p=projection.

F. Focus Section: Attracting Foreign Direct Investment to Kazakhstan¹⁴

The government of Kazakhstan has expressed a strong interest in attracting more FDI to the country in a bid to improve productivity and competitiveness in the nonoil economy through the transfer of skills and technology. This effort is accompanied by a renewed emphasis on value-chain and cluster development as part of the SPIID 2015-2019 industrialization program. This focus section examines recent trends in FDI in Kazakhstan, focusing on four key questions. What types of investment has Kazakhstan attracted? What benefits can FDI offer Kazakhstan? What types of investment should the country focus on attracting? And what can it do to attract its preferred types of investment?

1. What kind of investment has Kazakhstan attracted?

A strong upward trend in gross FDI flows over the past decade

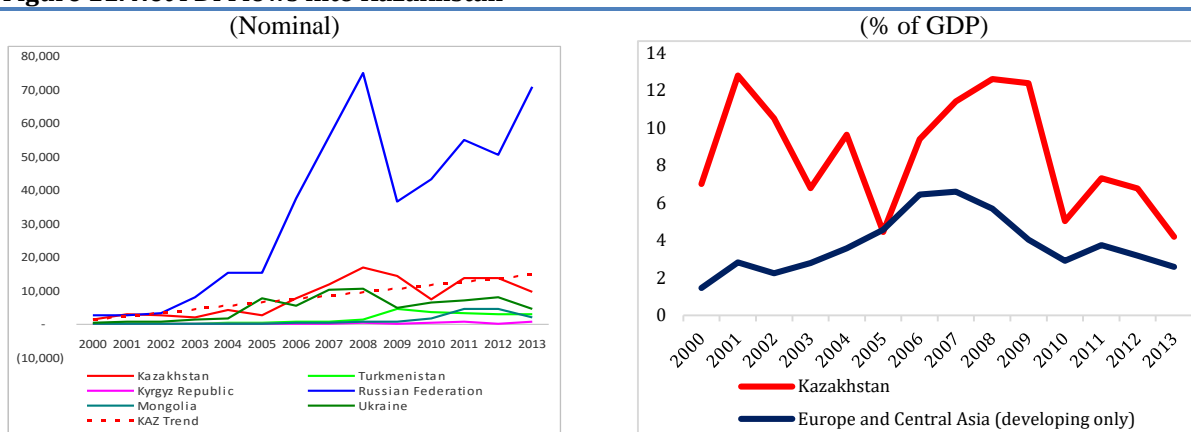
Since the early 2000s FDI flows into Kazakhstan have been growing on a steady upward trend, but with sharp short-term fluctuations since the 2008 financial crisis.¹⁵ Overall, it has

¹⁴ As noted in the Acknowledgements this section was developed with input and advice from Sara Rebollo Ramirez, Robert Whyte, Harald Jedlicka, Persephone Economou and Ekaterina Kniga (World Bank Group).

¹⁵ Such a pattern is not unusual for resource-based economies, since foreign investment projects in the extractive sectors tend to be large, with the bulk of investment typically occurring in a single year.

performed consistently better than the overall average for the Europe and Central Asia (ECA) region in terms of the ratio of FDI flows to GDP.¹⁶ Kazakhstan's inward FDI stock, an indicator of the size of international production present in the country, was valued at US\$ 120 billion at the end of 2012.

Figure 11. Net FDI Flows into Kazakhstan

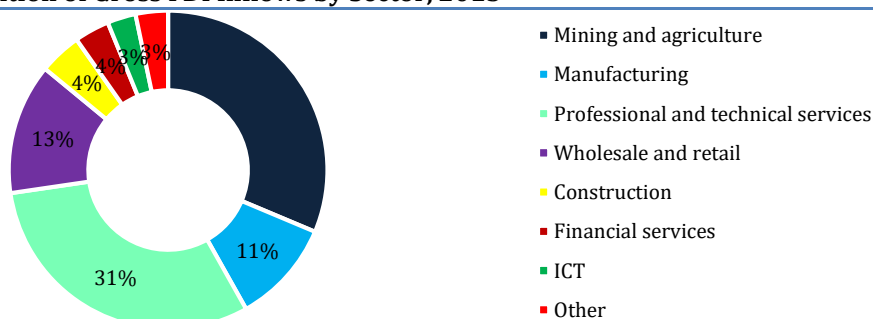


Source: World Bank Group. In 2010, the dip in Kazakhstan's net FDI inflows is related to domestic investors acquiring domestic assets from foreign investors in the oil sector.

FDI inflows are heavily concentrated in extractives industries and related services

According to the National Bank of Kazakhstan about one-third of the country's FDI inflows in 2013 were focused on the primary sector (oil, mining and agriculture), with another third invested in professional and technical services, many of which are involved in the extractive industries (Figure 12). The high share of investments in the latter may be explained by the central role that a range of business services, such as engineering activities, technical testing and analysis activities and geological exploration and prospecting activities, play in supporting activities in the primary sector. FDI in wholesale trade was also principally geared towards supporting the primary sector. The manufacturing sector received only about a tenth of all FDI inflows, and these investments were heavily concentrated in basic metals and fabricated metal products, with much more modest investments in food, beverages and tobacco products. Construction, information and communications technology, and financial services each accounted for a small share of FDI inflows.

Figure 12. Composition of Gross FDI Inflows by Sector, 2013



Source: WB staff calculations based on official data by the National Bank of Kazakhstan.

¹⁶ For several years Kazakhstan's FDI-to-GDP ratio was more than three times the regional average. Kazakhstan outperformed Russia, Europe and Central Asia's largest nominal recipient of FDI inflows, yet it has lagged behind some of the region's smaller resource-based economies, including Mongolia, the Kyrgyz Republic and Turkmenistan.

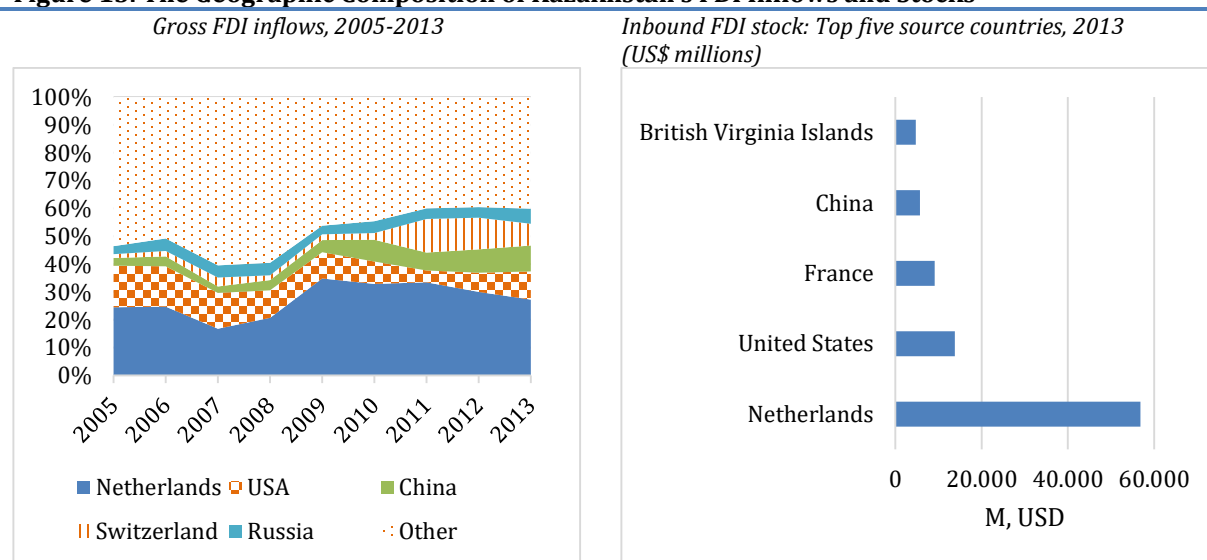
The European Union is Kazakhstan's main source of FDI, but China's share is growing fast

The composition of gross FDI inflows¹⁷ in Kazakhstan over the 2005-2013 period underscores the importance of the EU member states as a source of investment. However, China's share of Kazakhstan's FDI inflows increased from 2 percent in 2007 to 9 percent in 2013, while Russia's share remained largely unchanged over the period, accounting for 5 percent of gross FDI inflows in 2013. The geographical distribution of FDI stocks displays a similar pattern (Figure 13).

FDI in Kazakhstan has not achieving its full economic potential yet

Reinvested earnings constitute an unusually small share of gross FDI inflows in Kazakhstan, averaging just 10 percent during 2005-2014, though in 2014 this share increased to 22 percent. In developing countries reinvested earnings typically represent between a quarter and a third of inbound FDI. Low ratios of reinvested earnings imply that profits are typically repatriated rather than retained for reinvestment and expansion. This, in turn, may indicate challenges in retaining existing foreign investors or that foreign investors face weak incentives to remain in the country and expand their operations.

Figure 13. The Geographic Composition of Kazakhstan's FDI Inflows and Stocks



Source: National Bank of Kazakhstan (gross FDI inflows); IMF, CDIS (inbound FDI stock).

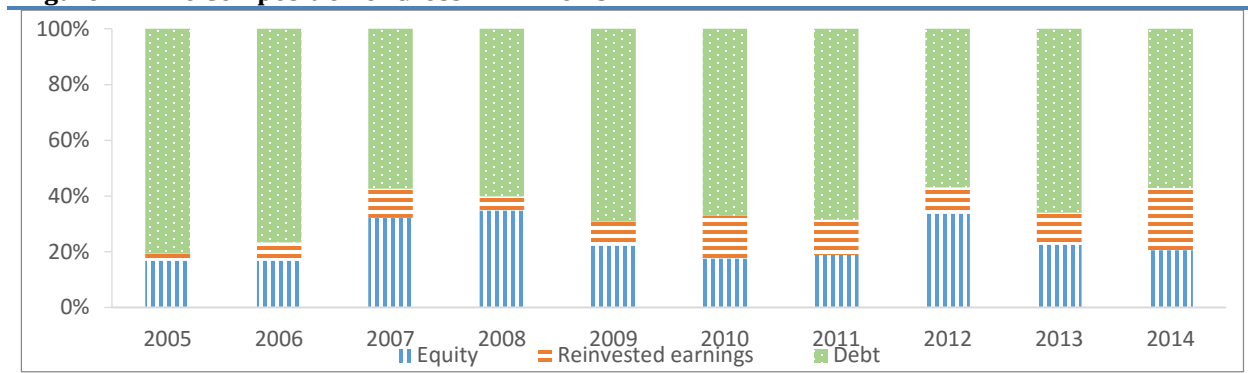
The role of FDI in job creation varies considerably by sector. Foreign companies registered in Kazakhstan account for roughly 7 percent of total employment, or about 238,000 jobs.¹⁸ Foreign firms employ a full 27 percent of workers in the mining sector. In manufacturing, foreign firms account for 17 percent of employment on average, while in professional, financial and business services the share of foreign firms in total employment is 17, 13 and 16 percent, respectively. The

¹⁷ According to the central bank's definition gross FDI inflows include increases of equity (i.e. purchases of at least 10 percent of the voting shares in Kazakhstani firms by non-residents or purchases of real estate in Kazakhstan by non-residents), reinvested earnings (i.e. the share of foreign direct investors in undistributed income, or losses, by Kazakhstani firms), and increases in debt instruments (i.e. the flow of funds from foreign direct investors, both in cash and in kind, without amortization).

¹⁸ Domestic private companies accounted for an estimated 54 percent and state-owned enterprises for 39 percent.

contribution of foreign firms to employment in sectors traditionally dominated by the state, such as education, healthcare, social services, and water and sanitation, is negligible (Annex Table 1).

Figure 14. The Composition of Gross FDI Inflows



Source: National Bank of Kazakhstan.

2. What benefits and drawbacks can FDI bring to a host country?

FDI can bring a host of potential benefits to a country. In addition to job creation, FDI can add to capital stock, promote research and development and transfer of new – and potentially greener and cleaner-technology, facilitate the adoption of enhanced management techniques, build workforce skills, contribute to additional tax revenues, encourage competition and expand exports (Figure 15). Empirical studies have concluded that FDI contributes to increased total factor productivity and higher incomes in recipient countries to a greater extent than domestic investment. However, the magnitude of this effect is difficult to quantify.

Yet despite its considerable economic potential the international experience suggests that FDI can also have significant drawbacks for recipient countries. These include the deterioration of the balance of payments as profits are repatriated (though this is often offset by new incoming FDI), a lack of positive linkages with local firms and the domestic labor market, potentially negative environmental impacts (especially in the extractive and heavy industries), social disruptions associated with accelerated commercialization, the effects of additional competition in domestic markets, or even undue influence by foreign firms in the domestic political process. The net impact of FDI depends on the policy environment of the host country—its capacity to administer FDI inflows, regulate the activities of foreign firms, and monitor the effects of foreign investment. The relative sophistication of the domestic economy is also a key factor, as it conditions the extent to which the economy is able to absorb the benefits of capital accumulation and technology transfer.¹⁹

3. What kind of investment needs to be attracted?

Strengthening the policy framework could help to attract and retain high-quality FDI

Kazakhstan has traditionally mostly attracted resource-seeking FDI and some market-seeking FDI, but little efficiency seeking investment. Resource seeking FDI is investment in natural resources. Market seeking FDI is investment provides goods and services to the domestic market. Efficiency-seeking FDI strives to take advantage of domestic economic assets to increase the productive efficiency of export-oriented goods or services. It is estimated that a mere 11 percent of Kazakhstan's total inbound FDI from 2005 through 2014 was efficiency-seeking. This helps explain

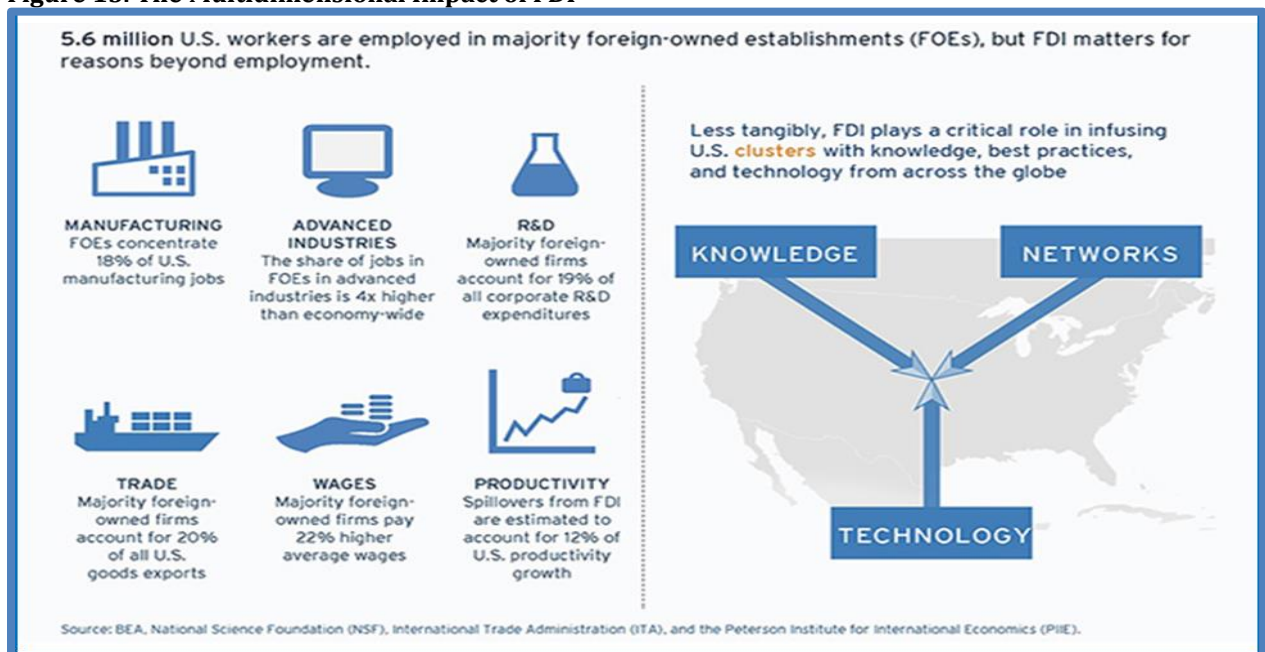
¹⁹ OECD, 2002.

the country's narrow export mix and the generally weak integration of Kazakhstan's firms into regional and global value chains.

Kazakhstan's experience with FDI is similar to that of other countries in the Commonwealth of Independent States (CIS). A recent study on FDI in CIS countries found that the choice of location always depends on a preliminary analysis of national macroeconomic advantages and disadvantages. Relevant factors include the existing FDI stock, the size of the domestic market, the availability of natural resources, the government's fiscal stance and the inflation rate. These conditions can predict the type of FDI (resource-seeking, market seeking, or efficiency-seeking) attracted by a given country.²⁰

Leveraging FDI to promote diversification and employment growth in Kazakhstan will require attracting greater volumes of market-seeking FDI and especially efficiency-seeking FDI. Efficiency-seeking investment has the most transformative potential of any type of foreign investment, with its ability to transfer technology and skills and spur diversification by increasing linkages with regional and global value chains. This type of FDI can have a powerful impact on exports, introducing domestic producers to new foreign markets and allowing domestic workers to increase their productivity. Efficiency-seeking investment takes advantage of lower labor costs, higher labor productivity, easier or even preferential access to export markets, access to key inputs and components, more efficient international production and supply patterns, or other factors that improve firm-level competitiveness.

Figure 15. The Multidimensional Impact of FDI



Source: US National Science Foundation and International Trade Administration.

4. Kazakhstan's challenge: How to better attract and retain FDI in non-mineral sectors?

The international experience suggests that successfully attracting and retaining FDI requires that recipient countries offer an attractive policy framework as well as specific investment incentives and services. An accommodative policy framework includes a stable macro-fiscal

²⁰ Shukurov, S. 2015. "Determinants of FDI in Transition Economies: The Case of CIS Countries," https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=2673766

environment, a sound monetary policy and substantial trade openness. In addition, the government must make sustained efforts to address regulatory, governance and corruption issues to improve the business environment. In some cases the authorities should take steps to reduce the role of the public sector in the economy, ease restrictions on capital flows, expatriate labor or foreign ownership of land or other assets, reduce the extent of price controls, or alleviate burdensome tax policies and administrative requirements.²¹ In addition to these general measures, specific policies to attract FDI need to be well aligned with the country's global and sectoral development objectives. Evidence from selected countries suggests that providing services that directly address problems faced by investors—such as regulatory, financing or taxation issues—can effectively attract FDI. Investment grants, e.g. for research or worker training, may appeal to foreign investors interested in greenfield FDI or regional investment projects.²²

Attracting and retaining market- or efficiency-seeking investment would require systematic and targeted investment-promotion efforts. Developing a national FDI strategy would help define Kazakhstan's global and sectoral approach to foreign investment and provide a framework for coordination among the different government ministries and agencies involved in attracting and retaining FDI. Such a strategy should clearly identify the types of investors the government is targeting and the most appropriate approaches for attracting the desired form of FDI.²³ A corresponding FDI marketing strategy would help attract foreign investors to selected sectors. Kazakhstan's FDI-related legislation must be consistent with its international commitments and limit the country's exposure to potential disputes between investors and the government. The package of incentives offered to domestic and foreign investors should be rationalized and aligned with Kazakhstan's sectoral priorities and development objectives. The incentives themselves should reflect the international experience with attracting different types of FDI (Table 7), and information on investment incentives should be widely publicized. The recent establishment of an Investment Ombudsman Office at the Ministry of Investment and Development has the potential to effectively address investor grievances and prevent them from escalating. Finally, the Government's capacity to undertake analytical and policy analysis could be strengthened to conduct rigorous empirical and qualitative policy analysis on the contribution of FDI to the country's economy and to develop a comprehensive framework for monitoring and evaluation (M&E), including a system of performance indicators for FDIs.

²¹ Vo, T.T. and Nguyen, A.D., 2012. "Experiences of Vietnam in FDI Promotion: Some Lessons for Myanmar." In *Economic Reforms in Myanmar: Pathways and Prospects*, edited by Hank Lim and Yasuhiro Yamada; BRC Research Report No.10, Bangkok Research Center, IDE-JETRO, Bangkok, Thailand; OECD, 2002. *Foreign Direct Investment for Development – maximizing benefits, minimizing costs*.

²² I. Tochitskaya 2009. "Policy Measures to Attract FDI: An Overview of International Experience and Recommendations for Belarus". Policy Paper [PP/05/2009]. IPM Research Center.

²³ The typology of FDI includes: natural resource-seeking investment, market-seeking investment, efficiency-seeking investment, and strategic asset-seeking investment. Each type is motivated by different factors (e.g. existence of natural resources; labor productivity and market access; availability of raw materials; etc.). Each offers different benefits; for example, efficiency-seeking investment tends to be more conducive to the creation of high-quality employment opportunities than natural resource-seeking investment. Attracting each specific type of investment requires a different approach.

Table 7. FDI Types and Investment Incentives, Lessons from the International Experience

Type of FDI	Description and Key Distinguishing Features	Key Associated Sectors	Implications for Locational Incentives
1. Natural Resource Seeking	<ul style="list-style-type: none"> • FDI motivated by the availability of, and access to, natural resources, raw materials in a host country. • Foreign firms look for valuable resources that can justify relocation of production. 	<ul style="list-style-type: none"> • Extractives (e.g. oil, gas, mining). • Agriculture, Forestry and Fisheries • Renewable energy (e.g. wind, solar, hydro). 	<p>Incentives are generally of limited use because the natural resource endowments of a country are the key drivers of this type of FDI.</p> <p>Incentives can potentially play a role to offset the quality and quantity of the natural resource.</p>
2. Market Seeking	<ul style="list-style-type: none"> • Firms search for new consumers of goods or services to achieve growing market share. • Focus is on market size, or growth and level of income or consumer attributes of host country. 	<ul style="list-style-type: none"> • Manufacturing (e.g. retail). • Services (e.g. finance, telecom, and transport). 	<p>Incentives are generally of limited use because investment decisions focus predominately on market attributes (size, population, etc.)</p> <p>Incentives can potentially play a role to offset the quantity or quality of the market.</p>
3. Efficiency Seeking	<ul style="list-style-type: none"> • Firms see to increase their competitiveness by leveraging different factors in the host country. • Goods and services produced in the host country are export-oriented. 	<ul style="list-style-type: none"> • Manufacturing from low (garments) to high tech (auto). • Services from low (call centers) to high tech (R&D design). 	<p>The discussion on incentives is primarily focused on this type of FDI, the role incentives can play is sector-specific.</p> <p>The role of incentives becomes relevant during at two stages of the investor's decision making: (i) location shortlisting; (ii) final site selection.</p>

Source: World Bank Group research, 2015.

Annex Table 1. Number of Jobs: Foreign, Private, and State-owned Firms

	Foreign enterprises	Private enterprises	State-owned enterprises
	Number of employees	Number of employees	Number of employees
Agriculture, Forestry, and Fishery	868	99,882	5,432
Mining	58,927	159,830	
Manufacturing	62,678	294,270	1,136
Electricity and Water supply	3,070	116,878	37,413
Construction	19,721	192,014	5,261
Retail and Wholesale	25,370	171,245	148
Transport and Warehousing	9,070	207,324	12,795
Habitation and Food Services	7,326	24,752	207
ICT	5,031	65,802	2,913
Financial Services	12,923	82,202	7,533
Real Estate Services	959	19,786	10,454
Professional Services	18,970	56,579	39,579
Administration and Support Services	3,680	116,053	11,507
Education	1,567	88,003	798,804
Healthcare and Social Services	684	62,011	328,503
Art and Recreation Services	556	9,835	58,643
Other Services	6,823	36,313	130

Source: WB staff calculations based on data published by the Statistical Office of Kazakhstan.

Note: Public administration and defense are not included, as they are almost entirely represented by state-owned enterprises.

Annex Table 2. Selected Macroeconomic and Social Indicators, 2012-17

	2012	2013	2014	2015e	2016p	2017p
<i>(Percent change, unless otherwise indicated)</i>						
National Accounts and Prices						
GDP growth	5.0	6.0	4.4	0.9	1.1	3.3
Oil sector growth	0.0	-4.8	-1.0	-1.0	-1.7	4.7
Non-oil sector growth	6.0	7.9	5.3	1.2	1.5	3.1
GDP per capita growth	3.5	4.5	2.9	-0.6	-0.3	1.9
GDP per capita (US\$)	12,120	13,612	12,602	10,326	8,910	9,737
Private consumption growth	11.0	12.6	-2.0	-2.0	0.0	2.0
Gross investment (percent of GDP)	24.8	23.9	24.2	23.5	22.7	22.9
Consumer price inflation, year-end	6.0	4.8	7.4	12.5	7.0	4.8
Consumer price inflation, period average	5.1	5.8	6.7	6.4	13.3	5.3
<i>(Percent of GDP, unless otherwise indicated)</i>						
Consolidated Fiscal Accounts						
Revenues	26.4	24.2	23.1	16.7	17.9	18.1
Oil revenue	13.8	11.8	11.4	6.1	6.5	6.9
Non-oil revenue	12.6	12.4	11.7	10.6	11.3	11.2
Expenditures	22.3	20.8	22.2	23.5	21.2	20.1
Current expenditures	16.1	15.5	15.7	16.9	17.3	16.4
Capital expenditures and net lending	6.2	5.4	6.6	6.6	3.9	3.7
Overall fiscal balance	4.0	3.4	0.9	-6.8	-3.3	-2.1
Non-oil fiscal deficit	-9.8	-8.4	-10.5	-12.9	-9.9	-8.9
<i>(Current US\$ billions, unless otherwise indicated)</i>						
External Accounts						
Merchandise exports, of which:	86.9	85.6	80.3	46.1	44.4	49.0
Oil exports	56.4	57.2	53.6	26.7	25.2	29.1
Merchandise imports	-48.8	-50.8	-43.6	-34.1	-32.9	-34.1
Services, net	-7.9	-7.2	-6.4	-5.4	-5.3	-5.1
Workers' remittances, net	-1.7	-1.8	-1.6	-1.5	-1.5	-1.5
Current account balance	1.1	0.9	6.0	-6.9	-7.2	-5.1
as percent of GDP	0.5	0.4	2.8	-3.8	-4.6	-2.9
Foreign direct investment, net	11.9	8.0	4.7	5.3	6.5	7.0
Total official international reserves	86.2	95.5	102.5	93.9	90.3	87.3
FX reserves in the Oil Fund	57.9	70.8	73.6	65.4	63.1	60.0
FX reserves at the Central Bank	22.1	19.2	21.5	20.9	19.4	19.8
Gold reserves	6.1	5.6	7.4	7.7	7.8	7.5
External debt, total	136.9	149.9	157.1	165.1	170.3	173.8
External debt, excl. intra-company loans	69.3	76.0	77.9	83.1	86.5	88.0
as percent of GDP	34.1	32.8	35.7	45.9	54.6	50.1
Multilateral debt (percent of external debt)	2.7	2.8	2.9	3.3	5.2	5.8
Debt service ratio (percent of exports)	20.6	21.3	21.1	36.5	36.5	32.0
Social Indicators						
Population, total (millions)	16.8	17.0	17.3	17.5	17.8	18.0
Population growth (percent)	1.4	1.5	1.5	1.5	1.4	1.3
Unemployment rate (percent of labor force)	5.3	5.2	5.0
Poverty rate, national (percent of population)	3.8	2.9	2.8

Sources: World Bank staff calculations and estimates based on data published by the Statistical Office of Kazakhstan, the Ministry of Finance of Kazakhstan, and the National Bank of Kazakhstan.

Note: e=estimate; p=projection.

Kazakhstan

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