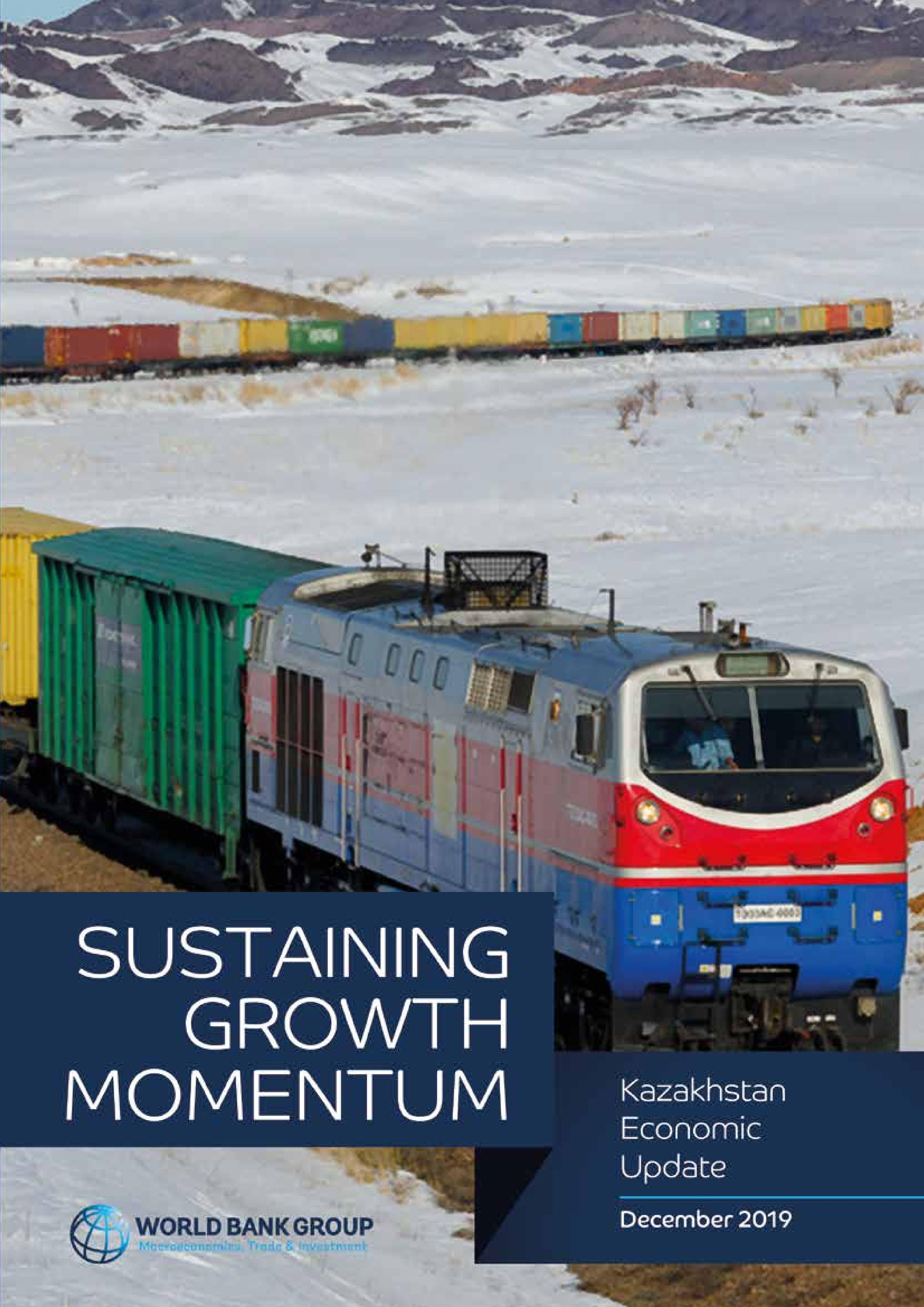

SUSTAINING GROWTH MOMENTUM

Kazakhstan Economic Update

December 2019

WORLD BANK GROUP
Macroeconomics, Trade & Investment

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Contents

BOX

FIGURES

TABLES

Acknowledgments

The Kazakhstan Economic Update is a semiannual report analyzing recent economic developments, prospects, and policy issues in Kazakhstan. The report draws on available data reported by the government, the National Bank of Kazakhstan, and additional information collected as part of the World Bank Group's regular economic monitoring.

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Cover photo by Dmitriy Lissin.

Abbreviations

ASEAN	Association of Southeast Asian Nations
CIS	Commonwealth of Independent States
EAEU	Eurasian Economic Union
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
GVC	global value chains
H1	first half
NBK	National Bank of Kazakhstan
Q2	second quarter
Q4	fourth quarter
SMEs	small and medium-sized enterprises

1 Overview

Kazakhstan's economy in 2019 is expected to grow at a modest rate. Strong domestic demand is likely to support annual gross domestic product (GDP) growth of about 4.0 percent this year, similar to last year's GDP growth. Greater social spending boosted household incomes, and with government support to relieve the debt burden of low-income households, sustained real consumption growth. Meanwhile, investments in residentials supported business investment and offset the decline in net exports. The services sector has performed well, while maintenance work in the major oil fields affected oil production. Rising domestic demand, higher food prices, and weakening of the exchange rate contributed to higher inflation. The year-on-year inflation rate, which hit 5.5 percent in October 2019, slightly higher than 5.2 percent rate, led the central bank to hike the policy rate.

But growth is expected to ease in 2020, with greater risks from the external environment and vulnerability to shocks. The economy is projected to grow by 3.7 percent in 2020 as the impact of fiscal stimulus is likely to diminish. Global economic growth is expected to improve slightly in 2020, but worse-than-expected growth in the European Union (EU), China, and Russia can rattle demand and prices of commodities relevant to Kazakhstan's exports. The recent forecast also suggests that global commodity prices are likely to soften on the back of ample supplies and weak global demand.[1] Against the backdrop of weakness in the banking sector and the limited prospect of a surge in economic growth in the medium term, the continued expansion of retail loans can increase the downside risks to the economy.

1 World Bank 2019a.

Recently, the economy expanded amid the slacking external environment. Global economic growth appears to have slowed to a projected 2.6 percent in 2019, constrained by subdued international trade and investments. Average growth of Kazakhstan's major trading partners, which include the EU, China, and Russia, is expected to decline to 1.7 percent in 2019 from 3 percent in 2018. The weak environment in global trade and lower oil prices have negatively affected Kazakhstan's exports and edged up the current account deficit to 2.4 percent of GDP. The sudden resignation of President Nazarbayev in March 2019 came as a surprise and paved the way for an orderly political transition and the election of President Tokayev.

Policy stimulus has helped domestic demand, but structural weakness is constraining the economy from expanding further. An increase in fiscal spending is expected to increase the government non-oil budget deficit to about 8.6 percent of GDP in 2019, higher than 7.6 percent last year. The policies included the government taking over the debt service of 443,000 citizens and raising social spending to 5 percent of GDP in 2019 from 4.4 percent in 2018. The subsidized loans for housing continued, although at a lower volume than in previous years. As increase in domestic demand widened the current account deficit and pushed up inflation; however, the National Bank of Kazakhstan's (NBK's) move to control inflation helped improve macroeconomic stability. Nevertheless, growth in the real sector is largely limited to non-tradeable services including construction, trade, and transport services, while lower prices and output weakened the performance of the oil sector. Corporate lending by the banking sector continues to sag, reflecting a conflation of low demand from corporations and risk aversion by banks. Although Kazakhstan's current GDP growth is higher than half the countries at similar levels of development, addressing structural weaknesses is imperative for the economy to join the ranks of the world's 30 most developed economies by 2050.[2]

Continuing with structural reforms is critical to sustain higher and more inclusive economic growth. In his September 2019 Annual Address to the Nation, President Tokayev underscored the need to implement the concept of a "Listening State" and called for raising the living standard, overcoming inequalities in the provision of services, and strengthening civil society. A National Council of Public Trust was created and convened for the first time to gather feedback from civil society organizations and involve various stakeholders in the design and implementation of government programs, including at the local levels. The government has also promised to increase financial support for low-income households, improve the public pension system, and introduce compulsory health insurance. Kazakhstan recently improved its standing in the Doing Business report, where it ranked 25th out of 190 countries. But against the backdrop of lackluster productivity growth, the plan to address weaknesses in the banking sector, improve the efficiency and delivery model for government services, reign in expansion of state-owned enterprises, and review the use of the National Oil Fund are key reforms requiring strong political commitment.

The special topic of this report is Kazakhstan's export diversification. Trade plays an important role in Kazakhstan's development, and the country is positioned to benefit from the growing markets of China, Europe, and Central Asia. Trade offers opportunities for Kazakhstan's economic growth and for diversifying away from oil. But to benefit from the opportunities, Kazakhstan needs further cross-cutting reforms such as improvement in transport logistics, trade facilitation, and the functioning of factor markets (finance, land, and labor). Therefore, understanding current developments and challenges in exports is important to inform policy to improve export competitiveness of non-resource products. The special topic section of this report highlights the fact that, although Kazakhstan has made progress in diversifying its export destinations, product quality outside commodities is still relatively low and has less than a 50 percent survival rate beyond the first year if a product was exported beyond the Eurasian Economic Union (EAEU) or Commonwealth of Independent States (CIS) markets. OECD data on trade in value added indicate that Kazakhstan's exporters used fewer imported inputs compared to a decade earlier, which suggests a declining participation in global value chains.

[2] Defined as upper middle-income countries with a 2018 current gross national income per capita between US$3,996 and US$12,375 .

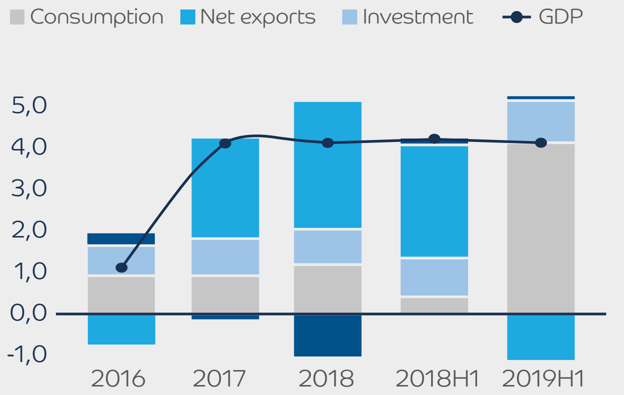
2 Growth and Inflation: moderate growth sustained by domestic demand and a pickup in inflation

Kazakhstan's GDP has continued to grow at a moderate pace of 4 percent, much lower than the breakneck expansion before the 2008 global financial crisis. The slowdown in growth over the last decade has reflected a lack of productivity increases, and a weak external environment is projected to be little changed in 2020. While increases in social spending supported domestic demand and sustained growth this year, with rising inflationary pressure, improvement in productivity is needed to accelerate growth.

The economy continued to grow at a solid pace supported by strengthening domestic demand and activities in the services sector. Preliminary data show that real GDP rose by 4.3 percent during January–September 2019, largely reflecting a sizable expansion in household and business activity (Figure 1). Reported data for the first half of 2019 suggest that real consumer spending grew at an annual growth rate of 5.9 percent, stronger than the 4.5 percent recorded for the same period of 2018. Rising wages, social benefits, and an increasing demand for consumer loans have supported household spending. Business investment expanded further at 5.7 percent during the period under review, and gains appears to be driven in large part by capital spending in the mining industry and activity in residential construction. After providing a substantial addition to GDP during the last two years, the contribution of net exports has faded because of a surge in imports. Real exports grew by 4.2 percent, down from the previous year's rate of 8.9 percent owing to moderating oil production – mainly export products – whereas imports, boosted by fiscal stimulus actions taken so far this year, grew by 10.5 percent, notably faster than the 2.7 percent registered over the review period. On the supply side, growth has been supported largely by trade and transport services (Figure 2). The contribution of mining and manufacturing has remained moderate compared to the previous year, considering weakening global trade. Oil production contracted by 0.5 percent during January–September because of maintenance in major oil fields, while activity in manufacturing expanded at a moderate pace of 3.5 percent.

Figure 1. Consumption and investment were the main drivers of growth

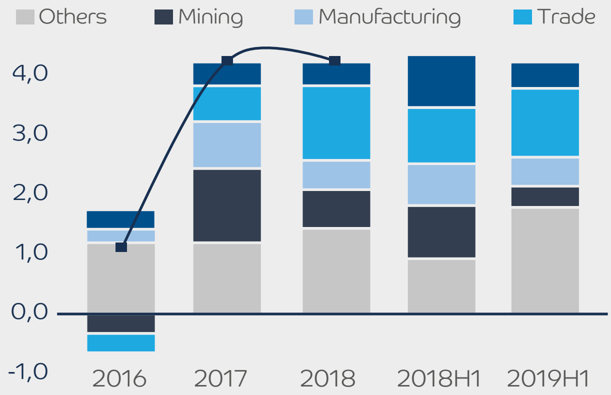
(contribution to GDP growth, percent)



Sources: World Bank staff calculations based on Committee on Statistics data.

Figure 2. Services and trade

(contribution to GDP growth, percent)

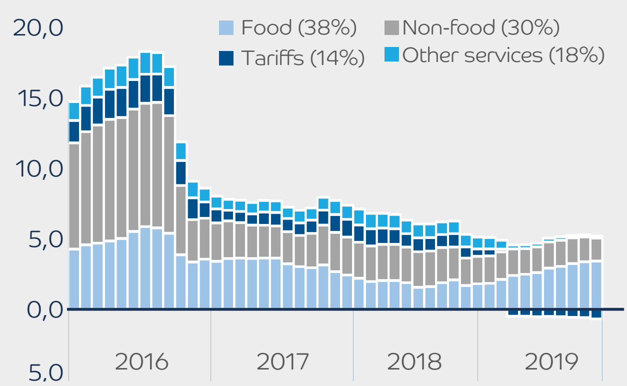


Sources: World Bank staff calculations based on Committee on Statistics data.

Consumer price inflation moved up to 5.3 percent (year-on-year) in September from its lowest record of 4.8 percent a year earlier, in part owing to a pickup in food prices. This inflation rate is almost at the upper bound of the 4 to 6 percent inflation target of the NBK. Food, accounting for around 40 percent of the consumption basket, continues to be main factor pushing up underlying inflation dynamics this year (Figure 3). Food prices grew by 9.1 percent in September, considerably above the previous year's record of 5.7 percent, while non-food products inflation moved lower in recent months, falling to 5.4 percent from 7.7 percent in September 2018. This year's lower grain harvest owing to colder weather conditions and lower yield will likely have an impact on the supply of grains to processing and affect prices. Underlying core inflation, excluding food and energy, however, showed a more convincing upward trend, jumping over the central bank's target of 4 to 6 percent for this year. The tenge depreciated about 6 percent in nominal terms against the U.S. dollar in October relative to the rate 12 months earlier. Import price inflation already accelerated in response to 8.1 percent year-on-year in August 2019 from 7.8 percent in August 2018 (Figure 4). This appears to reflect rising inflation expectations and will likely influence wage and price-setting decisions going forward. So far this year, the effect of those factors has been felt on food prices and, to a lesser extent, on prices of durable goods. But overall, looking beyond the volatility in recent months, inflation has been following a downward trend over the past three years and declined from the high levels recorded in 2016

Figure 3. Accelerated food prices push up inflation dynamics

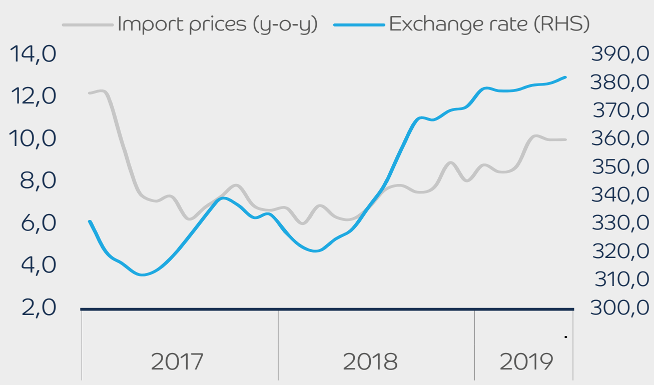
(contribution to inflation, percent)



Sources: World Bank staff calculations based on Committee on Statistics data.

Figure 4. Import prices increased along with the depreciation of the exchange rate

(changes in import prices and exchange rate)



Sources: World Bank staff calculations based on Committee on Statistics data.

3 Balance of Payments and Exchange Rate: widened current account deficit and modest real exchange rate depreciation

Weak global demand, lower international crude oil prices, and slightly lower oil production have curbed Kazakhstan's export growth and widened the current account deficit. A large outflow of portfolio investments contributed to currency depreciation and a decline in foreign reserves held by the NBK. Real exchange rate depreciation allowed import demand to adjust to higher import prices but rising domestic inflation can offset the effect.

Growth in export value has softened amidst lower global oil prices, a weak external environment, and supply problems. The softening of exports continued through the first half (H1) of 2019, and total export value increased by only 0.8 percent compared to 26 percent in the same period the previous year. For the first time since 2016, the value of oil and gas exports posted a negative growth rate (Figure 5). This performance is likely due to the lower average price of Brent oil per barrel in H1 2019, which was about 7 percent lower than in the same period last year. In addition, maintenance in the three giant oil fields (Karachaganak, Kashagan, and Tengiz) in H1 2019 have slightly lowered oil production during the observed period.[3] However, value of non-oil exports demonstrated better growth performance than oil and gas, with an annualized growth rate of 28 percent in H1. Commodities that contributed to the increase in non-oil exports were cotton and minerals. Meanwhile, lower yield per hectare of the 2019 grain harvest reduced the volume available of grain

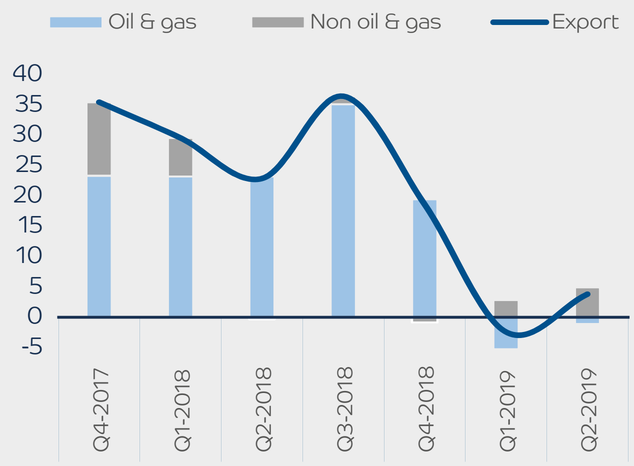
[3] As part of an agreement with OPEC and non-OPEC countries, Kazakhstan is also expected to cut oil production from 2.098 million barrels per day to 1.988 million barrels per day in 2019.

for export. Export growth to the Eurasian Economic Union (EAEU) countries also declined, reflecting weaker demand from the Russian market.

The increase in imports is associated with an uptick in the growth of domestic demand, but depreciation of the tenge helped rein in imports growth. Against strong growth in domestic demand, nominal import in H1 grew by 7.2 percent year-on-year, and 95 percent was contributed by non-oil and gas products (Figure 6). During H1, for example, the import quantity of transport equipment (cars and trucks) increased by 26 percent for cars and 120 percent for trucks. However, the depreciation of the tenge against the U.S. dollar by 15 percent year-on-year in H1 2019 helped ease the growth of imports. Allowing the tenge to depreciate in nominal and real terms has increased the prices of imported goods and helped dampen growth in import demand (see Box 1).

Figure 5. Oil and gas contributed to the decline in growth in nominal exports

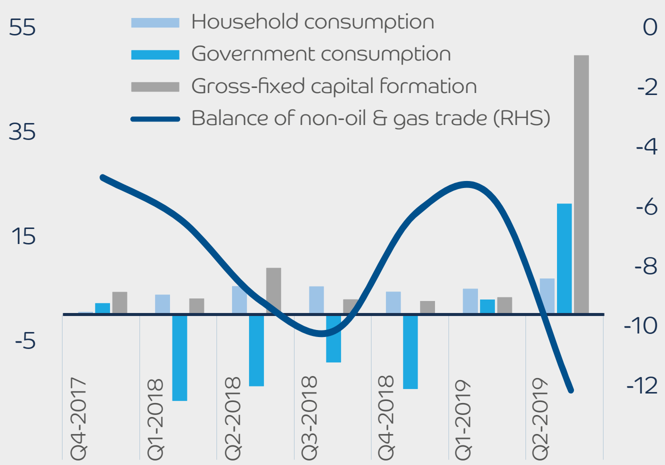
(contribution to y/y export growth, percentage)



Sources: World Bank staff calculations based on NBK data.

Figure 6. A surge in domestic demand pushed the deficit in the non-oil and natural gas trade

(y/y change, percent; balance of non-oil trade as percentage of GDP)



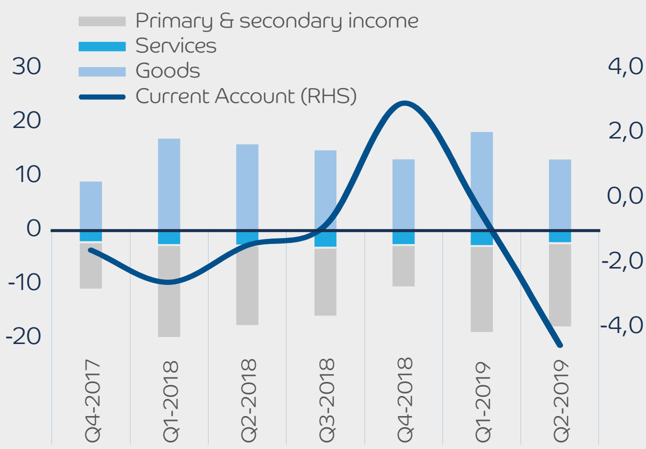
Sources: World Bank staff calculations based on NBK data.

The weak performance of exports and the continued outflow of investment income widened the current account deficit. A smaller deficit in services trade narrowed the surplus in the trade balance. However, the outflow of investment income continued and turned the current account into a deficit of 4.5 percent of GDP in the 2nd quarter, or 2.4 percent of GDP in H1 (Figure 7). The current account deficit is expected to continue throughout 2019 as exports continue to face a weak and uncertain environment.

Inflows of foreign direct investment (FDI) were offset by a surge in the outflow of portfolio investment. Kazakhstan recorded a net inflow of foreign direct investment of US$3.7 billion in H1 2019, 13 percent lower than the US$4.27 billion inflow during the same period last year. Compared with the 20 percent decline in the global foreign direct investment flow in H1 2019, however, Kazakhstan fared relatively better. However, in the same period, the net outflow of portfolio investment stood at US$4.2 billion compared to US$2.0 billion in the same period in 2018. The amount of outflow in portfolio investments intensified in Q1 this year driven mainly by soaring net purchases of foreign assets, mostly corporate and sovereign debt securities. The timing of the large portfolio outflow also aligned with the sharp depreciation of the tenge and coincided with the surprise political transition in March 2019. The repayment of Eurobonds by state-owned enterprises led to an increase in the portfolio investments outflow in the amount of $1.1 billion in H1, lower than $2.6 billion in the same period last year. The easing of the monetary policy stance in developed economies might have contributed to the flow of short-term funds to emerging and frontier markets. But domestic inflation pressure and the perception of risk might have dampened investor confidence despite the upgrade of the outlook in sovereign risk by international rating agencies. The current account deficit and net outflow in the financial account have caused foreign reserves to fluctuate from US$30 billion in January 2019 to US$27 billion in June, before it edged up to US$29 billion in October this year.

Figure 7. Components of the current account

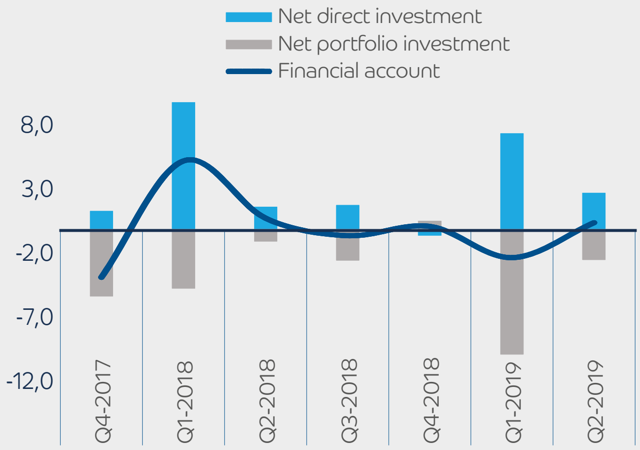
(percentage of GDP)



Sources: World Bank staff calculations based on Haver Analytics and the NBK.

Figure 8. Net outflows of portfolio investment offset net inflows of foreign direct investment

(percentage of GDP)



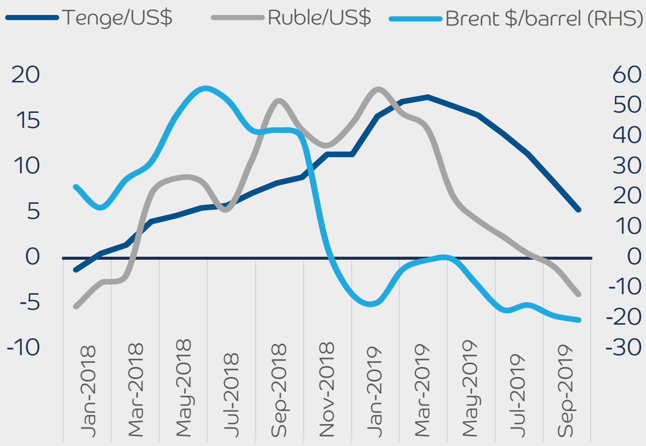
Sources: World Bank staff calculations based on Haver Analytics and the NBK. For presentation purpose, signs are in reverse from the orignial format.

The Kazakhstan tenge continued to depreciate against the U.S. dollar throughout the third quarter of 2019. The tenge depreciated against the U.S. dollar since January 2019, and by September it had depreciated by 5.3 percent (year-on-year), reaching 390 tenge per U.S. dollar in October 2019 before it stabilized. The depreciation of the tenge this year was broadly in line with lower oil prices, which affected nominal export of oil. The depreciation is also consistent with trends in movement of regional currencies such as the Russian ruble and Uzbek som (Figure 9).

However, the depreciation of Kazakhstan's real exchange rate has been more modest. Domestic inflation turned relatively higher than inflation in Kazakhstan's major trading partners, and it appeared to have reduced the pace of real exchange rate depreciation. Depreciation of the real exchange rate intensified during the first half of 2019 and slightly appreciated in July and August (Figure 10). Keeping domestic inflation under control is vital to maintain the relative competitiveness of Kazakhstan's products.

Figure 9. The tenge depreciated along with other regional currencies and declining oil prices

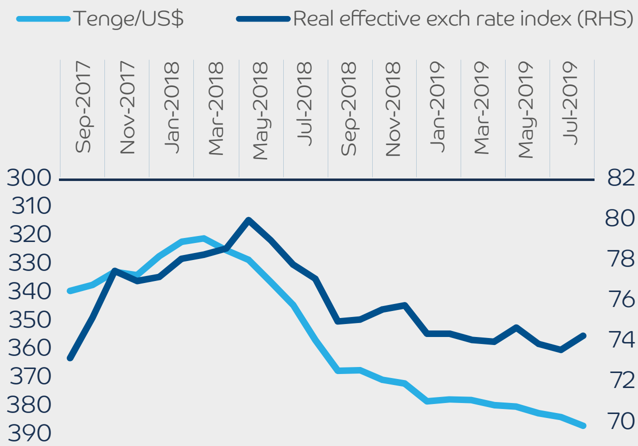
(y/y change, percent)



Sources: World Bank staff calculations based on Haver Analytics and the NBK.

Figure 10. Depreciation in the real exchange rate has been more modest

(real exchange rate index December 2013=100)



Sources: World Bank staff calculations based on Haver Analytics and NBK.
Note: A decline in real effective exchange rate is a depreciation.

Box 1. Real exchange rate movement and non-oil and gas trade

In August 2015, the NBK allowed the tenge to move more flexibly against the U.S. dollar.[a] Since then, Kazakhstan's exports and imports have been exposed to more fluctuations in the exchange rate. Kazakhstan's trade has a large share of oil and gas the production level of which typically follows period-specific contracts. Therefore, movement in the real exchange rate is likely to be relevant for trade in non-oil and gas products (non-oil, in short).

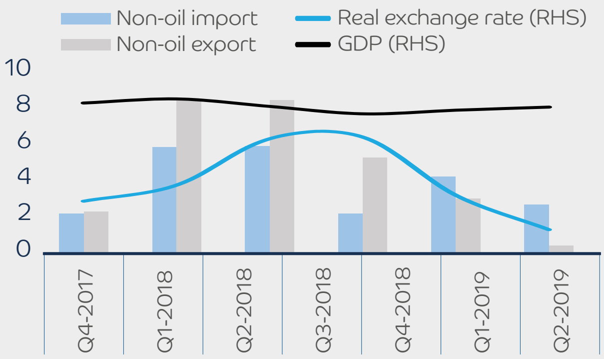
About 90 percent of Kazakhstan's imports are non-oil products. One estimate suggests that import demand elasticity for Kazakhstan is elastic and above average, which implies import volume tends to change more than changes in import prices.[b]

Figure 11 presents three quarters to three quarters growth of seasonally adjusted data of nominal non-oil exports, nominal non-oil imports, and the real exchange rate.[c] From Q2 to Q4 2018, the appreciation in the real exchange rate, which eroded the price competitiveness of domestic products, was accompanied by a rapid increase in imports. However, from Q4 2018 to Q2 2019, growth of imports decreased, together with depreciation in the real exchange rate. The decrease in non-oil import growth also occurred despite a sustained increase in real GDP. This implies that depreciation in the real exchange rate is associated with a decline in growth in demand of non-oil imports.

In contrast, during Q4 2018 to Q2 2019, growth of non-oil exports declined with the real exchange rate depreciation. One possible explanation for this is weaker global demand, and lower commodity prices dampened growth in non-oil export value. Another possibility is the time lag for depreciation in the real exchange rate to effectively influence the demand for Kazakhstan's non-oil exports.

Figure 11. Real exchange rate and non-oil and gas trade

(seasonally adjusted, 3Q/3Q growth)



Sources: World Bank staff calculations based on Haver Analytics and NBK.
Note: A decline in real effective exchange rate is a depreciation

Note: a. Official statistics suggest that, since September 2016, the NBK has done little to directly intervene in the foreign currency market. b. Mahdi Ghodsi, Julia Grubler, and Robert Stehrer, "Import Demand Elasticity Revisited," Vienna Institute for International Economic Studies Working Paper #132, Vienna, 2016. c. Export and import data were seasonally adjusted using the Census X-13 method.

4 Monetary Policy and the Financial Sector: inflation is under control, but credit growth remains weak

Sustained inflation pressure led the NBK to hike the policy rate. Meanwhile concerns over nonperforming loans continues to affect credit growth, which prompted the NBK to review the quality of assets of major banks. At the same time, the rapid buildup of retail lending raises concerns over higher risk from nonperforming loans.

Although inflation has been within the target range, the NBK raised the policy rate in September 2019 to anticipate further increases in inflation. Before the recent increase in inflation, the headline inflation in Kazakhstan had continued its downward trend through March this year. Higher food prices and import prices propped up inflation and caused the NBK to increase its policy rate by 25 percentage points, back to 9.25 percent in September 2019. The rate increase was taken after the NBK maintained a 9.0 percent rate for five months since April 2019 (Figure 12). The rate hike was enacted to rein in inflation expectations and retail lending, which has been driving overall lending activity over the last three years. NBK data also suggest that it has stepped up absorbing excess liquidity from the market through auctions of deposits and notes since October this year.[4] With rising import prices and a government plan to increase social spending and the salary of public servants in 2020, it is likely that the NBK will continue to maintain the current stance of monetary policy to contain inflation expectations.

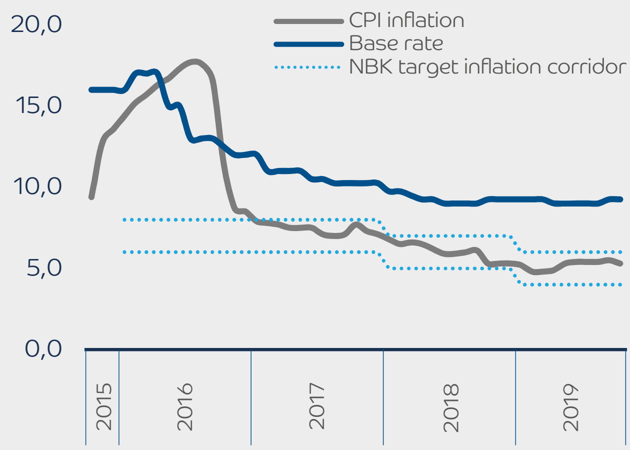
Existing credit growth is driven by retail lending to consumers, but credit to legal entities, particularly small and medium-sized enterprises (SMEs), continues to contract.

[4] For a list of NBK instruments for monetary policy, please see https://nationalbank.kz/?docid=3334&switch=english.

Domestic credit has barely grown and remained depressed in real terms in the last 10 months (Figure 13). Existing credit growth is driven by lending to individuals, both mortgage and consumer lending. Meanwhile lending to corporations (legal entities) remains in negative territory and continues to decrease its share in total lending (from 63 percent at end-2017 to 53 percent in September 2019) due to the write-off of nonperforming loans. Lending to SMEs is experiencing the largest contraction (12.9 percent during 2019 compared with a 1.9 percent contraction of corporate loans). Despite the slight improvement in credit growth, total lending and deposits of the Kazakhstan banking sector in H1 2019 accounted for 20.5 and 24.6 percent of GDP, respectively, down from 23.1 percent and 28.6 percent, respectively, at the beginning of the year. These lending ratios are well below the levels at the beginning of the decade (around 60 percent and 35 percent) and the levels observed for upper middle-income countries.

Figure 12. NBK hiked its policy rate in response to rising inflation pressure

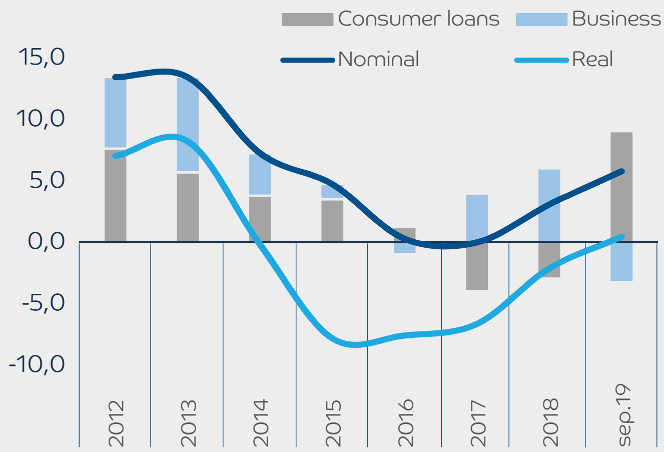
(percent year-on-year)



Sources: World Bank staff calculations based on NBK data.

Figure 13. Retail lending (consumer loans) have driven credit activity

(percent year-on-year)



Sources: World Bank staff calculations based on NBK data.

Although reported financial indicators show banks have high capitalization levels, nonperforming loans in the banking sector are likely higher than the official figure. On average, banks reported having 23 percent capital ratio and 17.9 percent common equity ratio. The reported nonperforming loans are about 1.3 trillion tenge, an increase to 9.5 percent from 7.4 percent of loans at end-2018. Recently, Standard & Poor's (S&P) estimated that the additional reserves to cover true nonperforming loan levels could amount to 1 trillion tenge (about US$2.6 billion). Although lending in dollars continues to decline, reaching 17.5 percent at end-September 2019 compared to 23 percent one year ago, deposit dollarization of 44 percent remains a concern. Banks may not be able to pass foreign currency deposits into foreign currency lending to local borrowers with no foreign currency receivables. To assess the extent of problematic assets, the NBK is completing an independent review of the quality of assets of 14 banks.

The rapid growth in retail lending raises concerns. It also suggests the connection between credit growth and the NBK policy rate is not that strong. By September 2019, retail lending grew by 22.4 percent year-on-year, while lending to the corporate sector still contracted by 5.5 percent. The rapid increase of retail lending throughout 2018 and 2019 also suggests the previous rate hike by the NBK from 9.0 percent to 9.25 percent between October 2018 to March 2019 has little effect on curbing the growth of this type of lending. The rapid buildup of retail lending can increase the risk of household indebtedness and increase nonperforming loans because consumer loans typically rely only on individual creditworthiness, with little or no collateral. To prevent the buildup of household indebtedness and limit the growth of consumer lending, the NBK plans to increase the capital charges of uncollateralized consumer loans and refine the household-debt burden calculations.

5 Fiscal Policy: stability amidst a wider deficit

Kazakhstan's fiscal position in 2019 remains stable as non-oil revenue improved on the back of better administration and sustained economic growth. Despite the goal of reducing the budget deficit over the medium term, the deficit in 2019 is likely to increase substantially because of the increase in social expenditure and continued infrastructure investments.

Kazakhstan's fiscal policy is judged to be more expansionary in 2019, with budget spending rising notably faster than in 2018. During January–June 2019, the general government budget, which is the aggregate of state and local budgets, posted higher spending across the range of expenditure items both in absolute terms and relative to GDP (Table 1). Higher wages for low-paid public sector workers; broader social entitlement programs, including education and health care; and housing and debt relief for low-income earners among others, boosted social transfers by an estimated 24 percent, while spending support to industry and transport facilitation moved up 9.1 percent and 13.3 percent, respectively. On the revenue side, improvements in tax administration and sustained increase in economic activity helped strengthen budget revenue. Corporate income tax and value-added tax, which account for half of fiscal tax revenue, increased by 16.9 percent and 27.4 percent, respectively, during the period under review compared to the first half of 2018. Oil revenue increased by almost 27 percent in the first half of 2019, owing to a discretional withdrawal from the National Oil Fund of T 370 billion, on top of a T 1.4 trillion guaranteed transfer to the budget from the total T 2.7 trillion guaranteed transfer allocated this year. There was little change in the overall deficit to 0.4 percent of GDP in the first half, which contrasts with a larger non-oil deficit associated with a calendar factor and expenditure execution processes. Although the non-oil deficit is likely to decline from the deficit in the first half-year, the non-oil deficit in 2019 is expected to be 8 percent of GDP, above the level observed in 2018. Overall, the government fiscal policy actions in 2019 are expected to boost GDP this year largely driven by higher expenditures both in nominal terms and adjusted for inflation.

Table 1. General government fiscal accounts, 2017–19
(in percent of GDP)

	2017	2018	1H2018	1H2019	2019 est.
Revenues	**21.8**	**18.1**	**21.1**	**22.2**	**18.5**
Oil revenue	10.0	6.2	7.7	8.6	6.6
Non-oil revenue	11.8	11.9	13.5	13.6	11.8
Expenditures	**23.5**	**19.0**	**20.6**	**21.4**	**20.2**
Goods and services	7.4	5.4	5.5	6.0	5.8
Social transfers and wages	7.1	7.3	8.6	9.3	8.0
Capital spending and subsidies	4.1	3.6	3.3	2.9	3.8
Interest payments and other transfers	5.0	2.8	3.1	3.2	2.6
Net lending and financial transactions	1.0	0.5	0.9	1.2	0.3
Overall balance	**-2.7**	**-1.4**	**-0.3**	**-0.4**	**-1.8**
Non-oil balance	**-12.7**	**-7.6**	**-8.0**	**-9.0**	**-8.6**
Memorandum items:					
Stock of FX assets in the National Oil Fund	35.8	33.5	32.8	35.0	34.3
Stock of total government debt	20.1	20.7	19.0	19.8	19.1
External debt and state guarantees	9.4	10.5	8.9	9.4	9.2
Domestic debt and state guarantees	10.7	10.2	10.1	10.3	9.9

Source: World Bank staff calculations based on data published by authorities.
Note: The general government budget comprises the state and local budgets. The stock values of foreign exchange assets and government debt relative to GDP for semiannual periods are calculated by using annualized GDP data. FX = foreign exchange.

The stock of government debt to GDP was about 19.8 percent of GDP in the first half of 2019, with the nominal value of US$31.8 billion in the first half of the year. A lower level of public debt helps the government to smoothly proceed with consolidation efforts and continuing economic growth together with stable oil prices are expected to put the debt-to-GDP ratio on a further declining trend. In September 2019, the government tapped the Eurobond market and successfully placed slightly over 1.1 million euros in bonds at a lower borrowing cost. The 15-year bond circulation term has been the longest issue denominated in euros ever offered by a country from the Commonwealth of Independent States region. Despite the economy's long-standing structural weaknesses, decent macro performance, a strong government balance sheet with low public debt, and sizable foreign exchange reserves allow the government to raise funding at lower borrowing costs. Eurobond issuance to a certain extent intends to firm up investor confidence and at the same time promote the newly launched Astana Financial center as a regional financial hub.

Keeping a lid on budget expenditures, improving its efficiency, and raising non-oil revenue collection are needed to retain fiscal sustainability. The Draft State Budget 2020, while designed assuming a steadily growing economy at a pace higher than the World Bank baseline and conservative oil price forecast, presents a deficit reduction path consistent with the midterm fiscal consolidation strategy. The non-oil deficit of the state budget – a numerical fiscal target – is expected to decline further in 2020 on the back of improved non-oil tax collection and implies no further additional withdrawals from the National Oil Fund apart from a T 2.7 trillion guaranteed transfer. Although achieving a lower budget deficit is feasible, the planned increase in social spending can increase the pressure for a budget deficit. Recently, the government has committed to lift salaries and compensation to teachers, medical workers, and other social sectors workers in the coming years. This planned increase in payroll and the larger proportion of spending on the social sector in the past few years could increasingly constrain capital spending.

6 Outlook and Risks: growth is likely to soften amidst external headwinds and domestic challenges

Despite the prospect for a modest recovery in global growth in 2020, the external economic environment remains fragile, with uncertainties over global trade weighing down global growth and commodity prices. Meanwhile, Kazakhstan's economy remains vulnerable to external shocks, and domestic challenges are limiting growth potential.

The economy is expected to grow amidst sluggish demand by Kazakhstan's main trading partners and the diminishing effect of the previous fiscal stimulus on domestic demand. The World Bank is projecting the economy to grow by 4.0 percent in 2019 and to soften to 3.7 percent in 2020 (Table 2). Household spending and investment are expected to continue to drive demand, although to a lesser extent than in previous years. Services are also expected to support growth on the supply side. Weak performance of manufacturing, however, owing to lackluster FDI beyond the oil and gas sector, is weighing down economic expansion. Lower international oil prices and higher domestic demand for imports will likely keep the current account in a modest deficit over the medium term. Meanwhile, international reserves held by the NBK remain adequate as they can cover at least nine months of imports.[5] The continued expansion of Tengiz oil field until 2022 is expected to lead the FDI inflow in the coming years. FDI in other sectors can potentially rise if Kazakhstan continues implementing commitments to the World Trade Organization and bilateral agreements of the EAEU (see section on Policy Watch).

As monetary policy remains focused on preserving price stability, inflation is projected to stabilize within the NBK's target. However, fiscal measures, including larger social spending, rising domestic cost pressure, and exchange rate volatility can still strengthen inflation expectations. To help keep a lid on inflation and effectively steer inflation expectations, the central bank can further enhance its communication strategy and strengthen the interest rate transmission channel.

Although the fiscal position of the government is expected to remain strong, it is important to continue with fiscal consolidation. The 2019 adjustment to the midterm budget includes additional spending on social assistance, infrastructure, and subsidies to SMEs, which will bring the non-oil deficit to 8.6

percent of GDP (Table 2). For 2020, the government is likely to increase expenditure on social allowances for low-income households, salaries of education workers, contributions to pensions, and spending on the national health care system. However, because the government has not announced a new program on capital expenditure, the non-oil deficit for 2020 is expected to be about 7.6 percent of GDP. To ensure fiscal sustainability, the government should proceed on the announcement of cutting the non-oil deficit. Increased spending in this regard will need to be accompanied by higher non-oil revenues. Fiscal consolidation is also important as the government already announced a reduction in the amount of scheduled transfers from the National Oil Fund[6] to the budget.

Table 2. Baseline scenario: selected macro-fiscal indicators, 2016–21
(In percent, unless otherwise indicated))

	2016	2017	2018	2019	2020	2021
					Projections	
Real GDP growth	**1.1**	**4.1**	**4.1**	**4.0**	**3.7**	**3.9**
Oil sector	2.3	7.4	4.7	2.0	1.8	2.0
Non-oil economy	0.9	3.2	3.9	4.5	4.2	4.5
Consumer price inflation, end of period	8.3	7.2	5.4	5.6	5.5	5.5
percent of GDP, unless otherwise indicated						
Current account balance	-5.9	-3.1	0.0	-2.8	-2.5	-1.7
Foreign direct investment	10.0	2.3	2.8	2.1	2.5	2.2
Overall fiscal balance	-5.5	-4.5	2.7	-1.3	-0.6	-1.1
Non-oil fiscal balance	-10.0	-12.8	-7.6	-8.6	-7.6	-7.4
Net financial assets	25.0	15.7	12.7	13.8	12.1	10.1
Poverty rate (US$5.5 per day at PPP terms)	12.2	8.6	7.4	6.6	5.8	5.2

Source: World Bank staff calculations based on data published by authorities.
Note: PPP = purchasing power parity.

The economy's vulnerability to external shocks remains the primary source of risk to medium-term growth and poverty reduction. Market expectations of GDP growth have deteriorated, with average forecasts for global and emerging market and developing economy growth continuing to edge downward. In September 2019, global trade contracted by 1 percent year-on-year. Therefore, this year, growth in the global economy is expected to slide to 2.6 percent, the lowest since 2009, before picking up modestly in 2020.[7] The ongoing trade war between China and the United States has weakened the global business confidence for FDI flows. A worse-than-anticipated growth of the Chinese economy can further depress global economic growth. For Kazakhstan, such a scenario can further soften global commodity prices and negatively affect the demand for Kazakhstan's exports. The outlook for commodity prices relevant for Kazakhstan, such as energy and metal, is expected to soften in 2020 and remains vulnerable to a larger-than-expected slowdown in global growth.[8]

The limited progress in advancing reforms to expand the economy's productive potential is limiting the scope for growth. Kazakhstan made progress in the 2020 Doing Business ranking and is in the top 25 countries of the 190 countries surveyed. Nevertheless, the lack of dynamism in the private sector, persistent market capture by large state-owned enterprises, and banks that are not lending to small and medium-sized corporates present high downside risks to the economy. Therefore, a renewed vigor in advancing structural reforms becomes imperative for the government to boost productivity and attract much needed foreign investment in the non-oil economy. The policy actions taken so far by the government to support socially vulnerable people, along with robust job creation, are expected to help bring the poverty rate down to almost 8 percent by 2021. A significant portion of the population will likely remain close to the poverty line, and any potential shocks to economic activity might reverse the prior gains.

5 Assuming monthly imports of US$3 billion.
6 Kazakhstan's sovereign wealth fund.
7 World Bank 2019a.
8 World Bank 2019b.

7 Policy Watch

a. Asset quality review of major banks

The National Bank of Kazakhstan (NBK) is completing an independent review of the quality of assets possessed by 14 banks, which make up about 87 percent of the assets of the banking sector. In 2014–15, the fall in oil prices and the depreciation of the tenge adversely affected the quality of Kazakhstan's asset portfolio and the solvency of the country's banking sector. The authorities provided liquidity and subordinated loans to banks, purchased bad assets, and provided regulatory forbearance on loan classification and provisioning to stabilize the banking sector. Despite these measures and generous credit support programs funded with quasi-fiscal resources, bank credit to legal entities, especially to SMEs, continued to retrench to 7 trillion tenge by end-September 2019, from 8.6 trillion tenge by end-2016. The ratio of deposits to GDP has also been declining. The asset quality ratio process of second-tier banks would help reveal the true extent of banks' problem assets and their solvency position so that authorities could take the necessary measures to restore the health of the financial sector.

b. Bilateral agreements between the Eurasian Economic Union with other countries and new visa-free policies for 12 countries

New trade agreements of the Eurasian Economic Union (EAEU) could expand Kazakhstan's export opportunities. On October 1, 2019, the EAEU-Singapore free trade agreement was signed. It incorporates trade in goods as well as regulation of trade in services and terms of investment. An economic cooperation agreement with China also entered into force at the end of October, which focuses on simplified trade procedures. On October 25, 2019, the EAEU-Serbia free trade agreement was signed, which was largely based on already existing bilateral trade agreements Serbia had with Belarus, Kazakhstan, and Russia. Why is this important for Kazakhstan? As a member of an EAEU customs union, Kazakhstan is bound to implement a common import tariff structure of the EAEU. These new agreements add trading partners to the EAEU and provide opportunities for Kazakhstan to diversify export markets, attract FDI, reduce trade diversion, and increase trade in services.

The government added 12 countries whose citizens can visit Kazakhstan for 30 days without a visa. Bahrain, Colombia, Indonesia, Kuwait, Lichtenstein, Oman, the Philippines, Qatar, Saudi Arabia, Thailand, the Vatican, and Vietnam added to the list of countries whose citizens can travel to Kazakhstan without a visa.[9] Some of these countries, particularly Southeast Asian countries, have a growing appetite for outbound tourism travel. The policy can substantially increase foreign business and tourism travel to Kazakhstan and strengthen economic links between Kazakhstan and the Middle East and Southeast Asia. In November 2019, the government also complemented this policy by announcing the adoption of an Open Sky policy to allow foreign air carriers to fly to 11 airports in Kazakhstan and continue connection to cities in other countries over the next three years. This initiative is expected to attract traffic, increase competition in the aviation industry, and significantly improve the accessibility of Kazakhstan to international travelers.

[9] These new countries add to the existing list of members of European Union and other 45 countries.

Special Topics

Diversification and survival rates of Kazakhstan exports*

Trade can play an important role in Kazakhstan's development prospects through enlarging access to markets, increasing access to FDI and technology, and increasing competition. Recently, Kazakhstan achieved modest progress in diversifying exports, but export quality is still relatively low, and Kazakhstan participation in the global value chain is still limited. In addition, beyond markets in the Eurasian Economic Union, Kazakhstan exports are facing low survival rates.

Kazakhstan has a relatively small domestic market and the economy has significant exposure to hydrocarbon. To sustain growth and achieve high-income status, it cannot rely only on domestic demand. Instead, it needs to integrate with growth in other economies through cross-border investment and trade. In addition, the high exposure to hydrocarbon has caused growth to remain vulnerable to shocks in international commodity prices. In the past, rising oil prices have led to a rapid increase in growth, substantial real wage increases, and a sharp decline in poverty. Since the decline in global commodity prices, however, economic growth has slowed, from 10.2 percent on average during 2000–07 to 4.1 percent during 2008–17, and productivity increases have been nearly nil.

Growing opportunities in regional trade can support growth and productivity increases. Against the deceleration in growth of global trade during 2014–17, two-way trade within

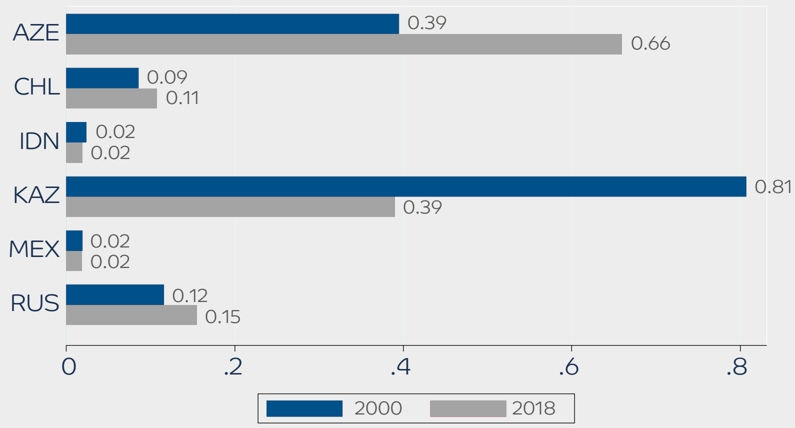
* This section draws heavily from a background note developed by Guillermo Carlos Arenas.

Russia and the Central Asia region increased by an average of 6.5 percent, and two-way trade in non-oil products between Russia and Central and East Asia increased by an average of 2.6 percent. Those expansions provide Kazakhstan the opportunity to tap into growing middle-class consumption and demand for intermediate goods from industries in those countries. Access to imported goods can also improve access to better technology and competition in the market, which are important for productivity growth.

The concentration of Kazakhstan's export basket has decreased along both the product and market dimension. Figure 14 shows that although the concentration index has decreased over the years, especially after the decline in international prices in 2013, Kazakhstan's exports are still highly concentrated in terms of products that are mostly raw and unprocessed commodities. The decrease in concentration appears to be a trend unique among all benchmark countries, as most (except for Indonesia) increased their product concentration over this period. The World Trade Organization's most-favored nation treatment of Kazakhstan's exports allows access to more markets. This has allowed Kazakhstan exports to make progress in diversifying across markets (Figure 15).

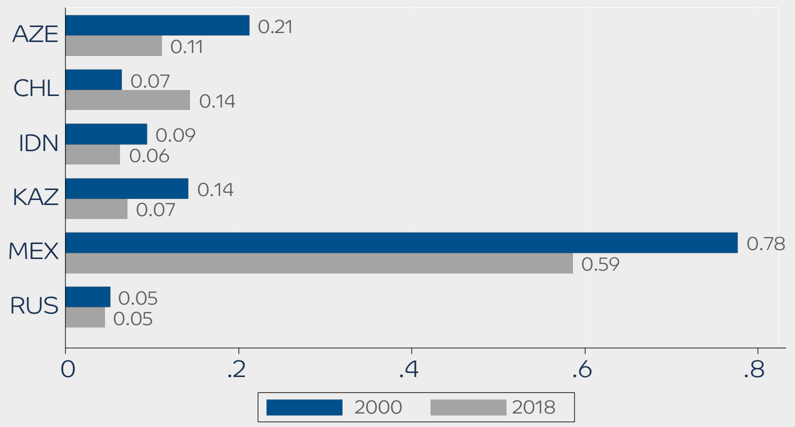
Diversification along commodity exports has played an important role in Kazakhstan's export growth performance over the last two decades. Figure 16 shows that during 2000–18, 66 percent of total export growth of Kazakhstan was explained by ability to sustain market presence (selling the same commodities to the same destinations), and 34 percent was explained by product expansion in the existing markets (sales of new products to old markets) (Figure 16). More significantly, less than 1 percent of growth resulted from selling (either old or new products) to new markets.

Figure 14. HHI on export product concentration



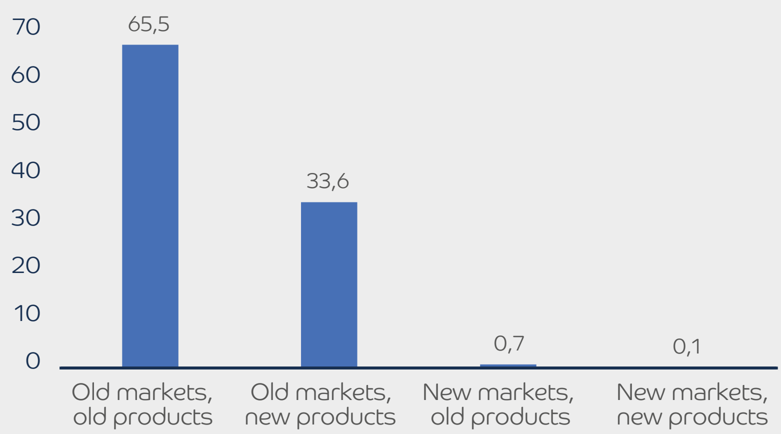
Sources: World Bank staff calculations based on UN-COMTRADE data.
Note: HHI = Herfindahl–Hirschman Index. AZE = Azerbaijan; CHL = Chile; IDN = Indonesia; KAZ = Kazakhstan; MEX = Mexico; RUS: Russia.

Figure 15. HHI on export market concentration



Sources: World Bank staff calculations based on UN-COMTRADE data.
Note: HHI: Herfindahl–Hirschman Index. AZE = Azerbaijan; CHL = Chile; IDN = Indonesia; KAZ = Kazakhstan; MEX = Mexico; RUS: Russia.

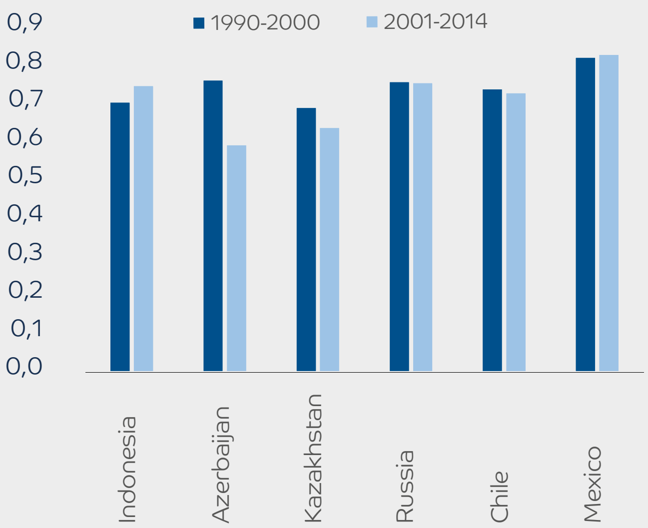
Figure 16. Export growth decomposition, 2000–18 (percent)



Sources: World Bank staff calculations based on UN-COMTRADE data

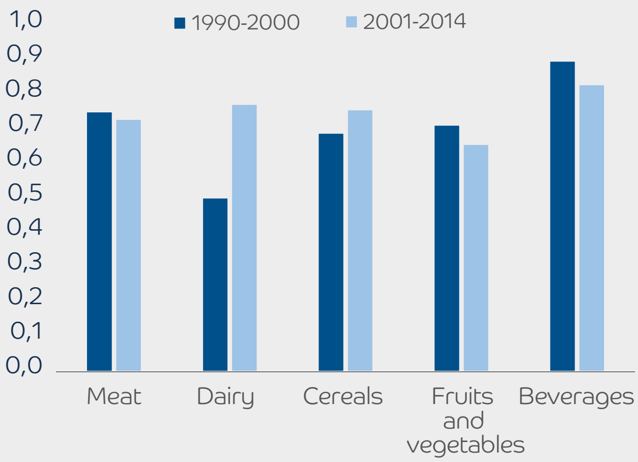
But despite the modest improvement in diversification, most of Kazakhstan's non-oil exports did not show a marked quality upgrade, except some agricultural and food products. During 1990–2000, Kazakhstan's unit value of exports was close to that of other commodity exporters such as Chile and Indonesia. A decade later, however, unit values of Kazakhstan have steadily declined and are of low quality compared to peers (Figure 17). Nevertheless, the quality of Kazakhstan's exports of dairy products is showing significant improvement (Figure 18), which suggests the possibility of improving product quality and the potential for these types of exports to play a larger role in export diversification.

Figure 17. Export quality: median distance to the world quality frontier



Sources: IMF Quality Index; World Bank staff calculations

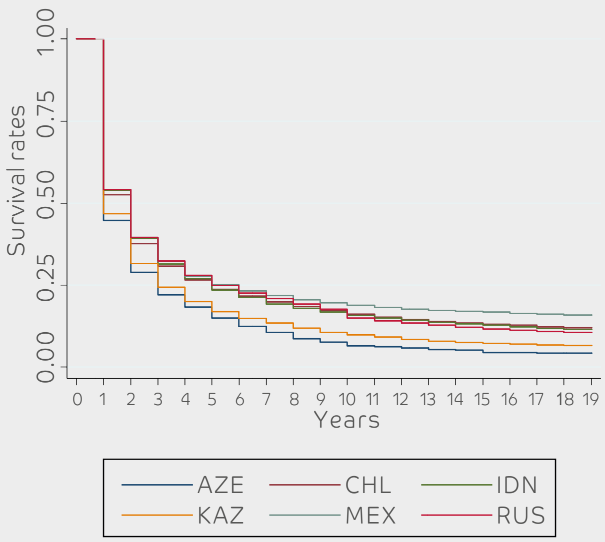
Figure 18. Kazakhstan's export quality by sector: median distance to the world quality frontier



Sources: IMF Quality Index; World Bank staff calculations

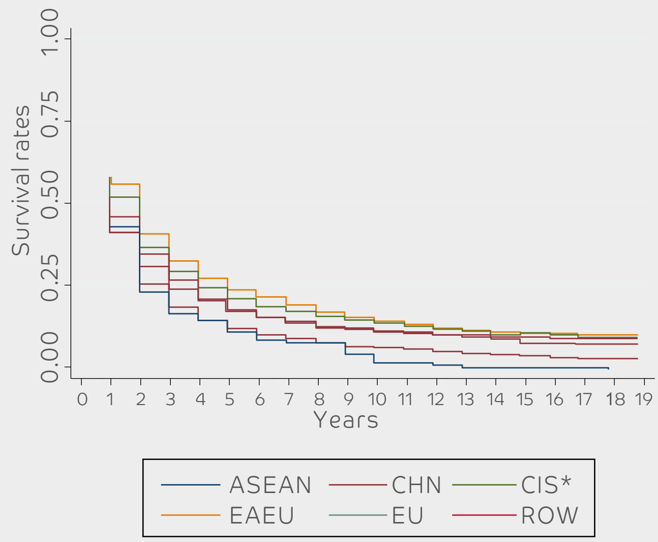
Kazakhstan's exports have less than a 50 percent chance of surviving after the first year. The probability of maintaining that relationship for more than three years is less than 25 percent. Furthermore, 90 percent of Kazakhstan's export flows disappear by their 10th year. In comparison, the export survival rate of most comparators is higher throughout the period of observation. The probability of an export relationship with Chile, Indonesia, Mexico, or Russia surviving after the first year is 54 percent, after which it drops to 32 percent past the third year (which is 7 and 8 percentage points higher than in Kazakhstan, respectively). The survival rate beyond the 10th year is 16 percent for Chile, Indonesia, and Russia, and 19 percent for Mexico. Kazakhstan's nontraditional manufacturing exports, such as machinery and transport equipment, have the lowest survival rates among main export products (Figure 19). Beyond markets in the Eurasian Economic Union (EEAU) or Commonwealth of Independent States (CIS), Kazakhstan's exports to other "nontraditional" markets have lower survival rates. The probability that an export relationship will survive if it is established with members of the EEAU or CIS is significantly higher (Figure 20), but the probability that exporting ties with other EEAU or CIS countries last beyond a year is significantly lower. After the first year, the survival rate for exports to China is 50 percent, the EU 46 percent, and Association of Southeast Asian Nation (ASEAN) countries 43 percent.

Figure 19. Export survival, Kazakhstan and comparators, 2000–18



Sources: World Bank staff calculations based on UN-COMTRADE data.
Note: AZE = Azerbaijan; CHL = Chile; IDN = Indonesia; KAZ = Kazakhstan; MEX = Mexico; RUS: Russia.

Figure 20. Kazakhstan export survival, by destination, 2000–18



Sources: World Bank staff calculations based on UN-COMTRADE data.
Note: ASEAN = Association of Southeast Asian Nations; CHN = China; CIS = Commonwealth of Independent States; EAEU = Eurasian Economic Union; EU = European Union; ROW = rest of the world.

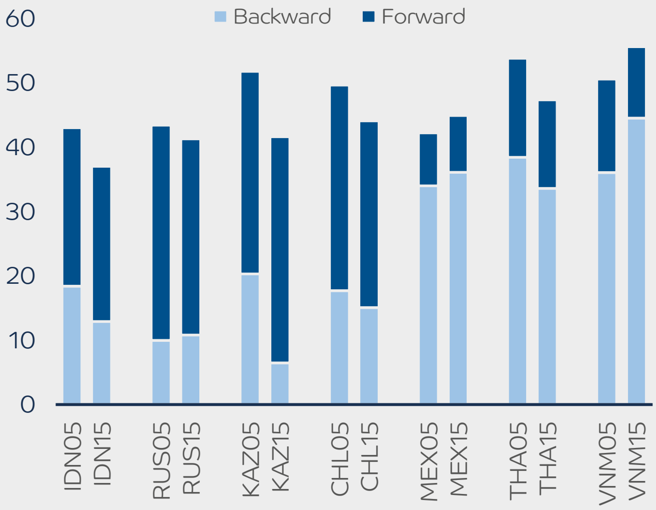
Increasing integration in global value chains (GVCs) is crucial for Kazakhstan's effort to diversify exports. For a commodity exporter, participation in GVCs presents an opportunity for growth in non-commodity exports. Kazakhstan could start diversifying its export basket and find nontraditional sources of export growth by participating in a new GVCs, or "deepening" the existing participation in GVCs. By integrating into GVCs, Kazakhstan firms will gain exposure and access to international technologies and knowledge and will be forced to meet international standards, all of which can be sources of productivity growth.

Kazakhstan's overall participation in GVCs is relatively low compared to peer countries. Kazakhstan is substantially forward integrated in GVCs because its raw materials are used as inputs in other countries' exports. Such integration is not a measure of sophistication, but rather of Kazakhstan's ability to integrate into the global economy based on its dominant asset, which is natural resources (Figure 21). By contrast, Kazakhstan has weak backward integration into GVCs because of the low use of foreign value added in its exports. Moreover, the share of foreign value added in Kazakhstan's exports has dropped almost three times since 2000 and is well below that of resource-rich comparators such as Indonesia and Russia, and less than a fifth of the levels in countries highly integrated into GVCs, like Mexico, Thailand, or Vietnam.

Kazakhstan's exporters are using fewer imported inputs than a decade ago even though their use is necessary for participation in GVCs. The share of exports that is accounted for by imported value added, a key measure of GVC integration, dropped from 20.3 percent to 6.5 percent in Kazakhstan between 2005 and 2015 (Figure 22). Although the decline in GVC integration has also been seen at the global level in recent years, the decrease in use of foreign inputs is spread among almost all industries in Kazakhstan and may reflect a higher relative trade cost (transport, logistics, tariff structure, and non-tariff measures) of Kazakhstan.

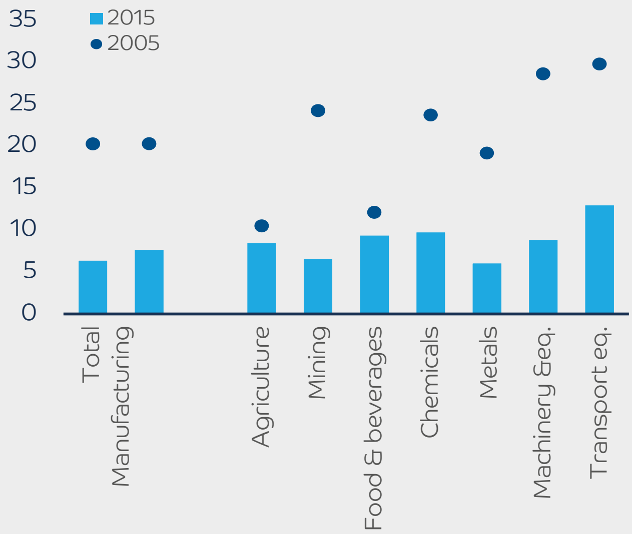
Domestic production also became less reliant on foreign demand (from 40.6 percent to 25.3 percent) and more reliant on domestic demand over the last decade. While this significant increase in the importance of the domestic market reflects the growing size of the internal market, it is also consistent with a general loss of export competitiveness that might have that pushed domestic firms to forego export markets as a growth diversification strategy.

Figure 21. GVC Participation Index in 2005 and 2015



Sources: World Bank staff calculations based on OECD TiVa data. Note: CHL = Chile; IDN = Indonesia; KAZ = Kazakhstan; MEX = Mexico; RUS: Russia; THA = Thailand; VNM = Vietnam.

Figure 22. Foreign value-added content of exports in 2005 and 2015



Sources: World Bank staff calculations based on OECD TiVa data.

The recent announcement of a Roadmap to Promote Non-Resources Exports is also timely. The Ministry of Trade and Integration suggests that the Roadmap contains 81 measures, which include policies to reduce costs to comply with documentary requirements, improve brand awareness, and realign various government supports to promote Kazakhstan exports. The Roadmap also contains a plan to develop financial instruments to support exporters. One of the measures is to create QazTrade, or "one-stop shop" services for exporters. QazTrade will be set up in selected Kazakhstan trade missions abroad to promote Kazakhstan products and mediate issues between exporters and relevant government agencies. Experience also suggests that export promotion agencies can reduce information and research costs for traders and help them comply with market regulations.[10] Nevertheless, effective delivery and monitoring are needed for the Roadmap to have an impact on exports.

Further reforms are needed for Kazakhstan to continue diversifying exports. Kazakhstan can focus on unilaterally streamlining procedures in trade facilitation within the EAEU and improving connectivity in transport and logistics. For instance, streamlining the business processes of key agencies such as Customs and Quarantine can be a first step in developing a single window for processing trade clearances. Policies to attract and retain FDI beyond in natural resources, such as in agriculture and livestock, can also help Kazakhstan diversify exports by increasing participation in GVCs. In addition, Kazakhstan needs to continue developing the absorptive capacity of local firms to link with foreign manufacturers and comply with standards in the foreign markets.

[10] Lederman, Olarreaga, and Payton 2010.

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FOR NOTES

Kazakhstan Economic Update – December 2019

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