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A SLOW RECOVERY THROUGH THE COVID-19 CRISIS

Kazakhstan Economic Update - December 2020

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Contents

Foreword

The Kazakhstan Economic Update (KEU) 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 (NBK), and additional information collected as part of the World Bank Group's regular economic monitoring.

The team is grateful to the Ministry of the National Economy and the National Bank of Kazakhstan for their support and feedback.

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Photo credit: Turar Kazangapov

I. Overview

2020 is the most challenging year for Kazakhstan's economy in the last two decades. The fallout of the COVID-19 pandemic has hit the economy more than the crises in 2008 and 2015. The spread of the COVID-19 pandemic halted global activity in the second quarter of 2020, and depressed global demand and price of oil, which is Kazakhstan's main export commodity. In April 2020, the average oil price dropped to $21 barrel, the lowest in the last two decades. The pandemic also depressed domestic economic activities, with GDP contracting by 2.8 percent over January-September 2020, compared to a 4.1 percent increase in the same period last year. The size of this economic contraction is significant because despite an economic uptick in the third and fourth quarters (Q3, Q4), the economy is still projected to shrink by 2.5 percent this year.

The economy is expected to grow modestly in 2021 and higher in 2022, but significant downside risks remain. The economy is expected to grow by 2.5 percent next year, based on an improved global economic outlook, higher demand for exports, resumption of domestic economic activities, and higher disposable income. Successful implementation of COVID-19 vaccines will further boost market sentiment and economic activities next year and support higher growth in 2022. Nevertheless, there are significant risks because of uneven economic recovery across countries due to the protracted pandemic and higher debt-related risks to the global financial market. Although the global oil price has regained some ground, the ample global oil reserves and OPEC+ commitment to limit production can limit Kazakhstan's oil export revenues. The domestic financial sector is also exposed to a higher risk of growing non-performing loans if support measures are withdrawn.

The fallout of COVID-19 has caused significant human suffering in Kazakhstan. This report estimates Kazakhstan's poverty rate will increase to 12-14 percent in 2020 from a baseline of 6 percent in 2016. The pandemic has hit severely retail, hospitality, wholesale, and transport sectors, which account for around 30 percent of employment, and are mostly concentrated in cities. However, the most significant increase in the number of the poor is expected to come from rural areas, which can increase inequality in Kazakhstan. More importantly, COVID-19 also has caused invaluable losses of human lives. Official figures show that in early December 2020, COVID-19 caused around 2,626 deaths, which is 1.4 percent of confirmed cases. Given the country's population size, these deaths, directly or indirectly related to COVID-19, constitute a tragedy that almost every person in Kazakhstan can relate to.

The Kazakhstan authorities have implemented strong policy measures to minimize the pandemic's impact on people and the economy. Access to emergency medical services was improved, including to uninsured people. The authorities introduced a substantive amount of direct support to firms through tax deferrals and subsidized loans, and financial support to poor households and affected individuals. The authorities introduced subsidized loans for working capital to minimize default in payments on salaries and suppliers by SMEs. Less than one month after declaring a nationwide emergency in mid-March, the

government deployed a cash-support program through on-line transfers to around 4.6 million recipients (24 percent of the population).

The authorities have also stepped up their efforts to renew reform momentum. In his Annual Address in September, the President stressed the need for policy changes to confront "a new reality" and has taken steps to initiate reforms. The establishment of a new Agency of Strategic Planning and Reforms, which also has the authority to collect statistics, has renewed the sense of reform, which slowed down because of the COVID-19 pandemic. This new Agency will identify and monitor the implementation of reforms. Further, the President transferred the authority to oversee competition policy to the newly established Agency for Development and Protection of Competition to reduce monopoly practices and unfair competition across economic activities.

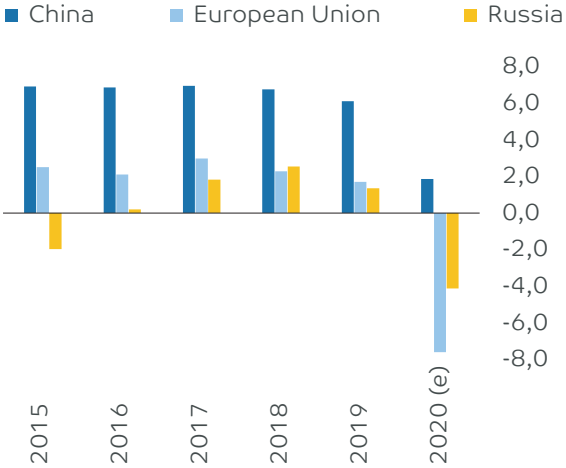
But Kazakhstan needs more reforms to increase productivity growth and sustain economic recovery. Kazakhstan's average GDP growth has declined after each economic crisis, weighed down by the lackluster growth in productivity and over-dependency on hydrocarbons. There are also emerging challenges, such as weaker global demand for fossil fuels, a higher regional competition to attract investments, higher risks of instability in the financial sector, and more need for accountable and transparent governance. It will be important for the authorities to show a commitment to continue addressing the long-standing problems that diminished productivity growth and establish a solid foundation for economic recovery.

II. The COVID-19 Pandemic: A Challenging External Environment

The COVID-19 pandemic plunged the global economy into the deepest slump since World War-II. Despite the massive stimulus, the resurgences of pandemic waves are undermining the firmness of global economic recovery. Global oil price weakened significantly, and, despite recent gain, will continue to fluctuate until vaccines can effectively suppress pandemic.

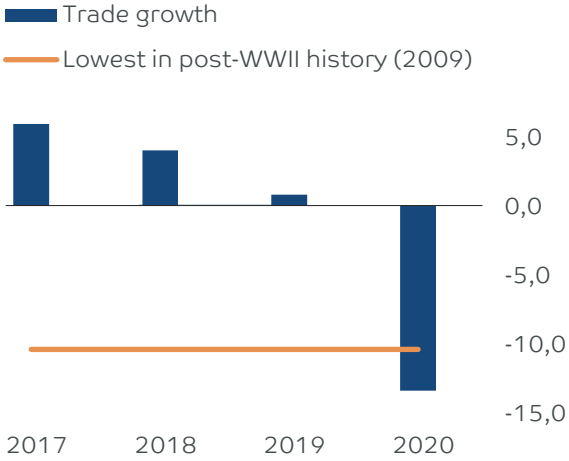
The COVID-19 related broad-based global recession continues even as governments put in place massive policy measures to support their economies. COVID-19 has been an unprecedented shock to the global economy, causing a steep fall in global economic activity, almost three times as deep as the 2009 global recession[1] (Figure 1). Pandemic-related restrictions inhibited investment and deeply disrupted labor markets, affecting the livelihoods of millions of workers across the globe. Despite massive fiscal support measures to mitigate the economic fallout from COVID-19, the growth rates in many advanced and developing market economies have shrunk. Because of disruptions to travel and value chains brought by control measures, global trade is expected to shrink by more than during the 2008-09 global financial crisis (Figure 2). Disruptions associated with the pandemic will push many million people back into poverty, reversing earlier periods' economic gains.

Figure 1. Growth in key foreign markets (year-on-year, percent)



Source: IMF.

Figure 2. Global trade is set to record a dramatic fall (year-on-year, percent)

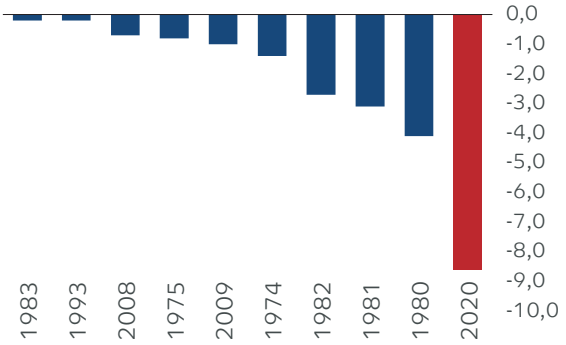


Source: WBG, Global Economic Prospects.

[1] World Bank ECA Economic Update Fall 2020.

The COVID-19 pandemic has dealt a blow to demand in Kazakhstan's main trading partner economies. The COVID-19 pandemic has hit hard Kazakhstan's main trade counterparts with a sharp decline in demand, interrupting commodity markets and supply chains. After plunging in the second quarter by 11.8 percent, GDP in the euro area has shown firming activity with 12.6 percent growth in the third quarter, because many member countries relaxed pandemic-linked restrictions. But, the recent rise in cases and re-introduction of the tough lockdowns has slowed the recovery pace. Strong policy support and an acceleration in infrastructure investments pushed up industrial production in China, and activity normalized faster than expected. GDP in China grew by 3.2 percent in the second quarter of 2020, with a much stronger path for recovery in the following quarters than for other export destinations. Russia's GDP contracted by 8 percent in the second quarter of 2020 against a backdrop of already weak external context and restrictions that hindered domestic activity. While growth in Russia began to gradually rebound recently, thanks to accommodative monetary policy and relaxation of fiscal rules, it is expected to be slow due to depressed oil prices and compliance with OPEC+ oil production cuts.

Figure 3. 2020 marks a year with the largest decline in global oil demand (percent)

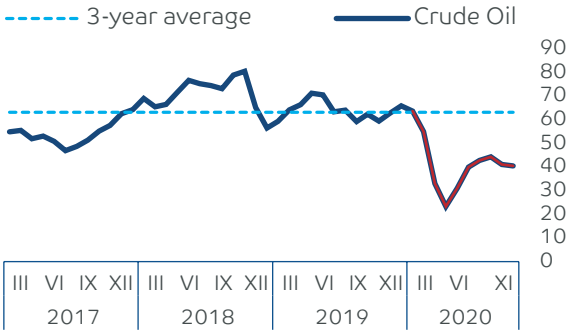


Source: International Energy Agency.

The global oil market was hurt by a combination of weaker demand, triggered by the pandemic, and rising oil supply. Restrictions and lockdown across the globe to curb the spread of the virus have led to a sharp fall in travel and transport, which account for two-thirds of oil consumption. Oil prices plunged in March 2020 to a 17-year low of roughly $25 per barrel. To rebalance the market in response to a demand collapse, the OPEC+ partner countries, which together produce more than half the global crude, agreed to cut production. Global consumption also picked up from its lows in 2020Q2.

Following a precipitous fall in March-April in the wake of COVID-19, oil prices have bounced back and regained earlier losses. The recent positive news about vaccine development and hopes that demand will pick-up in travel and energy-intensive industries have helped to prop up oil prices. However, a second wave of the virus and lockdowns in the Eurozone area countries, the primary export market for Kazakhstan, still poses a threat to a speedy recovery in demand in the short run. Oil demand is expected to drop by an unprecedented 8.6 percent in 2020 – the largest decline on record (Figures 3,4).

Figure 4. Price for oil plunged before regaining some ground ($US per barrel)



Source: IMF.

Prices of non-energy commodities have mostly returned to pre-pandemic level, with prices of agriculture products rising to the highest level since 2018. The global prices of metals and minerals increased by 12 percent and 18 percent in September and October, respectively, as demand from China gradually resumed amidst market disruption from COVID-19. However, the global prices of agricultural products have risen at an increasing rate since August, with an increase of 7.5 percent in August, 10.8 percent in September, and 11.2 percent in November.[2] The monthly index of agriculture price reached 94.9 in November 2020, compared to 91.8, the highest for 2018. Unfavorable weather conditions have tightened supplies of cereals and grains, and increased purchases for stocking-up commodities are driving up prices.[3]

Despite an improvement in the global financing conditions, emerging markets and developing economies (EMDEs) continue to face challenges. Global equity prices picked up strongly in September after positive results from preliminary vaccine trials in several countries. However, the risk appetite for EMDEs' debt and equities remain fragile. Portfolio flows to EMDEs decelerated in September after improvement throughout the third quarter. Foreign direct investment flows to EMDEs are projected to decline by nearly 32 percent in 2020 amid delayed investment and lower corporate profits, which likely reduced reinvested earnings.[4]

[2] World Bank, "Pink Sheet", December 2020.
[3] FAO News, September 3rd 2020.
[4] World Bank. 2020. Migration and Development Brief 33, October 2020. Washington, DC: World Bank.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III. Recession and Rising Inflation in Kazakhstan

The year 2020 had the worst recession in Kazakhstan for the last two decades. Domestic demand fell sharply because of job losses and lower disposable income. But unlike in the previous crises, services were hit hard from movement restrictions and lower activities in the mining sector. The increase in food prices has pushed up inflation above the target range of the National Bank of Kazakhstan (NBK).

The coronavirus pandemic and a slump in oil price have been a double hit to the Kazakh economy, leading to a contraction of economic activity for the first time in nearly two decades. In January-September 2020, real GDP fell by 2.8 percent y-o-y, following a 1.8 percent contraction in January-June 2020, reflecting the severity of the second lockdown measures in July-August. Even though economic activity bounced back slightly over the following months, the decline in growth is the steepest in nearly two decades, with a broad-based contraction across most demand components (Figure 5).

A sharp drop in domestic demand played a key role in contracting the economy. Consumer demand has fallen significantly as retail trade declined by almost 40 percent in April-June of the year as a nationwide state emergency over COVID-19 reduced spending. Although retail trade shows a sharp rebound in August-September, it remains well below the pre-pandemic level. While social transfers helped low-income families and recipients, a fall in employment and incomes has depressed consumption. Business investment reportedly dropped by almost 5.0 percent in January-September, largely because of a sharp decline in foreign direct investment (FDI) in the oil and gas industry in an environment of extreme uncertainty.

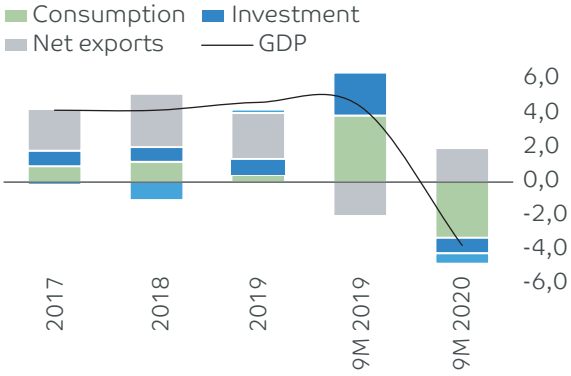
Unlike past recessions, such as in 2008-09 and 2015-16, activity in the services sector has been hit the hardest. Restrictions in movement and the nature of social distancing measures have strong negative impact on the services sector, which is based on personal interaction. The economic contraction has been concentrated on the sectors most affected by the lockdown – hospitality, retail, travel, and leisure, representing more than half of the GDP (Figure 6).

Output picked up in the third quarter as authorities started to relax movement restrictions. Short-term economic indicators, which include agriculture, industry, construction, trade, and transport, grew by 5.3 percent in Q3 (y-o-y). The increase in short-term indicators was also supported by expansion in purchases by firms in non-oil manufacturing and services during September, as shown by the headline Purchasing Managers Index (PMI) value of 52.8.[5] However, the volume of cargo transport throughout Q2 and Q3 has not recovered to pre-pandemic levels, suggesting that the increase in short-term indicators and purchases is mostly replenishment of inventories.

[5] HIS Market Purchasing Managers Survey. Number between 50 to 100 indicates expansion, numbers below 50 indicates contraction.

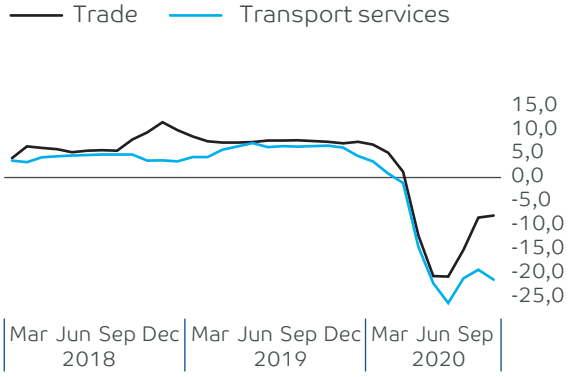
Inflation has increased during the coronavirus lockdown, primarily driven by a rise in food prices. Annual inflation rose to 7.0 percent in September from 5.4 percent in December 2019, jumping well above the NBK's 4–6 percent target range. Food prices grew by 10.8 percent in August 2020 year-on-year, up from 9.1 percent in September last year (Figure 7). Hoarding, driven by a fear of supply disruptions associated with restrictions on movement, likely caused higher demand and boosted food prices. Non-food items show a steady increase of 5.5 percent and services grew by 3.6 percent, respectively, in September, suggesting that some firms might be passing increased costs through to customers even though consumer demand has been weak, and most of the services were unavailable during the lockdown. Higher import prices, reflecting exchange rate movements, remain an important source of pressure on essential consumer goods, having increased by 4.1 percent in September (Figure 8).

Figure 5. Broad-based deceleration within demand components (contribution, percent)



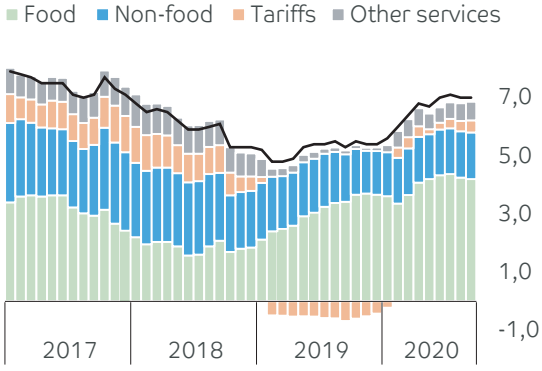
Source: World Bank staff calculations based on Committee on Statistics data.

Figure 6. Services sectors slowed the most (year-on-year, percent)



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

Figure 7. Inflation has picked up following the lockdown (percentage point, percent)



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

Figure 8. Import prices moved up but had a limited effect on inflation (percent)

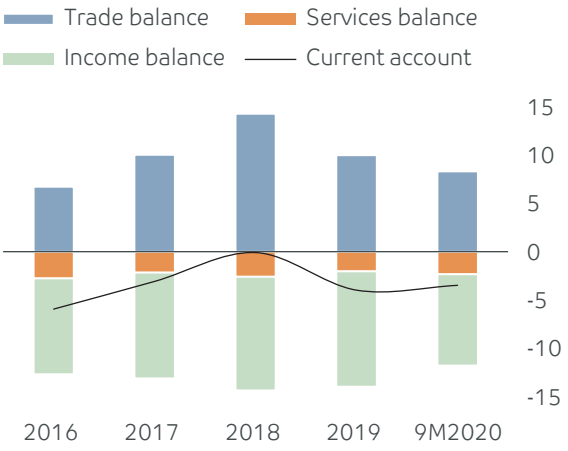
Source: World Bank staff calculations based on Committee on Statistics data.

IV. Balance of Payments

Weak external demand depressed exports, which led to a reduction in the trade balance this year. The financial account recorded net positive inflows, supported by net direct investment, and net sales of foreign assets by the central bank, SOEs, and the government.

The deficit in the current account is lower than last year's, but this masks the sharp deterioration in exports since the outbreak of the pandemic. Kazakhstan's deficit in the current account was -3.5 percent of GDP in January to September, compared to -3.9 percent last year. Imports weakened this year, down to $26 billion in the first nine months compared to $29 billion during the same period last year. But goods exports dropped to $35 billion in the first nine months this year, compared to $43 billion in the same period last year. A sharp decline in the import of services, mostly travel and transportation, reduced the service sector's deficit this year. The deficit of primary income fell substantially this year, due, in part, to lower repatriation of earnings from FDI in the mining industry.

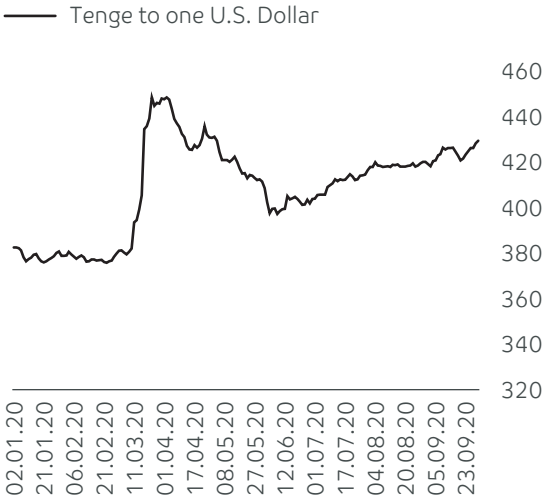
Figure 9. Lower deficit in income balance helped reduced deficit in the current account (percent of GDP)



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

Kazakhstan's exports declined due to a lower oil price and output, but the export of certain products inched up. Monthly export figures fell after February and reach the lowest level of $2,8 billion in July, which is the lowest monthly export value since September 2016. The export value of crude oil and gas condensate declined by 31 percent in Q2, and 57 percent in Q3. However, exports picked up in August and September, supported by exports of agriculture, ferro-alloys, and iron ore.

Figure 10. The tenge slid against USD in Q3 (tenge to US dollar)



Source: The National Bank of Kazakhstan.

A net inflow of direct investment and portfolio investment created a surplus in the financial account. Preliminary figures suggest nine-month net FDI inflow remained positive at $4.5 billion, thanks to net in-

flows to Kazakhstan's petroleum sector. In Q2-2020, the petroleum sector contributed about 60 percent of the net inflow of direct investment, while wholesale-retail and financial services accounted for the remaining of the inflow of direct investment. The financial account recorded also recorded $8.3 billion net inflow of portfolio assets as government and SOEs continued to sell their holdings of foreign assets.

The gross international reserves of the central bank have increased this year. NBK's gross international reserves reached $33.6 billion by the end of September, compared to $29 billion at the same time last year (Figure 9).[6] In parallel, the tenge declined against USD throughout Q3, and fell to an average value of 429 tenge/USD in October, compared to an average value of 402 tenge/USD in May (Figure 10).

[6] NBK's gold reserve increased significantly to $23 billion in September from $18 billion in the previous year.

V. Monetary Policy and the Financial Sector

An inflation, rising above its target range, pose an additional challenge to NBK to contain price pressure and reduce it to a pre-crisis target range. The authorities increased support to SMEs through subsidized loans for working capital. While the support is needed to avoid short-run payment defaults or insolvencies, it adds to the credit market's distortion. NPLs are also rising during this crisis, which is deteriorating the banking sector's asset quality.

The weak external demand, drop in oil price, and subsequent exchange rate depreciation led to higher inflation. In response to an accelerated inflation, jumping over its 4-6 target, in mid-July the NBK stated that it will deploy the full range of tools at disposal to lessen an inflationary pressure and contain it within 8-8.5 percent (Figure 11)[7]. The sudden rise in inflation reflects the continued challenge faced by NBK in managing inflation expectations, especially during crisis times. Accommodative fiscal stance, more subsidized lending, depreciating local currency, and businesses and consumer responses to supply disruptions have complicated the management of inflation expectations. However, the central bank is developing a new monetary policy strategy to improve the effectiveness of monetary policy.

Lower exports and oil price pushed the value of tenge to its lowest level ever, making the NBK intervene forcefully in the foreign exchange (FX) market to stabilize the exchange rate. The tenge has been under sustained pressure since the early stages of the lockdown. The tenge depreciated by about 18 percent against the US dollar in March due to collapsing oil prices and shattered the confidence in the economy. However, subsequent oil price recovery helped the tenge regain some of its earlier losses. In the first nine months of the year, the National Bank spent US$1.8 billion of its FX reserves—more than in the past three years combined—to stabilize the tenge. Transfers from the National Fund to the government budget have also supported the exchange rate because US dollars are converted to the tenge during the transfer.

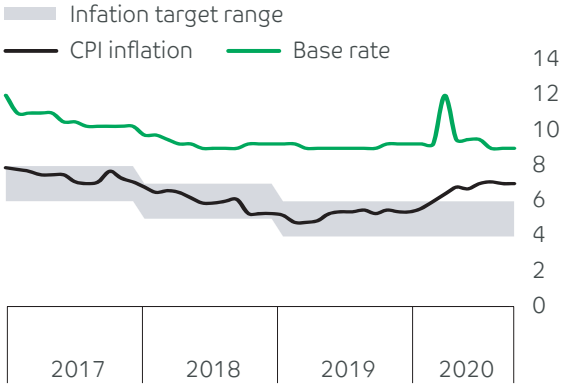
The NBK and government adopted anti-crisis measures, scaling up subsidized credit that may have provided relief but also hurt the effectiveness of credit markets and monetary policy. In 2020, the coronavirus pandemic forced the central bank to act decisively and stimulate the economy. The NBK launched a subsidized lending program for SME working capital with a budget of 800 billion tenge, channeled through banks, with an interest rate of 8 percent. This relief facility helped SMEs that faced a cash crunch. However, it also added to the planned subsidized lending of one trillion tenge for the Economy of Simple Things. The widespread subsidized loans displace regular bank lending that requires a thorough assessment of project creditworthiness and bankability. The subsidized loans can uphold businesses that otherwise would have become non-viable and give firms that depend on public sup-

[7] https://primeminister.kz/en/news/nacbank-budet-ispolzovat-vse-imeyushchiesya-instrumenty-dlya-uderzhaniya-inflyacii-v-predelah-koridora-8-85-v-2020-godu-1462944

port a new lease on life. From the monetary policy standpoint, the active involvement of the NBK in direct lending under various government programs can hamper the effectiveness of its interest rate policy tool by distorting the interest rate pass-through and weaken monetary policy credibility. Therefore, NBK involvement in the government support program should be temporary.

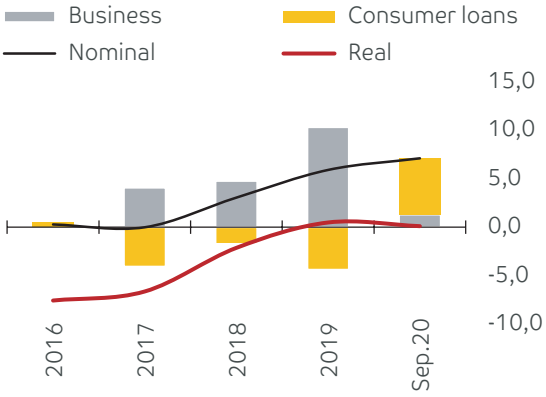
The banking sector remained profitable through the coronavirus crisis, but the quality of assets began to deteriorate. The banking system weathered the crisis relatively well, supported by large scale regulatory forbearance measures and credit targeting policies. Despite the reduced economic activity, banks have managed to remain profitable in 2020 due, in part, to continued lending on the back of consumer loans and various government support programs to businesses. Bank profitability, measured by return to total assets, increased to 3.4 percent in August, compared to 2.4 percent a year earlier.[8] The overall credit provided by banks increased, supported by consumer loans. However, corporate lending remains subdued in real terms (Figure 12). The ratio of non-performing loans (NPLs) to total loans has increased to 8.7 percent by September 2020, compared to 8.1 percent at the beginning of 2020. This change indicates an increasing incidence of upcoming defaults on loans because economic activity remains weak. What is even more worrying is that the bank reserves for bad loans have not increased, and, as a result, the bank capital buffers may weaken. For some banks, the deteriorating asset quality comes on top of considerable amounts of legacy problem assets.

Figure 11. The inflation target rate has been adjusted to accommodate COVID-19 shocks
(year-on-year, percent)



Source: World Bank staff calculations based on NBK data.

Figure 12. Lending increased mostly due to consumer borrowing
(year-on-year, percent)



Source: World Bank staff calculations based on NBK data.

[8] Agency for Regulation and Development of the Financial Market. Current State of the Banking Sector of Kazakhstan. November 2020

Regulatory forbearance measures and repayment holidays coupled with subsidized lending programs to SMEs could mask potential stress on banks' loan portfolios. Temporary regulatory forbearance allows banks to freeze loan classification for restructured loans. Should these support measures be withdrawn, the actual size of distressed assets could be substantially higher than the officially reported levels. An increasing likelihood of bankruptcies, notably among micro and small businesses, could worsen the banks' loan portfolio quality, and require banks to build higher reserves to cover future losses, or the bank owners to inject new capital. The true extent of mounting problem loans on bank balance sheets is likely to be revealed next year, when the regulatory forbearance measures are expected to be lifted.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VI. Fiscal Policy

Fiscal policy is playing an important role in minimizing the socio-economic impact of the COVID-19 pandemic. The government introduced a sizeable package to minimize human suffering and support SMEs from collapsing. The depth of the crisis is likely to require the government to continue with an accommodative fiscal policy to support economic recovery.

The authorities introduced a sizeable stimulus package to manage the fall-out of COVID-19. The stimulus package, worth $10 billion, or 5.7 percent of GDP, includes tax deferrals for SMEs, and additional spending on health, cash transfers to households, and subsidized loans to enterprises.

The contraction in economic activities has depressed tax revenue and made the government's budget rely more on oil revenues. Falling exports and price for oil and economic recession brought by the pandemic this year caused a decrease in corporate income taxes, VAT, and customs duty on oil exports. According to officials, the tax revenue shortfall attributed solely to the pandemic is estimated at US$2.6 billion in January-September, or 2.4 percent of GDP. To support the fiscal measures, the government tapped into the National Oil Fund (NFRK), taking out additional transfers on top of the planned amount, leaving the budget highly exposed to oil revenues in 2020. Transfers from the National Oil Fund, amounting to 7.1 percent of GDP in 2020, are part of budget revenues. Without such transfers, the budget deficit would have been much higher. The government (state and local) budget spending increased by an estimated 4.6 percent of GDP to 25.9 percent in January-September (Table 1). The total deficit rose to 4.2 percent of GDP from 1.5 percent a year earlier, whereas the non-oil deficit surged to 14.3 percent, reflecting the increasing reliance on oil revenues.

Kazakhstan has the fiscal space to support a counter-cyclical fiscal response. Kazakhstan still has considerable fiscal space, thanks to sizeable NFRK reserves of about 33 percent of GDP (Table 1). Nevertheless, the value of NFRK assets of NFRK has declined to $56 billion in October this year from $59 billion in the same period last year, due to higher transfers to the budget to support the fiscal measures. About 97 percent of the overall deficit for 2020 is expected to be financed by issuing government bonds in the domestic market (in tenge), and the rest will be from issuing international bonds in Russian rubles. As a result of government borrowing to address the crisis's effects, the debt-to-GDP ratio would increase by 6.0 percentage points to 26 percent of GDP in 2020. The debt-to-GDP remains sustainable even with this increase.

Kazakhstan is still managing the COVID-19 pandemic, which means that continuing fiscal support is likely to be needed to sustain economic recovery. Given the unprecedented scale of damage the COVID-19 brought up to the Kazakh economy, the authorities should not be constrained from implementing additional spending to tackle the economic fall-

out from the pandemic, even if it means higher budget deficits. The country has ample fiscal reserves and would face no difficulties in investing in infrastructure, education, and healthcare, as well as a green agenda put forward by the authorities. Maintaining sustained budget spending during the crisis would help the government to pull the economy out of the recession triggered by the pandemic, and ensure steady and resilient recovery from COVID-19.

Table 1. General government fiscal accounts, 2017–20
(Percent of GDP)

	2017	2018	2019	9M 2019	9M 2020
Revenues	21.3	17.5	18.5	20.9	22.9
Oil revenue	9.8	6.0	6.2	7.8	10.0
Non-oil revenue	11.5	11.5	12.3	13.2	12.9
Expenditures	23.0	18.4	19.6	21.3	25.9
Goods and services	7.2	5.2	5.7	6.0	6.7
Social transfers and wages	6.9	7.0	7.7	8.8	10.4
Capital spending and subsidies	4.0	3.4	3.6	3.5	4.8
Interest payments and other transfers	4.9	2.7	2.7	3.1w	4.0
Net lending and financial transactions	1.0	0.5	0.7	1.1	1.2
Overall balance	-2.7	-1.3	-1.9	-1.5	-4.2
Non-oil balance	-12.4	-7.3	-8.0	-9.2	-14.3
Financing of deficit/use of surplus	2.7	1.3	1.9	1.5	4.2
External borrowing (net)	-0.1	0.6	0.3	0.5	-0.2
Domestic borrowing (net)	2.8	0.8	1.6	0.9	4.4
Memorandum items:					
National Oil Fund FX reserves	35.0	32.3	34.0	34.1	33.4
National Bank FX reserves	18.6	17.2	15.2	16.6	19.7
Total government debt	19.6	19.9	21.2	21.6	24.0
External, including guarantees	9.2	10.1	10.4	10.2	10.4

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.

VII. Economic Outlook and Risks

We project the economy will grow moderately by 2.5 percent in 2021, supported by a rise in consumption spending and resumption of investment delayed by the COVID-19 induced restrictions. The pace of economic recovery remains dependent on the situation around the pandemic. A successful rollout of the COVID-19 vaccine can boost confidence and offer impetus to economic activity across the country. However, risks remain elevated because of uncertainty about external demand and prices for oil, exposure to insolvencies, and possible adverse effect on the balance sheet of a banking sector.

The economic fallout from COVID-19 poses significant challenges for the Kazakh economy. Although activity has normalized somewhat following a gradual reopening in early August, the recovery is still fragile as a second wave of the virus has accelerated. The economic activity has remained under pressure from the recent resurgence in the number of cases across the country, and the re-introduction of stricter lockdown measures. Business activity has been constrained by uncertainty over the course of the virus and economic slack, and there is limited appetite for risk-taking and expanding investments.. The declining activity in mining, and most notably in the service sectors that require face-to-face interactions, pose a threat for employment prospects and might take a heavy toll on many low-paid workers' living standards. The economy faces a contraction in 2020, and economic recovery hinges on progress to bring the pandemic under control.

The baseline forecast is that GDP growth will rebound to 2.5 percent in 2021, with a steady increase in the pace of growth in 2022. The baseline scenario assumes gradual relaxation of control measures associated with the virus, and COVID-19 vaccines become available, and inoculation be carried out in the country and across the globe. The growth projection for 2021 also assumes that growth rebounds in key export markets, global demand for oil recovers and prices for oil stabilize around $US 40 per barrel. Further, it is assumed that domestic fiscal policy will remain supportive.

Even with the projected GDP growth, the economy is expected to reach its pre-crisis level of activity only by 2022. On the back of uncertainty over global demand for oil and the OPEC+ group's decision, the baseline forecast is only a little increase in oil production and exports. Private consumption is projected to continue recovering in 2021-22, as rising social spending is likely to support disposable incomes, and demand and precautionary saving motives will wind down after the relaxation of the imposed limits on movement. However, slow growth and meager employment prospects can act as a drag on consumer spending. While investment decreased in 2020 in the face of the COVID-19 and plunging FDIs into the mining industry, the baseline forecast is for the investment to recover gradually in 2021-22 at a very limited pace as uncertainty diminishes (Table 2).

Table 2. Baseline scenario: selected macro-fiscal indicators, 2017–22
(Percent, unless otherwise indicated)

	2017	2018	2019	2020	2021	2022
				Projections		
Real GDP growth	**4.1**	**4.1**	**4.5**	**-2.5**	**2.5**	**3.5**
Oil sector	7.4	8.6	5.0	-8.5	2.1	1.2
Nonoil economy	3.2	3.0	4.4	-0.8	2.7	4.1
Consumer price inflation, end of period	7.4	6.2	5.3	6.2	6.6	5.9
(In percent of GDP, unless otherwise indicated)						
Current account balance	-3.1	-0.1	-4.0	-2.7	-2.5	-1.3
Foreign direct investment	2.3	2.6	3.0	2.2	2.6	5.1
Overall fiscal balance /1	-4.4	2.6	-0.5	-8.1	-6.2	-3.4
Nonoil fiscal balance	-12.6	-7.3	-8.0	-13.3	-11.5	-8.6
Stock of FX assets in the Oil Fund	35.0	32.3	34.0	37.0	34.0	32.3
Government debt	19.6	19.9	19.6	26.3	29.7	31.5

Source: World Bank staff calculations based on data published by authorities.
1/ The Consolidated Budget comprises the general government budget and the Oil Fund net consumption.

Inflation is expected to decrease to its target range in 2021, after a sharp upward movement in 2020 due to higher food prices and the pass-through from the currency's depreciation. In 2020, depreciation of the tenge and the pandemic supply disruptions caused inflation to move up above the central bank's target band. The baseline scenario assumes a gradual reduction in the inflation rate in 2021 as disruptions and stockpiling behavior during the lockdown diminish. Food process inflation, which accelerated in the wake of the pandemic, is projected to come down as most of the lockdown related travel restrictions and fear-driven hoarding by households ease. The planned decreases in VAT rates on shipment and postal services by authorities starting 2021 can imply a reduction in the cost of those services and can exert the downward pressures on service inflation. However, in general, a pick-up in demand boosted by the expansionary fiscal policy will imply an overall high inflation trajectory in coming periods. Also, inflation remains highly sensitive to changes in the tenge exchange rate. In an environment of lower prices and uncertain demand for oil, downward pressure on the tenge can push up inflation again, owing to a significant exchange rate pass-through.

After increasing substantially in 2020, the budget deficit is expected remain elevated in 2021 with fiscal policy as-

sumed to be supportive of the economic recovery. The crisis required forceful fiscal support, and the authorities stepped in to mitigate the economic fallout from COVID and provided the needed fiscal support to the economy. The COVID-19 crisis necessitated large and immediate public spending on protection and economic relief measures. Further commensurate support is needed to ensure a steady recovery from the crisis. With businesses struggling to cope with a drop in sales, non-oil revenue in 2021 is expected to remain weak. In this context, in 2021, the authorities plan to withdraw additional transfers of 1.0 trillion tenge from the National Oil Fund to cover budget spending. Both overall and the non-oil budget deficits are projected to remain elevated because of emergency measures and still weak macroeconomic conditions. The non-oil deficit will stay at a double-digit level of 11.5 percent of GDP in 2021, and come down in 2022. The government debt is projected to increase to above 30 percent of GDP but remain at a sustainable level.

The current account deficit is expected to be little changed in 2021 at 2.5 percent of GDP in large part due to the external conditions. Our current forecast reflects a significant upward revision than the much deeper deficit projected in the initial wave of COVID-19, when oil prices collapsed. The flexible exchange rate and its depreciation in March-April of 2020 likely facilitated adjustment to external shocks and alleviated the pressure on the current account. Gradual recovery in investment, mainly in mining, will boost demand for imports, and exports are likely to pick-up along with improvement in external demand. The authority's decision to deposit part of the FX earnings of major exporting SOEs in the domestic banking sector would also support the current account.

Risks to the outlook in the short run are skewed to the downside and, to a greater extent, linked to the course of the pandemic. There are at least three conditions that could cause economic growth to be above or below our baseline projection. First, the pandemic is not yet under control, and the country has reinstated regional lockdowns and restrictions in response to a second wave outbreaks, which can prolong hardship faced by households and businesses. The longer the pandemic lasts in 2021, the greater its adverse impact on activity and employment would be. In the short run, this could potentially squeeze incomes and adversely affect the livelihood of a large portion of low-skilled service sector workers.

Second, weak demand for Kazakhstan's exports and depressed oil prices can delay recovery in growth. Despite the renewed commitment by OPEC+ to cut production, a high level of crude inventories and sluggish global economic recovery can continue to depress price well into 2021, at about 30 percent below the 2019 average price. Sluggish activity in extractive industries can ripple through other parts of the economy affecting employment and incomes.

Third, the government's support to businesses through concessional loans, bankruptcy moratorium, and other reliefs can benefit firms, which were unviable and non-productive even before the crisis. A correction to the less stringent rules to channel and classify loans to SMEs could increase the size of true NPLs, and can potentially undermine the balance-sheet of the banking sector and limit credit growth.

VII. Policy Watch

Amidst the pandemic and economic crisis, President Tokayev initiated important initiatives to renew the reform momentum. The establishment of the Agency of Strategic Planning and Reform and the Agency for Protection of Competition are important developments. A strong implementation to achieve tangible results can further public support for reforms.

The COVID-19 crisis renewed a sense of urgency for institutional and policy reforms. The crisis uncovered bottlenecks in infrastructure, which affected the delivery of services such as education and health. To address these short-term issues, the government took swift actions such as rolling out remote learning programs, improving ICT connectivity, and setting up emergency health facilities across the country. However, the crisis added new development challenges for Kazakhstan while the authorities were focused on managing the immediate effect of the COVID-19 pandemic. The President, in his speech in September, unveiled cross-sector initiatives to reform institutions and policies to confront "the new reality" and announced a national plan with actions for implementation in 2020 and 2021. To further accelerate the implementation of the needed reforms outlined above, strengthening public sector performance will be crucial to accelerate a fast-response to COVID 19, recovery in the medium term, and resilience in the long term. Thus, the COVID 19 crisis further emphasizes the need for strategic planning to prioritize government action, making strategic choices in light of the reduced fiscal space and social needs.

As shown by a World Bank's study on Kazakhstan,[9] a core of such reforms should be an integrated set of public sector performance reforms across the public-policy cycle aligned with planning, budgeting over management, and monitoring functions of service delivery. Strategic planning has its greatest impact when it is designed not just as a separate, stand-alone, aspirational function, but as an integrated function aligned with budget and public investment management, performance management, and performance monitoring and evaluation. As Kazakhstan moves toward a new public sector performance model, starting with planning, it can build on domestic progress made, such as in the design of its national Strategic Plan 2025. It can also consider lessons learned by good practice countries in their design and implementation of innovative and agile planning reforms. This calls for an ambitious, transformational set of cutting-edge reforms to achieve its objectives, deliver better services to citizens and the private sector, and move towards its long-term goal of achieving high-income status.

In September 2020, President Tokayev announced a new stage of public sector reforms, including a new agency to foster policy coordination. In his speech, he noted that despite the necessity to tackle the COVID-19, it should not obscure long-term goals, stressing the need for changes

[9] Kazakhstan Joint Economic Research Program FY2019. Support to the Implementation of Strategic Development Plan 2025.

in approaches to public administration, performance management, decision-making system, and responsibility for their implementation. The Agency of Strategic Planning and Reforms (ASPR), under the President of the Republic of Kazakhstan, was established in 2020 to implement the proposed reforms. It has a broad mandate, including policy-coordination, strategic planning, reform design, and facilitating performance M&E to track the delivery of government programs. The Agency's priority is to reform the strategic planning system in Kazakhstan to make it more agile, results-focused and reorient it towards implementing a few prioritized "national projects" that deliver tangible results, as opposed to the previous system of very numerous state programs. Greater policy-coordination will be much needed to address short- and medium-term measures to allow a fast crisis response, while making them fiscally, economically, and socially sustainable in the medium term.

The establishment of the Agency for Protection of Competition is an important step to promote a level playing field for Kazakhstan's private sector. In September, the President issued a decree establishing the Agency for Protection of Competition, an independent agency that will address the growing concerns of the negative impact of non-competitive behavior by state or non-state economic actors on the economy. The new Agency is expected to take an active role in improving competitive conduct in the markets, a function previously performed by the Ministry of National Economy. This initiative signals a renewed commitment by the President to improve the functioning of markets, many of which are dominated by handful of SOEs and business groups.

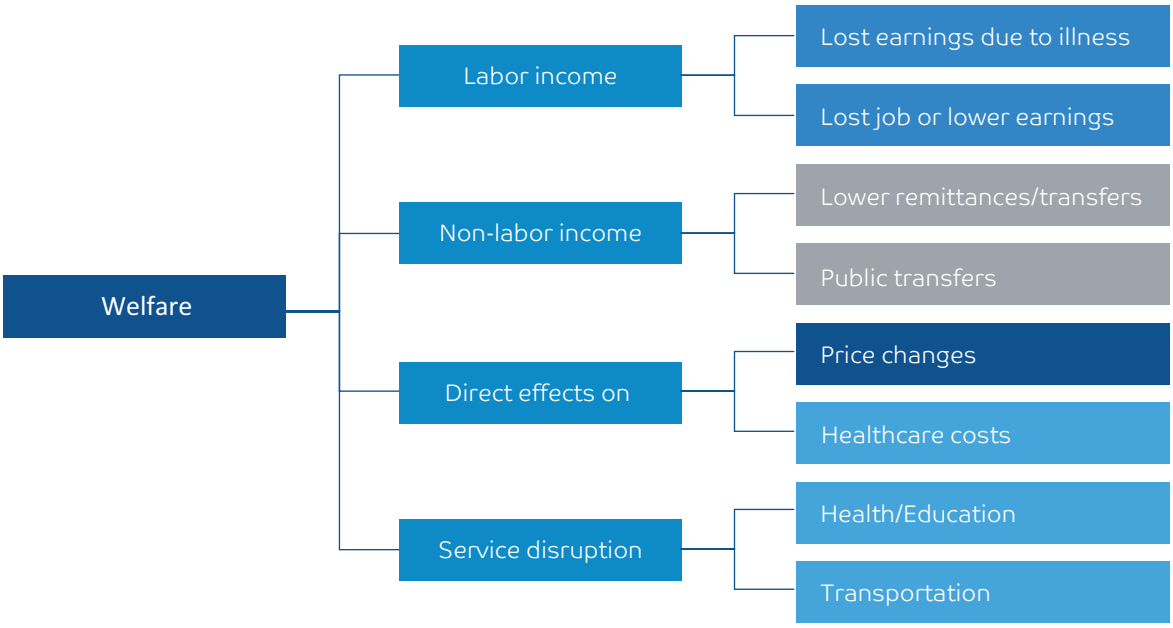
VIII. COVID-19 Pandemic and Poverty in Kazakhstan

The pandemic is likely to increase the number of poor people, which would offset the recent success in reducing the poverty rate. The impact of COVID-19 is likely to be larger for communities in Kazakhstan's rural areas, where job opportunities and access to services are limited. Strengthening poverty monitoring and continuously improving the delivery of social services can minimize the crisis's impact on human suffering.

For the second time in this decade, poverty in Kazakhstan is likely to rise again in 2020 and reverse the impressive progress in poverty reduction over the past two decades. The economic downturn in 2015 caused the poverty rate, defined as the share of the population living on less than $5.5 per day at the original 2011 Purchasing Power Parity (PPP), to increase significantly. This reversal highlights the risks of an economy highly dependent on the oil sector, and the extent to which it affects the most vulnerable households. The COVID-19 crisis in 2020 once again underlines such vulnerability. Based on World Bank staff estimates, the poverty rate could increase up to 14 percent this year, equivalent to 1.5 million additional poor people in Kazakhstan.

Aggregate shocks from the COVID-19 pandemic to economic activity can affect Kazakhstan households' welfare through multiple channels (Figure 13). First, affect-

Figure 13: Potential transmission channels of the pandemic on households' welfare.

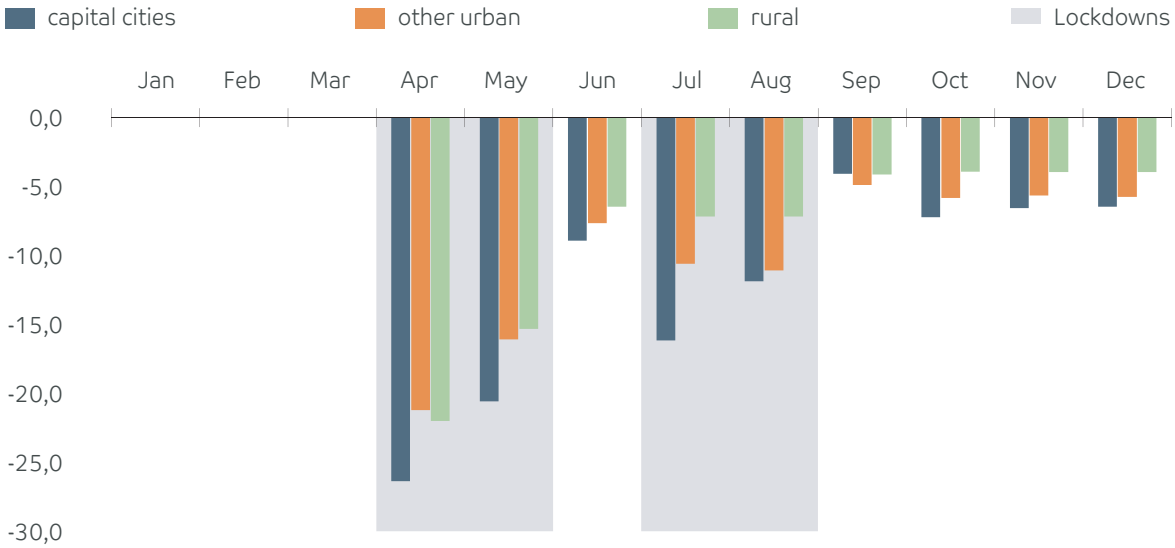


ed households are likely to suffer a loss of labor income due to contraction in employment or illness directly related to COVID-19. Second, households are expected to experience changes in non-labor income through a reduction in remittances or an increase in social payments from the government's assistance programs, or both. Third, rising prices, particularly food prices, can reduce the households' purchasing power so that they cannot sustain their pre-crisis living standards. Last but not least, adverse impacts on households' quality of life can come from the disruption of basic services such as school closure, overwhelmed hospitals, and disruption in transportation and delivery. Based on the currently available data, our estimation of the implication of COVID-19 for poverty in Kazakhstan takes into account two major channels: (i) loss of labor income from contraction in employment and (ii) loss of purchasing power from rising inflation.

With labor income accounting for about 70 percent of household income, loss of even temporary employment can have severe impacts on Kazakhstan's people. During the first national lockdown to curb the spread of COVID-19 in April and May this year, household incomes dropped by 15 to 25 percent, reflecting the severity of the restriction measures on employment. However, the magnitude of income loss was nearly halved during the second lockdown, partially because of less strict implementation. As the measures eased over time, economic activities resumed and further alleviated some of the income losses (Figure 14).

Nevertheless, it is important to note that the impacts are heterogeneous across locations. Throughout the year 2020, residents in Nur Sultan and Almaty suffered the most because the most affected sectors – services sectors including hospitality,

Figure 14: Estimation of household monthly income losses linked to a contraction in employment, % income loss



Source: World Bank staff calculations based on Kazakhstan Household Budget Survey 2018.

trade, and transport – are concentrated there. For an average household living in either of these cities, more than a quarter of their April monthly income was wiped out because of loss of employment directly linked to COVID-19.

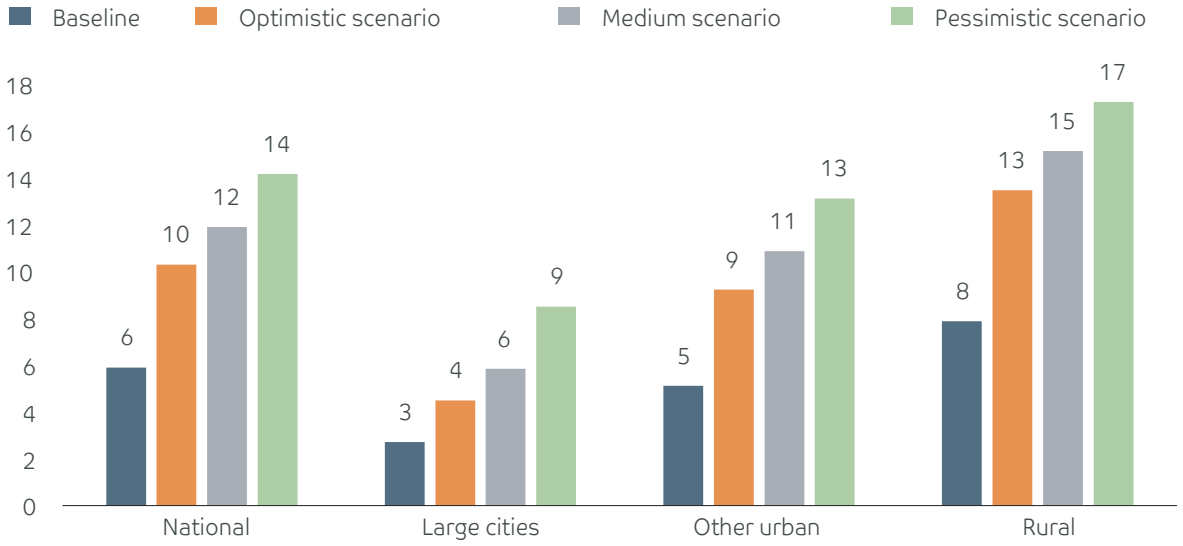
The compounded effects of loss of labor income and higher food and non-food prices were devastating for the poor. Under an optimistic scenario where households can cushion some of the losses through savings and borrowings as they did in the pre-crisis period, the poverty rate could increase to 10 percent in 2020 (Figure 15). However, this annual average poverty rate can mask a large variation across months. During the months of the first lockdown, where the heaviest toll on employment took place, about 17 percent of Kazakhstan lived below the poverty line. However, the optimistic scenario does not take into account the prolonged nature of the pandemic and the low levels of savings among the poor. As the pandemic extends, savings and borrowings cannot continue without limits. Moreover, the poor have very limited access to financial services to endure continuing hardship. Thus, if we assume that households are unable to mitigate the shocks (a pessimistic scenario), the overall poverty in 2020 is estimated to reach 14 percent of the population, or about 2.6 million people.

Moreover, as observed in the past, exogenous shocks such as the global financial crisis and the plunge in oil prices further amplify Kazakhstan's urban-rural divide. The pandemic this time is no exception. Increasing evidence around the world[10] suggests that COVID-19 has a postcode. In other words, economically disadvantaged locations such as rural areas in Kazakhstan are more likely to bear the pandemic's brunt. While it is true that households in Nur Sultan and Almaty endured the biggest cut in income from the COVID-19 pandemic, most of them were well above the poverty line. In fact, the pre-crisis poverty rate in large cities in Kazakhstan was only 3 percent, and the economic fallout from the pandemic could triple poverty in large cities to up to 9 percent (Figure 15).

However, even with such a high increase, the number of poor people living in big cities accounts for less than 10 percent of the total poor population. The biggest share of the additional poor due to COVID-19 still comes from rural areas. In 2020, there could be as many as 0.7 million more poor people in rural Kazakhstan – half of the total additional poor in the nation (Figure 16). The remaining poor reside in other urban towns. This number still does not portray a full story of the acute and prolonged impacts of the pandemic on poor rural households. Without the right support, rural residents may take much longer to recover to their pre-crisis levels of living standards because of the deep-rooted characteristics of rural areas: higher risks of unemployment, slower economic recovery, and poorer basic service delivery.

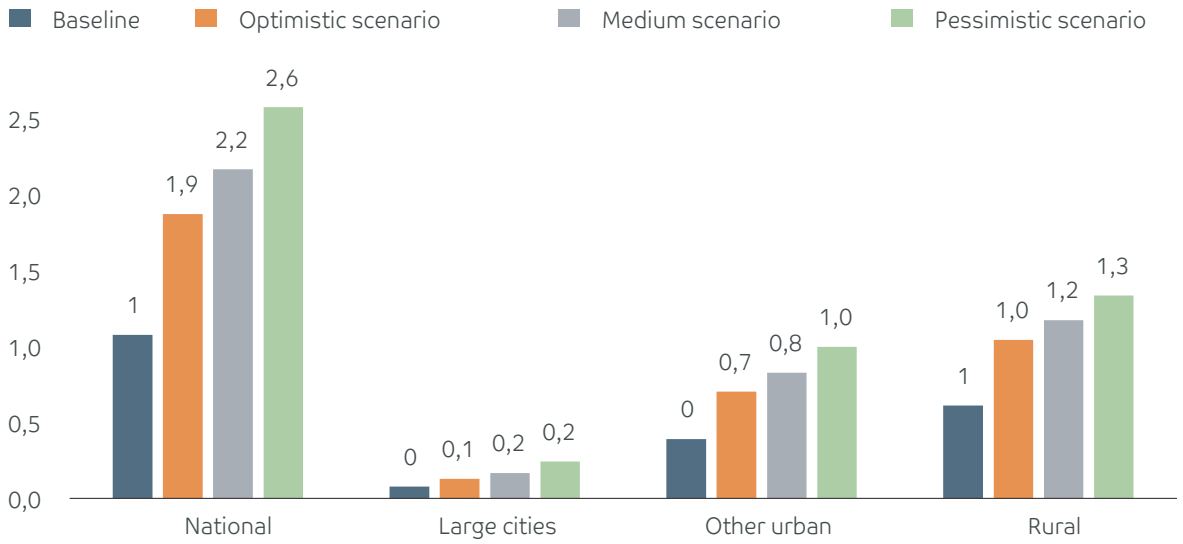
[10] For the U.S., see Chatty et al. (2020). "The Economic Impacts of COVID-19: Evidence from a New Public Database Built from Private Sector Data". For the UK, see Bhattacharjee et al. (2020) "Introduction: The Prospects for Regional Disparities in the UK in Times of Brexit and COVID-19". For Latin America, see World Bank (2020). "COVID-19 in Latin America: A pandemic meets extreme inequality". For South Africa, see Davis et al (2020). "Spatial Inequality through the Prism of a Pandemic: COVID-19 in South Africa." For the world, see United Nations (2020). "Policy brief: COVID-19 in an urban world."

Figure 15: Poverty estimates in 2020



Source: World Bank staff calculations based on Kazakhstan Household Budget Survey 2018.

Figure 16: Number of poor people (million) in 2020



Source: World Bank staff calculations based on Kazakhstan Household Budget Survey 2018.

The magnitude and the extent to which the pandemic continues to affect Kazakhstan people in the months to come is far from certain, underlying the importance of continuous crisis-monitoring measures in the short run, and strong policy reforms in the long run. In the short-term, Kazakhstan's Government has responded quickly to mitigate the crisis's immediate impact by implementing a sizeable social payment program to compensate income losses for unemployed workers in SMEs and self-employed sectors.

However, fiscal spending has its limit. To formulate the most appropriate and cost-effective response actions in the coming months, now is a critical time to closely and frequently monitor how the crisis evolves, which population segments are the most at risk, and where the aftermaths of the crises are the most severe. In the long-run, responsive and well-designed social assistance are necessary but still not sufficient to help Kazakhstan people to fully return to pre-COVID19 levels of prosperity.

More actions are needed to catalyze support to the labor market, deliver high-quality basic services, and equip people with adequate productive assets and skills to generate inclusive growth. In this direction, Kazakhstan's Government has proposed an ambitious reform program to protect the most vulnerable, including the development of the social code, state benefits for children and people with disabilities. Moreover, other reforms to stimulate the labor market are also under discussion, such as the revision of the minimum wage and unemployment benefits, development of flexible forms of employment and labor protection, and improvement of skills and qualifications. With the right design and implementation, these reforms have high potential to mitigate the adverse impacts of the pandemic and accelerate the recovery process.

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